Macro
ASEAN Economics

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Vietnam at a glance

Open for business: trade and investment

- **Manufacturing is Vietnam's rock star: helping exports rise by 18% y-o-y in June**
- **On 29 June, President Obama signed the TPA, and Vietnam stated it will remove foreign ownership cap, with exceptions**
- **While the TPP will boost growth, the benefits from the investment law are limited as key sectors are still protected**

With all the turbulence in the world, Vietnam stands out with the more upbeat news flow and economic data. Exports accelerated in June by 18% y-o-y, defying gravity, and taking the year-to-date growth close to 10%. The PMI is equally positive, expanding sharply in Q2. While the June number decelerated to 52.2 from 54.8, the leading indicator – new orders minus inventories - rose sharply, suggesting output will rise in the months ahead. Credit growth, too, picked up by 17% y-o-y, thanks to improving demand.

On 29 June, President Obama signed the Trade Promotion Authority (TPA), suggesting that the Trans-Pacific Partnership (TPP) negotiation may conclude in the months ahead. This is particularly positive for Vietnam, which still does not have a free trade agreement with its largest export market – the United States. The TPP also has investment and service clauses, which may force Vietnam to liberalize its protected sectors. At the same time, the Vietnamese government issued Decree 60 on its website, stating that it will remove the 49% ownership cap to many sectors, with the exception of key industries such as banking, effective September 2015.

Unequivocally, we believe the TPP will be very beneficial for Vietnam. The country is rich in cheap labour and the trend will continue for the next two decades. Labour productivity is amongst the lowest in the region, but growing the fastest, thanks to more efficient FDI sectors. We expect GDP to accelerate in the coming years. The question is whether Vietnam can move beyond the easy gains of using its cheap labour endowment to grow. Since joining the WTO in January 2007, domestic firms have been ailing, thanks to inefficient allocation of resources and unfocused industrial policy. Despite numerous reforms, the state sector continues to dominate investment, contributing less to output. While we believe Decree 60 is positive, the continued protection of key sectors suggests that reforms are slow to come.

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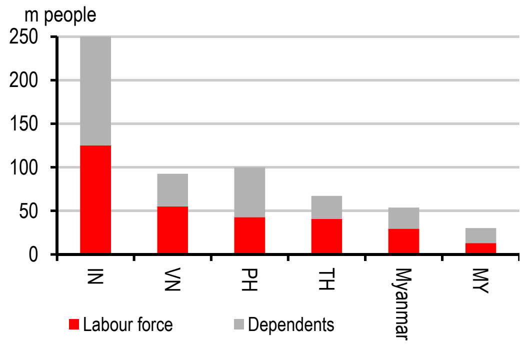
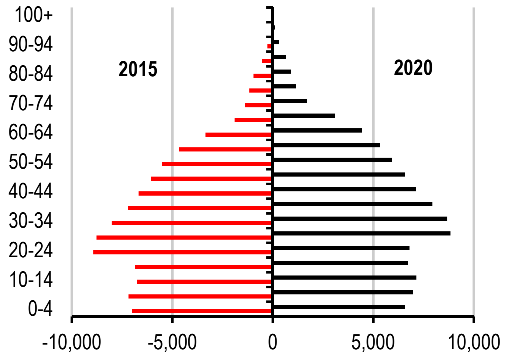
Chart 1. Large labour force, higher than the Philippines



Source: UNCTAD, HSBC

Chart 2. The population pyramid will look good into the future



Source: The UN Population Statistics, HSBC

Trade: cloth for wine

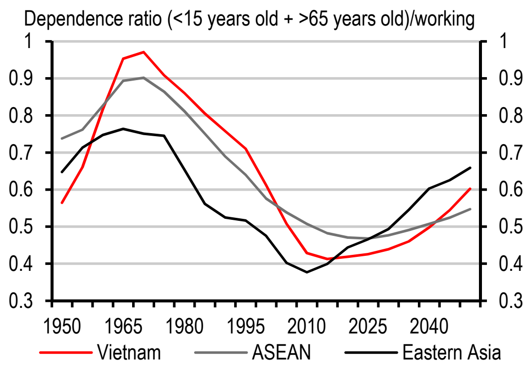
Vietnam's growth model is a classic text book one: using one's comparative advantage of factor intensity of production and factor endowments to excel in international trade. The economy's obvious endowments are: cheap labour costs and abundant arable land. Chart 1 and 2 shows the country's population, labour force, and population transitions. While Vietnam has a smaller population than the Philippines, it has a larger labour force, second to only Indonesia in Southeast Asia. About 70% of the population is still in the rural areas, doing subsistence farming.

Chart 3 shows Vietnam's dependency ratio dropping sharply and staying low in the next two decades. This combined with this positive working age population growth, especially relative to Eastern Asia (China, Japan, Mongolia and Korea) means that it can gain through relative competitiveness from a labour cost perspective.

This comparative advantage has not gone unnoticed: FDI inflows have been rather sticky and robust. In emerging Asia, Vietnam has the highest share of FDI to GDP, making its capital flows amongst the stickiest. Foreign firms primarily partake in green-field investment in the manufacturing sector to take advantage of relative labour costs, especially for sectors that are labour intensive.

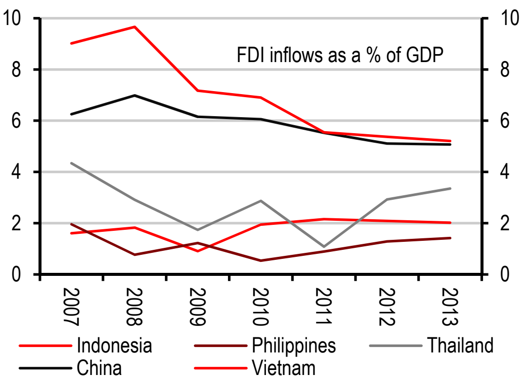
Chart 5 shows the manufacturing PMI rising sharply since end 2013. In recent months, despite the global slump, the sector has gone from strength to strength. The average output rose sharply while the PMI index averaged 53.5. Despite the drag from external demand in June,

Chart 3. Vietnam's dependency ratios are dropping



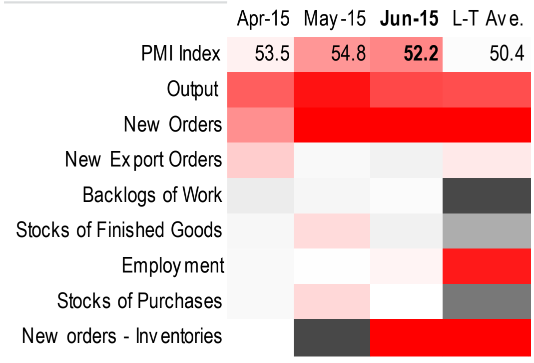
Source: The UN Population Statistics, HSBC

Chart 4. FDI inflows will continue to be strong in Vietnam



Source: UNCTAD, HSBC

Chart 5. The PMI has been positive since end 2013



Source: Markit, HSBC; Scale moves from stronger (red) to weaker (grey).

Chart 6. Weaker external demand dragged down performance but our leading indicator suggests output will expand

Source: Markit, HSBC

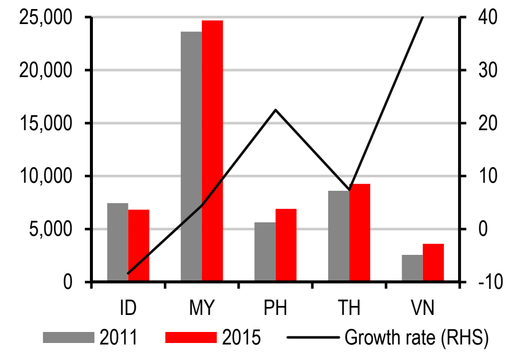
we believe that output will expand in the months ahead as the leading indicator – new orders minus inventories expanded sharply.

Chart 7 shows Vietnam's labour productivity growth in comparison to ASEAN economies (defined as output per worker). Vietnam has had the highest labour productivity growth in recent years simply through absorbing rural labour into simple manufacturing jobs. That said, Vietnam is starting at a low base and also has the lowest labour productivity per worker in ASEAN. This essentially means that while there are a lot of Vietnamese workers toiling away in farms and factories, they are not producing as much output value as the other ASEAN workers.

Prior to Vietnam's accession to the World Trade Organization (WTO) in January 2007, commodity, food and manufacturing were large contributors to export growth. But since the Great Financial Crisis (GFC), commodity-driven exports have done as well. The downturn of the global commodity cycle, the inefficient management of capital and resource allocation and the lack of focused industrialization policy caused domestic firms to lose competitiveness. Now, most of the export growth is driven by foreign firms. Chart 8 shows manufacturing become the main contributor to export growth since end 2014.

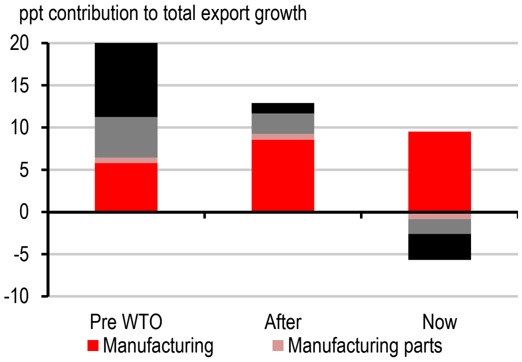
Chart 9 shows domestic firms not being able to capitalize on Vietnam's labour cost endowment. While this shows the ownership structure of export growth, it also displays a similar tale. After

Chart 7. Labour productivity is the lowest in ASEAN but the growth rate is the fastest (USD of output per worker per year)



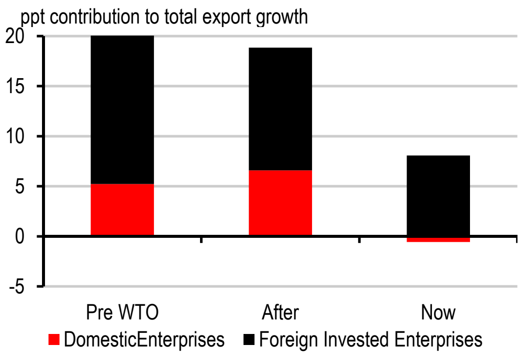
Source: UNCTAD, HSBC

Chart 8. Manufacturing has become the biggest income earner for Vietnam



Source:

Chart 9. Domestic enterprises have not been able to compete; Foreign firms are capitalizing better



Source: CEIC, HSBC

Table 1. A history of Vietnam's trade liberalization efforts

	Trade milestones	Exports
Jan-95	Became 7th member of ASEAN	5
Jan-96	ASEAN Common Effective Tariffs (CEPT)	7
Dec-01	Bilateral trade agreement between US and VN	15
Nov-04	ASEAN and China goods agreement	27
Jun-05	ASEAN Free Trade Area (AFTA)	32
Jan-07	Vietnam joins the WTO	49
Jan-10	ASEAN-China, Japan, India, Korea, Aus-NZ FTAs	72
Nov-10	Joins TPP negotiations	97
Jun-12	EU-Vietnam FTA negotiations	115
Jun-15	TPA signed by President Obama	151

Source: HSBC research

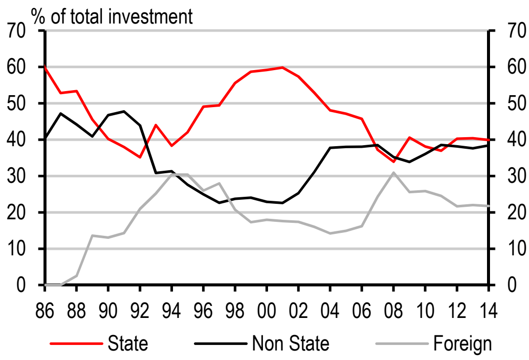
Vietnam joined the WTO, Vietnamese firms still managed to expand their market share in the global market. However, inefficient allocation of resources, especially by state-owned enterprises and the supply glut globally have hurt domestic firms. As a result, the trajectory has diverged, in which foreign firms due to more efficient allocation of resources, better technological support and tax incentives, have performed much better. Domestic firms have languished and contributed negatively to export growth.

Table 1 recaps Vietnam's trade liberalization efforts. The biggest news in recent days has been the passage of the Trade Promotion Authority (TPA) by the Senate and subsequently President Obama. This paves way for more foreign investment to come to Vietnam to capitalize on the country's labour cost comparative advantage and preferential tariff rates. This will be positive for the overall economic trajectory and labour productivity growth, as rural workers can simply improve their lot by working in factory jobs.

Investment: opening up?

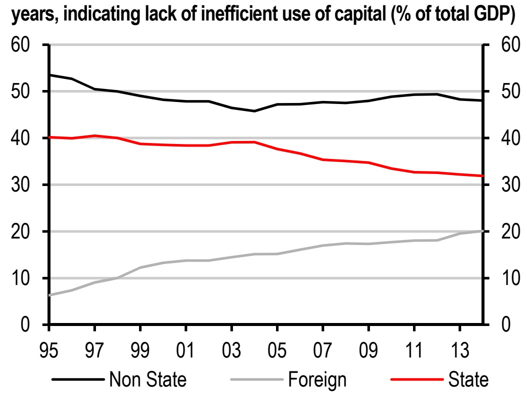
However, our analysis suggests that the current growth model is unsustainable, especially in the medium term when the excess supply of cheap labour disappears and wage costs wane. The main reason lies in the management of resources, especially capital allocation. The state sector, while inefficient, remains large. Chart 10 shows the share of state investment. While it has declined in share since the early 2000s, the share is sticky at 40%. State's output share has decline steadily (Chart 11), giving space for foreign and private sectors. This essentially means while it retains a dominant share of investment, it generates less output over time.

Chart 10. Domestic firms are dragged down by inefficient state-led investment; the state stills dominate



Source: CEIC, HSBC

Chart 11. But its contribution to GDP has lessened over the years, indicating lack of inefficient use of capital (% of total GDP)



Source: CEIC, HSBC

On 29 June, the same day President Obama signed the TPA, the Vietnamese government announced on the state's website that it will remove the 49% foreign ownership on most of the sectors, effective September 2015. Key sectors such as banking will still retain the 30% cap. The specific details of what the "key" sectors beyond banking are not available. Numerous international news organizations as well as Vietnam experts praised the development.

While we believe the decree itself is a step in the right direction, its lack of details as well as retention of cap on the banking sector suggests that progress will be slow. Vietnam Ho Chi Minh Stock Exchange (HSX) has a market cap of about USD49bn while Hanoi Stock Exchange (HNX) about USD6bn, totalling USD55bn. Within HSX, banks that have a 30% cap make up 23% of the HSX. This essentially means that the sector that would benefit from further liberalization to improve corporate government and efficiency is off limits. Secondly, sectors that currently have 49% ownership limit may not even have shares for foreigners to buy as the state retains close to 100% control (e.g. BID and GAS). In the HSX, >50% state ownership makes up 36% of the total market capitalization.

We believe that Vietnam is slowly liberalizing its economy. That said, it will unlikely do it overnight. Whether it's state-owned-enterprise equitisation efforts or liberalization of public equity to foreign investment, it is important to pay attention to the details of the laws as well as the implementation.

We believe Vietnam's biggest growth driver in the coming years will be trade, facilitated by key trade agreements such as the TPP and labour cost endowment. The biggest risks will come from within Vietnam, where inefficient allocation of resources will sap productivity and leave the country caught in the low-middle income trap. Experiences from other countries show that escaping this is an anomaly and requires proactive efforts to boost efficiency of investment, whether on soft or hard infrastructure.

Disclosure appendix

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Hold	43%	(29% of these provided with Investment Banking Services)
Sell	17%	(20% of these provided with Investment Banking Services)

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