

Vietnam at a glance

Cautiously optimistic on trade

- ▶ Vietnam is one of the most trade-reliant economies in the region, with a big share of exports going to China and the United States
- ▶ Although the external accounts are not under immediate strain, rising protectionism abroad could pose a challenge to exporters
- ▶ This underscores the need for reforms in order to get rid of structural imbalances and diversify risk

Trade is the engine of Vietnam's growth. With China's fading competitiveness in lower end manufacturing, mostly due to soaring wage costs on the Mainland, the country continues to gain global market share, particularly in electronics and apparel. Across Asia, Vietnam is thus one of the few countries still enjoying a vibrant export sector amid sluggish global demand.

The presence of free trade agreements with strategic members augments the gains for the sector. To that end the 12-nation Trans-Pacific Partnership (TPP, a trade deal with the US and 11 Pacific Rim countries, excluding China) would have been a powerful driver of further gains in exports while accelerating needed structural reforms at home.

Unfortunately, given opposition to the deal by President-elect Donald Trump, the TPP now appears unlikely to ever be ratified. In response, Vietnam too, turned away from the agreement, with Prime Minister Nguyễn Xuân Phúc telling the National Assembly (the legislative body) that there aren't "sufficient conditions" for Vietnam to pursue its own ratification.

However, the country has various other trade deals in place, giving Vietnam good access to international markets. These include the recently negotiated EU free trade deal and other agreements through the Association of Southeast Asian Nations.

The failure of the TPP is certainly a setback for Vietnam, but still leaves the economy with plenty of growth potential. The country remains highly competitive and continues to benefit from China's rapid climb up the value chain, vacating valuable export space at the lower end that few countries have so far been able to occupy (with the notable exception of Vietnam).

For the time being, therefore, Vietnam's trade position looks relatively robust. But that does not mean the government can afford to let up on reforms. The TPP, for example, would have required far-reaching changes to state-owned enterprise conduct, labour and environmental, as well as intellectual property regulation. Pressing ahead with these even without implementation of the TPP would benefit Vietnam's economy greatly in the long-run.

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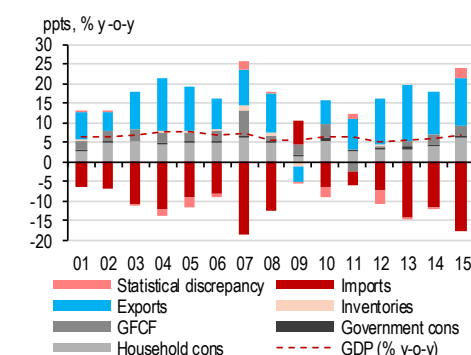
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Taking stock

Exports do matter

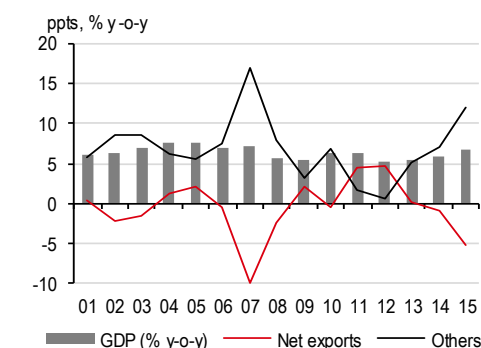
Vietnam is one of the most trade-reliant economies in the region. The first chart shows that barring a crisis year, exports have been the biggest contributor to growth. Not only that, it is also a major importer. In fact, imports have often outweighed exports, subtracting a few percentage points from GDP growth (Chart 2). Therefore, it is important that export growth remains robust. Further, exports also encourage domestic activity, particularly in the sectors that are export oriented. The role of exports in Vietnam is not limited to surpassing imports; it should also boost investment and help generate higher incomes and consumption.

Chart 1: Contribution to growth



Source: CEIC, HSBC.

Chart 2: Contribution of net exports



Source: CEIC, HSBC

On that note, the TPP (Trans-Pacific Partnership, a trade deal with the US and 11 Pacific Rim countries, excluding China) did provide a sea of opportunities. Although improved access to the US market was the main attraction, it would also have spurred many domestic reforms aimed at lifting productivity and streamlining business regulations. However, after President-elect Donald Trump signalled his administration would shelve the agreement, Vietnam chose not to ratify the deal, although the country was deemed to be the biggest beneficiary from it.

But not all is lost. The prospects are still bright for Vietnam's exports. With its rising costs, China is no longer the most attractive investment destination for many businesses, and Vietnam has come up as a serious contender. Its geographical location is of strategic importance for foreign companies with operations throughout Southeast Asia. Thus, Vietnam is an ideal export hub to reach other ASEAN markets. The other advantage, working in the economy's favour, is a young, inexpensive and increasingly highly skilled workforce.

Beyond TPP

Vietnam is already a part of the ASEAN Economic Community (AEC) which came into existence in late 2015. The idea is to drive the ten member states towards a single market and production base, with free flow of goods, services, labour, investments and capital. However, the member states can strive towards the objective only at the behest of respective national governments, and with every ASEAN country being so different, a common vision can be very hard to arrive at. But then the existence of AEC is not meant to be an end in itself. It is merely a stepping stone.

Nevertheless, a joint study by the International Labour Organization and Asian Development Bank has assessed that if the agreement is well managed over the next decade, the AEC can boost the region's economies by 7.1% between now and 2025 and generate 14 million additional jobs.

Then there is also Asian Regional Comprehensive Economic Partnership (RCEP). Its 15th negotiating round was concluded in October 2016. Although far narrower in scope than the TPP, the RCEP will link the world's three most populous markets: China, India and ASEAN. The RCEP covers the usual components of a free trade deal, such as trade in goods, services, investment, and intellectual property rights protection. However, there are already warning signs that the final treaty will be watered down due to country-specific exemptions and many tariff lines that are likely to remain intact.

Despite drawbacks, the RCEP should help boost trade volumes across Asia and spur investment in new supply chains. In addition, the deal effectively allows for convergence of existing agreements, and thereby does away with the “noodle bowl” effect. “Noodle bowl” refers to the existence of multiple bilateral agreements that make the rules of origin, tariff rates, standards, etc so tangled and inter-twined, that firms find it difficult to utilise the free trade agreements in place. For more on RCEP please see [Sad about the TPP? Look to the RCEP...](#) by Joseph F Incalcaterra, 11 November 2016.

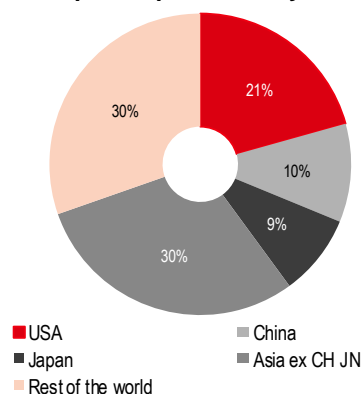
Facing the reality

It happens. Baseline scenarios, just like some of our best laid plans, go wrong. This year it happened not once, but twice. First, the Brexit vote triggered economic and political change. (See [Global Economics Quarterly: UK's revolt, global jolt](#) by Janet Henry and James Pomeroy, 5 July 2016). And now the election of Mr Trump is raising risks of trade protectionism. Although it is too early to know about the specific policies the Trump administration will pursue, for Asia, if he does what he promised during the campaign, there would be cause to worry. A more restrictive trade stance by the US is likely to hurt exports and investment in a country like Vietnam, where the US accounts for about a fifth of its exports. (See [Trump: the global impact – Mexico, China, Asia, Europe and the World](#) by Janet Henry et al, 9 November 2016)

In the short run: mind the US, but don't forget China

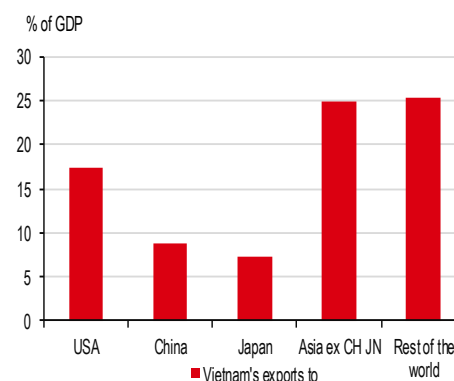
The US and China are Vietnam's largest trading partners (in that order). Needless to say, if the US begins to throttle back imports, Vietnam's exports will be hurt. That's not all. China too, could feel the brunt of a restrictive trade stance by the US. If that happens, Chinese demand for Vietnamese imports might decrease as well (especially for components used for re-exports from China to the US). The indirect effects of more restrictive US trade policy could thus provide a meaningful drag on Vietnam's exports.

Chart 3: Export dependence by destination



Source: CEIC, HSBC. 2015 annual data

Chart 4: Trade with China and the US



Source: CEIC, HSBC. 2015 annual data

The current state of affairs underscores the need for reforms

We think that Vietnam rightly remains committed to its structural reform agenda. The National Assembly, (Vietnam's legislative body) adopted three reform targets for 2016-2020, relating to public investment, state owned enterprises (SOE) and financial institutions. On the public investment front, the government is set to drastically reform budget expenditure and collections, ensuring the safety of public investment and the national fiscal situation. For SOEs, the target is to make the reform process "faster and stronger" by making the equitization (privatisation) process transparent and in line with the market mechanisms. Financial institutions will be strengthened by speeding up bad debt divestment and having at least 12 to 15 commercial banks in compliance with Basel II standards.

We believe that if pursued properly, the gains from these reforms will have far reaching consequences in strengthening the fundamentals of the economy. In turn, the economy should find itself less vulnerable to external shocks.

A few right strides and a lot of perseverance

As of now, Vietnam's economy is extremely trade reliant. Its geographical and economic position together with its cheap, abundant, young and skilled workforce are all aligned favourably to the cause. FTAs are likely to bolster the gains. The country has already signed 12 FTAs and is committed to enhancing economic integration under programmes it has already joined. The fact that the TPP will not be implemented is a set-back, but one that Vietnam should overcome on the back of its impressive competitive position.

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