Economics & Strategy

Understanding Vietnam: The rising star

Group Research 28 May 2019

Irvin Seah
Senior Economist

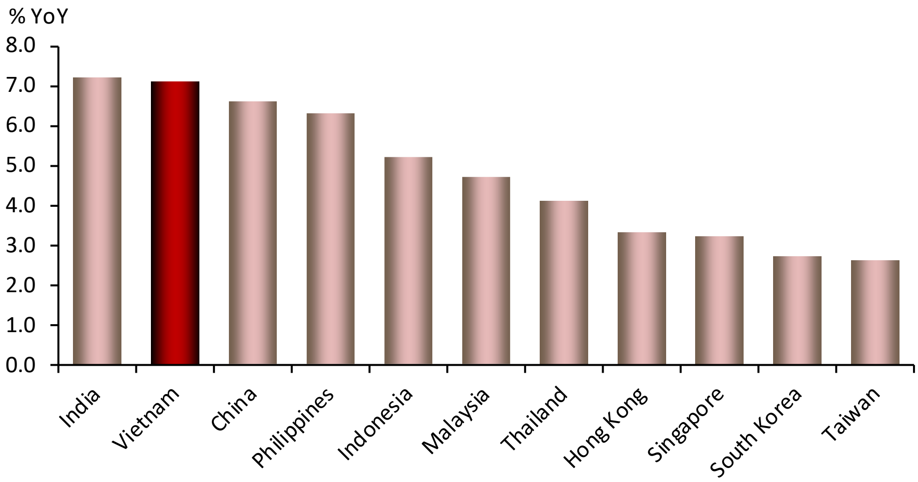
Please direct distribution queries to
Violet Lee +65 68785281
violetleeyh@dbs.com

- *Vietnam is coming of age.*
- *Attracted by its favourable demographic dynamic, productive labour force, much-improved infrastructure, and stable politics, global investors have been lining up to be a part of the Vietnam narrative.*
- *The ongoing trade war between China and the US has cast a spotlight on Vietnam's potential*
- *Vietnam's geographical position in the regional supply chain and its extensive network of FTAs are crucial advantages*
- *Strong FDI from China and Hong Kong in the first four months of this year may well mark the beginning of a new trend*
- *Considering the domestic fundamentals, we estimated that Vietnam has the potential to grow by about 6-6.5% in the medium term*
- *If it can sustain that pace of growth, **the Vietnam economy will be bigger than the size of the Singapore economy in ten years' time***

Emerging Vietnam

Vietnam recorded a remarkable GDP growth of 7.1% in 2018. This makes it the second fastest amongst Asian economies (7.2%) (Chart 1). However, it hasn't been all smooth sailing for this emerging Asian economy in recent years.

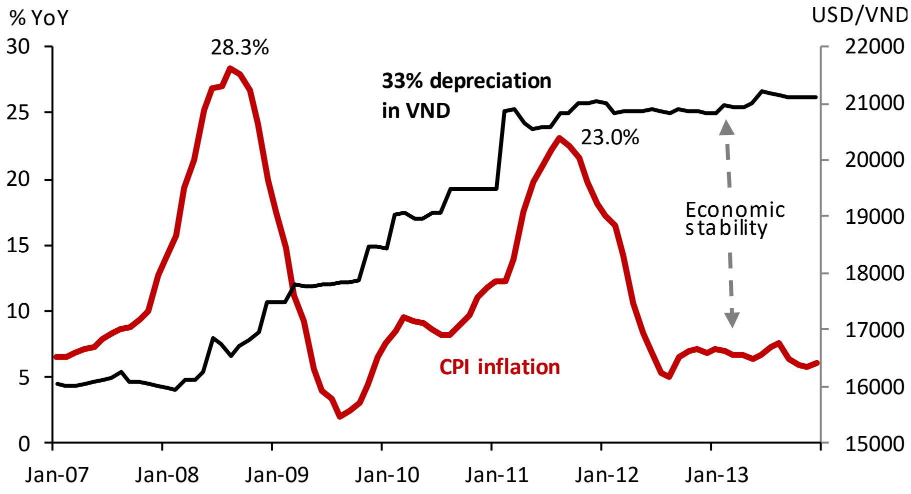
Chart 1: Second fastest in Asia, 2018



Source: CEIC, DBS

Just about a decade ago, Vietnam was struggling with exceptionally high inflation (up to 28%), weak growth, drastic devaluation of the VND, and risk of a balance of payment crisis (Chart 2). Rapid liberalization post WTO accession, the inability to manage domestic imbalances, as well as an over-reliance on the US export market amid the global financial crisis were some of the key reasons for the economic turmoil during that time. Economic stability only started to take hold from mid-2012 onwards, and that came only after some extreme monetary tightening measures were deployed [1].

Chart 2: A roller coaster ride for Vietnam in recent past



Source: CEIC, DBS

Economic sustainability is key

The experience from the economic tumult sowed the seed for Vietnam's economic transformation. Resolution 11 was passed in early 2012 to focus on economic stability while the Socio-Economic Development Plan (SEDP, 2011-2015) that focused on reforms in the state-owned enterprises (SOEs), the financial sector and public investment, was adopted in the National Assembly in November the same year.

Since then, the economic performance has been encouraging. Growth has averaged 6.4% in the past three years while inflation has been stable, at about 3.2% in the same period. What is perhaps most interesting is that beyond the headline figures, Vietnam is beginning to outperform many regional peers in several other aspects.

More importantly, **policymakers are now focusing on longer term economic stability and sustainability**, rather than the pace of growth per se. Domestic reform, albeit tepid, has been ongoing. The long-term prospects of this economy are positive, and in terms of the size of the economy (i.e., real GDP), Vietnam is expected to join the ranks of some of the relatively more developed economies in the region in the coming decade.

Investing into the future

One key policy focus is to build the capacity for longer term growth. This entails a deliberate effort to encourage investment and improve infrastructure. Vietnam is one of the top recipients of FDI in the region. It received about USD 14.1bn worth of FDI in 2017 (6.3% of nominal GDP), the third highest in ASEAN (Table 1). Key advantages offered by Vietnam would include its highly integrated and dedicated industrial / economic zones, its strategic location in the middle of regional supply chain, close proximity to China, attractive tax concessions and low corporate tax rate [2], and a competitive workforce.

Table 1: FDI flows into ASEAN, 2017

Host Country	USD bn	% share
Singapore	62.0	45.7
Indonesia	23.1	17.0
Vietnam	**14.1**	**10.4**
Philippines	10.1	7.4
Malaysia	9.4	7.0
Thailand	8.0	5.9
Myanmar	4.0	3.0
Cambodia	2.7	2.0
Laos	1.7	1.3
Brunei	0.5	0.3
ASEAN	**135.6**	**100.0**

Table 2: Sources of FDI for Vietnam

FDI sources	Registered capital, 2018 (USDbn)	% share
Japan	6.6	18.6
South Korea	3.7	10.3
Singapore	1.4	4.0
China	1.2	3.4
Hong Kong	1.1	3.2
Thailand	0.9	2.5
France	0.5	1.5
Taiwan	0.5	1.4
Total	**35.5**	**100.0**

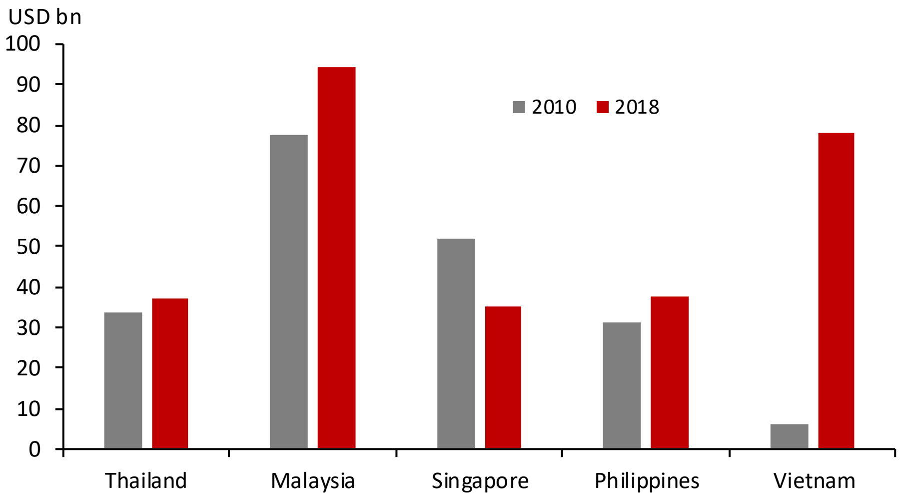
Source: ASEAN Investment Report 2018

An emerging electronics powerhouse

Key foreign investors in Vietnam are Japan (18.6%), Korea (10.3%), Singapore (4.0%), China (3.4%) and Hong Kong (3.2%) (Table 2). The scope of investment is also very diverse, from real estate, infrastructure, banking, telecommunication, and of course, manufacturing. Among the sectors, manufacturing is the main draw for investors, particularly in electronics.

The rise of Vietnam's electronics cluster is due in part to the structural shift in regional electronics supply chain [3]. Vietnam has captured market share from many of its regional peers. In a process seen over and over in Asia, earlier players saw incomes and wages rise, opening the door for lower cost producers. Vietnam is the latest new kid on the block.

Chart 3: Electronics exports by key ASEAN countries

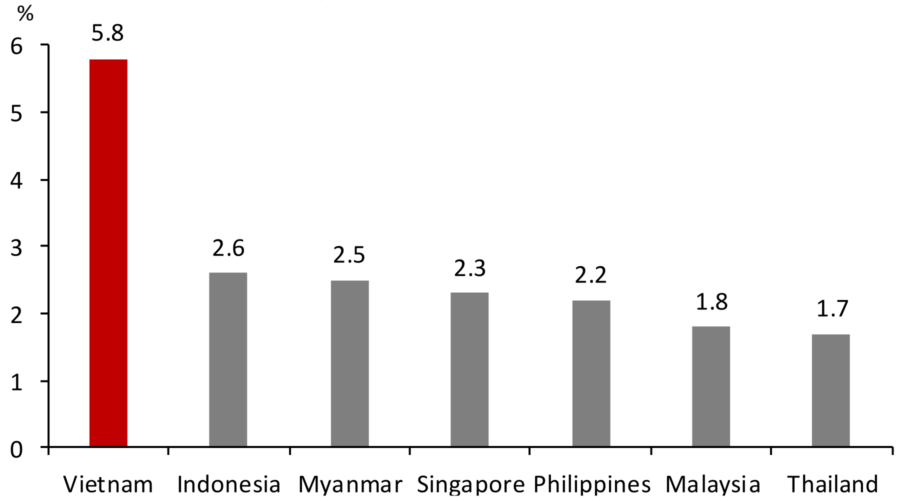


Source: CEIC, DBS

Investment into electronics is growing rapidly, and high-tech electronics players have established presence in Vietnam in recent years. Samsung, Intel, LG, Panasonic and Microsoft are among the global tech giants that have expanded in the country, marking a shift away from China. This trend is likely to persist, and the effect thus far has been apparent.

In less than a decade, **Vietnam has leapfrogged ahead of some of the more established electronics manufacturing hubs to become the second largest electronics exporter within ASEAN**, just marginally behind Malaysia (Chart 3). Indeed, at the current pace of growth, it will not come as a surprise if Vietnam becomes the top electronics manufacturer in ASEAN in the coming years.

Chart 4: Vietnam has the highest infrastructure spending as % of GDP in ASEAN



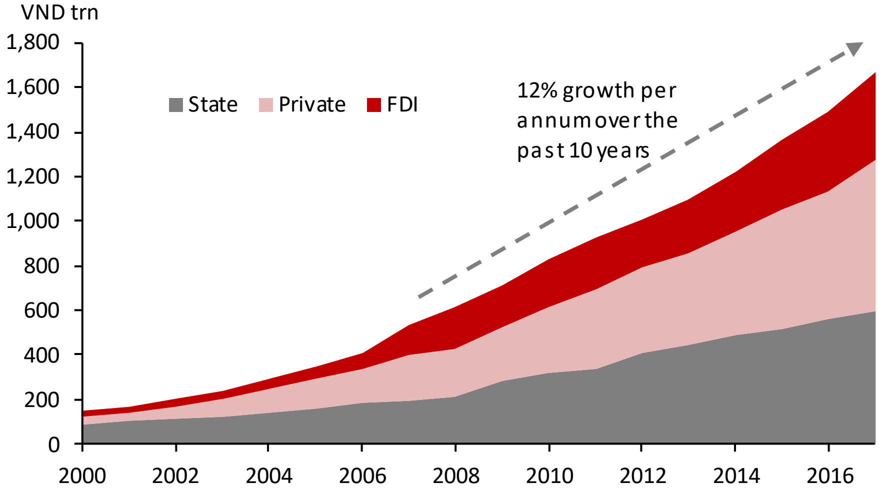
Source: Asian Development Bank, ADB

Strong private investment growth

To support the strong inflows of FDI, **Vietnam is investing heavily into infrastructure**. While many regional peers are also doing the same, Vietnam is doing that in a much bigger way, relative to the size of the economy. As a share of GDP, Vietnam's infrastructure investment dwarfs many of the regional peers. According to ADB, Vietnam's infrastructure spending as a percentage of GDP was 5.8% in 2017, significantly more than many of its ASEAN neighbours (Chart 4). The investment is focused on areas such as economic zones, industrial parks and clusters, hi-tech parks and agri-tech zones. The impetus in infrastructure development thus provides Vietnam the capacity to support longer term expansion of its economy, as well as to continue to attract more FDI flows.

The efforts to spur investment growth has paid off. Investment grew by an average of 12% per annum over the past decade (Chart 5). Perhaps what is most encouraging is that such growth is largely private sector led. As early as 2000, state investment accounted for about 60% of total investment. This has changed since 2004 when private sector started to take over. As of 2017, state driven investment was down to 35.7%, whereas domestic private sector (40.6%) and FDI (23.7%) became the main drivers of investment in Vietnam. We expect this trend to persist in the coming years, as domestic liberalization (e.g., SOE reform) and globalization continue to push the economy towards more market-led development.

Chart 5: Strong private sector led investment growth



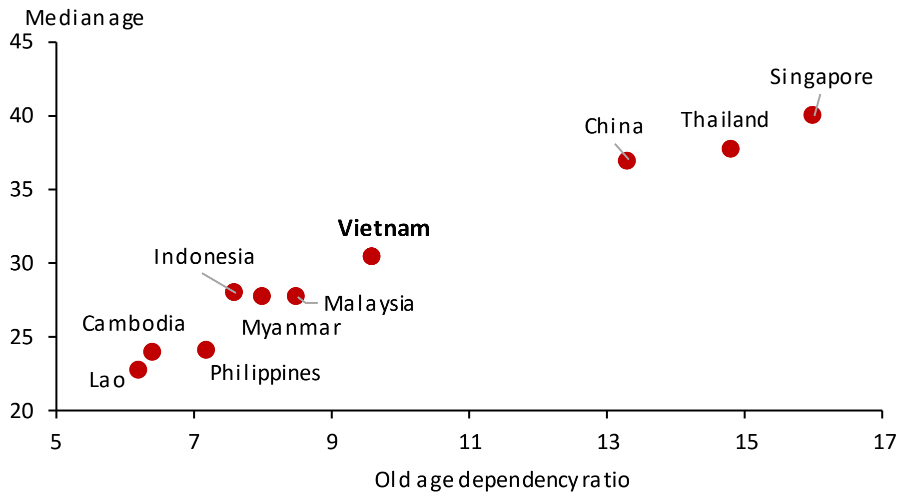
Source: CEIC, DBS

Focusing on human capital

Vietnam has a relatively conducive demographic profile as well. While its population is slightly more matured compared to some of the regional peers, mainly due to the post war baby boomers reaching middle-age, it remains favorable relative to some of the more developed economies in the region such as Singapore, Thailand and China. Median age is about 30 years old while old age dependency ratio stands at 9.6 (ratio of person aged 65+ per 100 persons aged 15-64) in 2015 (Chart 6).

Quality of human capital is just as important

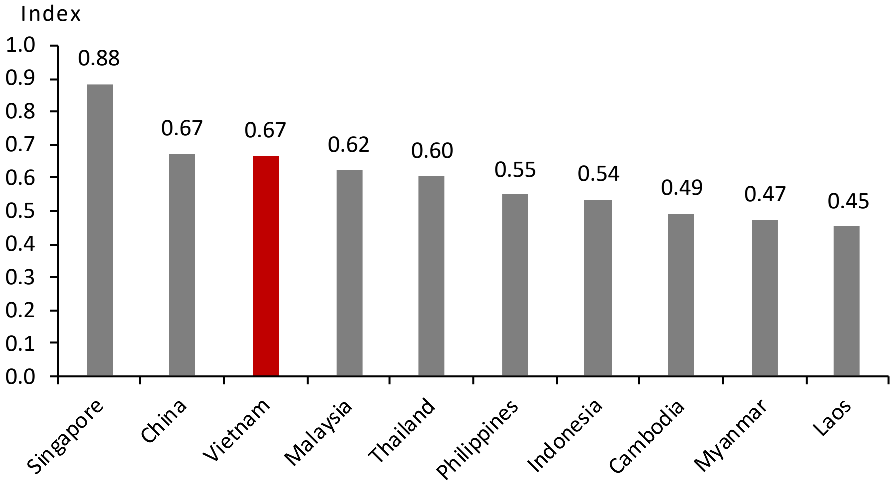
Chart 6: Demographic profile among selected Asia economies



Source: United Nation

The quality of human capital is just as important in determining the longer-term growth prospects of an economy. In this regard, Vietnam has outperformed many of her ASEAN neighbours. The World Bank Human Capital Index ranks Vietnam second in ASEAN and comparable to China (Chart 7) [4]. Besides having a hardworking labour force, the favorable ranking is likely a result of continued investment into education. For the past two decades, the government has consistently allocated about 20% of its total expenditure to education, which is relatively high by global standards.

Chart 7: Vietnam outperforms in Human Capital Index

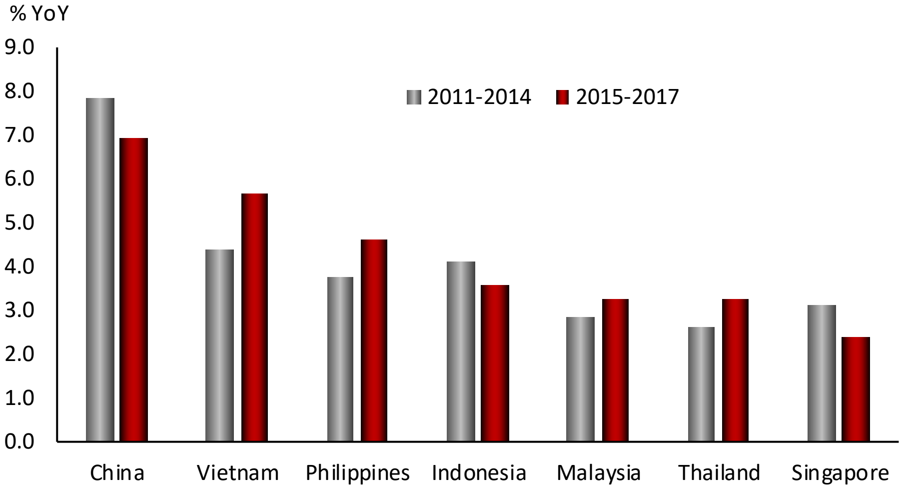


World Bank Human Capital Index

Vietnam has high productivity to wage ratio

That has paid off in terms of productivity of the workforce. Strong FDI flows into technology in recent years have augmented domestic factors, resulting in higher labour productivity growth. Vietnam's productivity growth has not only improved in recent years (averaging 5.7% between 2015-17) but is also outpacing many of the regional economies, and second only to China (Chart 8). Indeed, ensuring productivity gains is crucial in sustaining long term economic growth, especially when Vietnam's population will continue to age.

Chart 8: Vietnam outperforms in productivity growth amongst Asia economies

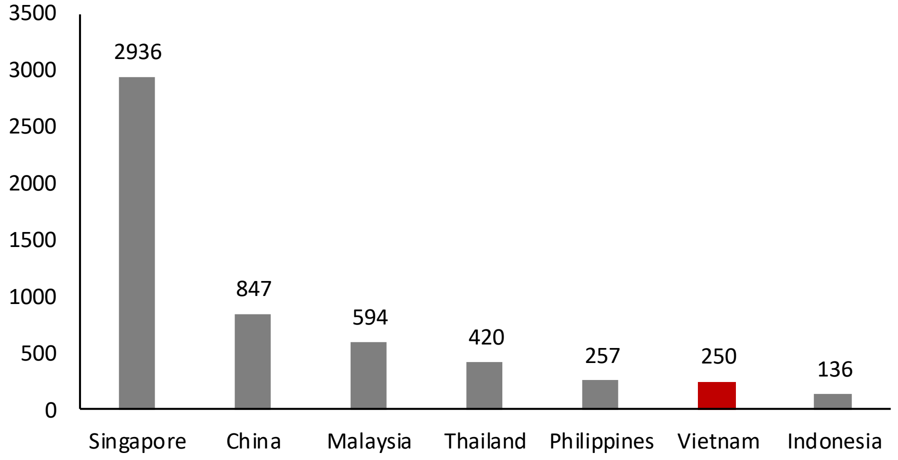


Source: World Bank. DBS estimates

Yet, despite the high productivity growth, **Vietnam has one of the most competitive wage costs in the region** (Chart 9). Average monthly wages in Vietnam is just about one-third of that in China. Such cost competitiveness is one of the key reasons why Vietnam is steadily capturing more of the regional electronics supply chain and will likely be one of the main beneficiaries of the ongoing trade disputes between the US and China.

Chart 9: Vietnam has one of the lowest average monthly wages in the region

USD per month



Source: World Bank, DBS estimates

Beneficiary of the trade war

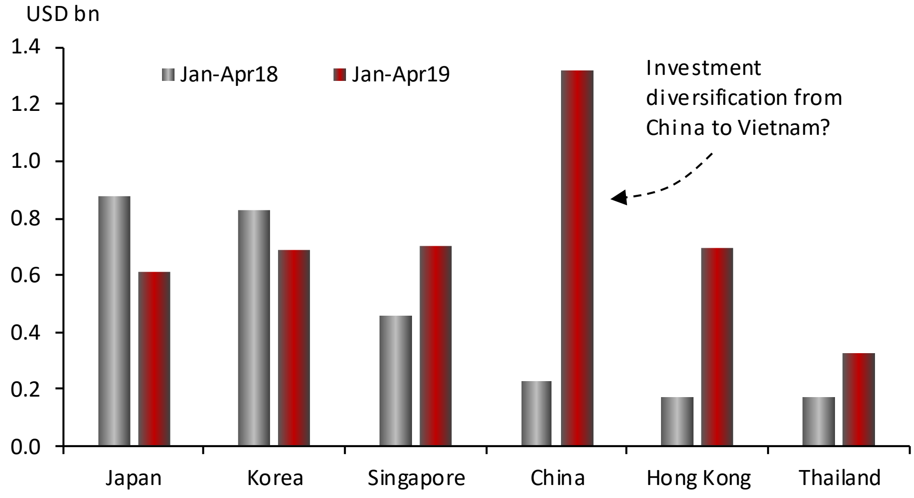
Vietnam will be a key beneficiary of the trade war

Vietnam is in a favorable position to benefit from the ongoing trade disputes between the US and China [5]. The economy is strategically plugged into the regional manufacturing supply chain. Strong FDI flows and technological transfers over the years have helped to establish Vietnam's manufacturing capability. In terms of connectivity, it has about 44 sea ports with a total capacity of about 500mn tonnes/annum, and has direct access to the South China Sea, an important sea route whereby about 20% of the world's maritime trade will flow through. Vietnam also has an extensive network of free trade agreements (FTA). It is an active member of several multilateral trade agreements (e.g., AFTA, AEC, CP-TPP, RCEP, ASEAN-China, ASEAN-Japan), and it has also secured several high-quality bilateral trade agreements with some of its key trading partners including Japan and Korea.

Moreover, after years of rapid growth, wages in China are now more than 3 times higher than in Vietnam. This has led to margin compression, forcing manufacturers to relocate their production bases. Beyond the cost advantage, geography plays a role. Vietnam's proximity to China makes it easier for companies that are currently based in China to integrate into existing supply chains. A growing middle class supporting domestic demand has further strengthened Vietnam's overall attractiveness for global manufacturers, particularly against the backdrop of the ongoing trade disputes between the US and China.

Indeed, **a very recent phenomenon is that FDI flows from China has been significantly stronger than usual**. In the first four months of this year, FDI from China registered USD 1.3bn (Chart 10). This has outstripped investment from all the other major investors year-to-date, as well as the same period last year. In fact, it is by no coincidence that China's total direct investment into Vietnam from January to April this year alone has already surpassed her total investment in Vietnam for the whole of last year. We reckon that **this could be an early sign of investment diversification out of China and into regional markets such as Vietnam**. Indeed, one can reasonably

Chart 10: FDI from China outstripped others in Jan-Apr19



Source: CEIC, DBS

assume that such phenomenon could accelerate in the coming quarters if the bilateral and trade relationship between the US and China continues to worsen.

Vietnam's GDP could be bigger than Singapore's by 2029

Considering the domestic fundamentals and the dynamics in the external environment, we attempt to project the medium-term potential growth of the economy. Judging from the potentially strong investment flows, we reckon that productivity growth in Vietnam could average about 5.5% in the coming years. Juxtaposed with a working age population growth rate of about 1% in the near term and gradually tapering off to 0.5% against the backdrop of the gradual aging of the post-war baby boomers, we reckon that **Vietnam has the potential to achieve a growth pace of about 6.0-6.5% over the next ten years**.

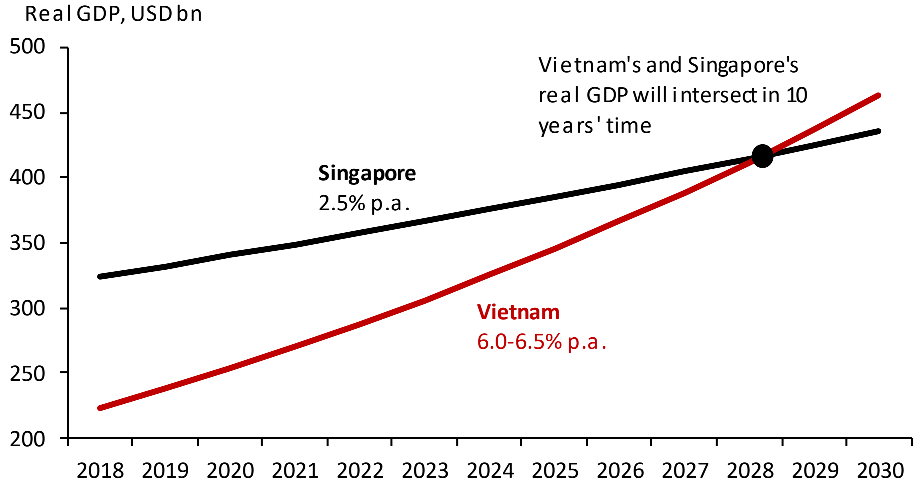
Bigger than the Singapore economy by 2029

To put things in a different perspective, it will be interesting to compare Vietnam's growth with some of the regional peers. If Vietnam is able to sustain a growth pace of about 6-6.5% in the near term, and that economies in the region continue to grow at their medium term potential growth rate (e.g., Singapore at 2.5%, Thailand at 4%, Indonesia at 5% etc), the pecking order in the region in terms of the size of the economy (real GDP) will change [6].

At present, the size of the Vietnam economy is about USD 224bn, or about 69% of the Singapore economy (USD 324bn), which is also the third largest in the region behind Indonesia and Thailand. If Vietnam is able to maintain the growth pace of about 6-6.5% in the coming years, and that Singapore continues to grow at a matured pace of about 2.5%, then the real GDP of these two economies will intersect by 2029.

Simply put, **the Vietnam economy will be bigger than the size of the Singapore economy in ten years' time**. And this implies tremendous growth opportunities for companies and investors looking to get a slice of the action.

Chart 11: Vietnam economy will be bigger than Singapore's by 2029



Source: CEIC and DBS estimates

A rising star in the region

Granted it will not exactly be "picture perfect" for Vietnam as a slew of domestic issues need to be resolved. For example, SOE reform has been tepid while financial sector liberalisation has been slower than expected, often dampened by concerns regarding non-performing loans (NPLs). Ambiguous domestic regulations and poor corporate governance are some of the pain-points confronting foreign investors. Yet, these are some of the common challenges associated with any emerging economies, and Vietnam is no exception.

What is certain is that Vietnam's policy direction is heading the right way, and underlying fundamentals within the economy are conducive. **Amid the uncertainties in the global economy, companies and investors would have to start focusing more on this "rising star" to leverage on its growth prospects.** Indeed, long term prospects of the economy, relative to the region, are exceptionally positive.

Notes:

[1] The State Bank of Vietnam hiked the refinance rates by 850bps in the first six months of 2008, and again raised the policy rate by 700bps in twelve months between late 2010-2011 to arrest the two episodes of runaway inflation.

[2] Vietnam's corporate income tax (CIT) rate is expected to be lowered to 20% by mid-2019, which is considerably lower than many regional peers including China (25%). In fact, CIT rate in special economic zones can be even lower (e.g., 5-10%)

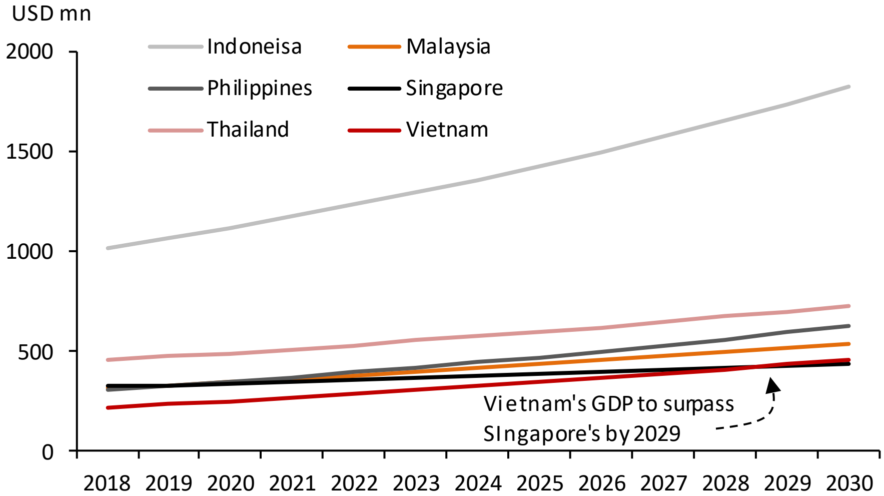
[3] See DBS report "Vietnam: Asia's latest electronics spark" dated 1 Jul15.

[4] The Human Capital Index (HCI) database provides data at the country level for each of the components of the Human Capital Index as well as for the overall index, disaggregated by gender. The index measures the amount of human capital that a child born today can expect to attain by age 18, given the risks of poor health and poor education that prevail in the country where she lives. It is designed to highlight how improvements in current health and education outcomes shape the productivity of the next generation of workers, assuming that children born today experience over the next 18 years the educational opportunities and health risks that children in this age range currently face.

[5] Japanese office equipment maker Ricoh Co. and Taiwan's Kenda Rubber said recently that they are moving some production from China to Thailand and Vietnam respectively to avoid trade war risks. Big consumer brands Samsonite International SA, Macy's Inc and Fossil Group Inc have all said that they are continuing to move production and sourcing out of China.

[6] We project the real GDP of the key ASEAN economies based on their potential growth rate up till 2030. From that, there will be some changes in the ranking of the size of the economy (real GDP) within the region over the next ten years. Specially, Vietnam will overtake Singapore in this regard by 2029.

Real GDP projection of ASEAN economies



Source: CEIC and DBS estimates

Group Research

Economics & Strategy

Taimur Baig, Ph.D.
Chief Economist - G3 & Asia
+65 6878-9548 taimurbaig@dbs.com

Nathan Chow
Strategist - China & Hong Kong
+852 3668-5693 nathanchow@dbs.com

Masyita Crystallin
Economist – Indonesia & Philippines
masyita@dbs.com

Joanne Goh
Regional equity strategist
+65 6878-5233 joannegohsc@dbs.com

Eugene Leow
Rates Strategist - G3 & Asia
+65 6878-2842 eugeneleow@dbs.com

Chris Leung
Economist - China & Hong Kong
+852 3668-5694 chrisleung@dbs.com

Ma Tieying
Economist - Japan, South Korea, & Taiwan
+65 6878-2408 matieying@dbs.com

Radhika Rao
Economist – Eurozone, India, & Thailand
+65 6878-5282 radhikarao@dbs.com

Irvin Seah
Economist - Singapore, Malaysia, & Vietnam
+65 6878-6727 irvinseah@dbs.com

Samuel Tse
Economist - China & Hong Kong
+852 3668-5694 samueltse@dbs.com

Duncan Tan
FX and Rates Strategist - Asean
+65 6878-2140 duncantan@dbs.com

Philip Wee
FX Strategist - G3 & Asia
+65 6878-4033 philipwee@dbs.com

Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).