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TAKING STOCK

AN UPDATE ON VIETNAM'S RECENT ECONOMIC DEVELOPMENTS

Hanoi, December, 2015

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An Update on Vietnam's Recent Economic Developments

Special Focus on Trans Pacific Partnership Agreement

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ACKNOWLEDGEMENTS

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ACRONYMS AND ABBREVIATIONS

ASEAN	Association of Southeast Asian Nations
CDS	Credit Default Swap
CIT	Corporate Income Tax
CPI	Consumer Price Index
EAP	East Asia and Pacific
FDI	Foreign Direct Investment
FPT	Corporation for Financing and Promoting Technology
FTA	Free trade agreement
GDP	Gross Domestic Product
GDC	General Department of Customs
GSO	General Statistics Office
ILO	International Labor Organization
IMF	International Monetary Fund
MOF	Ministry of Finance
MOIT	Ministry of Industry and Trade
MPI	Ministry of Planning and Investment
NTM	Non-tariff measure
ODA	Official Development Assistance
OOG	Office of Government
PIM	Public Investment Management
PIT	Personal Income Tax
PMI	Purchasing Manager Index
PPP	Purchasing Power Parity
SBV	State Bank of Vietnam
SOCBs	State-owned commercial banks
SOEs	State-owned Enterprises
SEGs	State Economic Groups
TPP	Trans Pacific Partnership Agreement
VAMC	Vietnam Asset Management Company
VAT	Value Added Tax
WB	World Bank
WTO	World Trade Organization

OFFICIAL INTERBANK EXCHANGE RATE: US$ = VND 21,890

Government Fiscal Year: January 1 to December 31

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Global economic prospects

Global growth remained weak in the first half of the year on account of a further slowdown in emerging markets and a weaker recovery in advanced economies. While purchasing managers index surveys suggest a moderately positive outlook in high-income countries, they point to a contraction in low- and middle-income countries. Growth in advanced economies is expected to increase modestly next year, with firmer growth especially in the Euro area and Japan. Meanwhile, prospects for developing economies remain challenging due to a weak outlook for commodity exporters, tightening capital flows, and still subdued trade growth.

Recent economic developments in Vietnam

Vietnam's economy has weathered the recent turbulence in the external environment fairly well, reflecting resilient domestic demand and robust performance of export-oriented manufacturing. Growth further accelerated to 6.5 percent (year-on-year) in the first three quarters of 2015 (after coming in at 6 percent last year). Low inflation and strengthening consumer confidence supported an uptick in private consumption while investment was lifted by robust foreign direct investment, rising government capital expenditures, and a recovery of credit growth. Exports of the foreign-invested manufacturing sector also accelerated, but this was offset by a slowdown of commodity exports and a surge in imports of capital and intermediate goods, reflecting stronger investment and the high import content of manufacturing exports.

Against the backdrop of low inflation, monetary policy remains accommodative. Reflecting lower oil and food prices and stable core inflation, headline consumer price inflation is at historical lows. Average inflation stood at 0.7 percent in the first ten months of 2015, down from 4.6 percent in the same period last year. Energy inflation is easing, thanks to lower international oil prices, which have been pushing fuel and transport prices down. Food inflation also remains lower this year, growing just 1.6 percent in the first nine months of 2015. While there has been no further monetary easing this year, credit growth has picked up markedly, coming in at around 12 percent (year-to-date) in September 2015 – the largest expansion since 2011.

Amid volatility in international currency markets, rising exchange rate pressures were alleviated by gradual devaluation. Pressures on the currency had been building since early 2015 on account of a rising trade deficit and weakening currencies across Asia, putting pressure on the State Bank of Vietnam (SBV) to follow suit to mitigate the Dong's relative strength. The SBV accordingly devalued the Dong reference rate by a cumulative 3 percent and by widening the trading band from +/-1% to +/-3%. This helped preserve currency market stability, but in the context of sharper depreciations of major currencies against the US dollar, concerns of real exchange rate appreciation against currencies of major trading partners remain.

Better macroeconomic conditions helped maintain stability in the banking system, but deep seated vulnerabilities continue to pose risks. Reported systemwide non-performing loans have declined to about 3 percent of total loans, due to transfers of NPLs to the Vietnam Asset Management Company (VAMC) and an uptick in credit growth. But the resolution of distressed assets has been slow, and only around 7 percent of the bad debts were resolved. Progress in this areas is hampered by the VAMC's lack of legal ownership of bad assets, the absence of an adequate enabling legal framework for insolvency, asset titling, and collateral seizures, and the personal liability of VAMC staff for selling assets for less than their book value.

Fiscal consolidation remains crucial to contain risks to fiscal sustainability. Fiscal pressures remained acute during the first nine months of the year. A combination of declining oil revenue and a further corporate income tax (CIT) rate cut dampened revenue performance. At the same time, expenditure expanded at a faster rate than revenue, driven mostly by an increase in recurrent spending. In the first nine months of 2015, the fiscal deficit was estimated at 4.9 percent of GDP (excluding off-budget activity), financed primarily by domestic debt. Maintaining the current fiscal stance would result in the accumulation of public-sector debt, which would create risks in terms of breaching the legal limit of 65 percent of GDP in the medium term.

On the external front, Vietnam's export performance remains strong. Vietnam's total export turnover increased by 9.2 percent from the same period last year. While primary commodity exports fell significantly under the weight of low commodity prices, manufacturing exports continued to grow robustly thanks to the strong performance of manufacturing exports, especially in such technology categories as cell phones, electronics, and computers. Meanwhile, imports, especially of capital goods, continued to surge, reflecting the uptick in investment activity and the high import content of some of Vietnam's exports. Overall, Vietnam's trade position weakened during 2015, narrowing the current account surplus. Even with the weaker current account and fairly low reserves, external financing risks were mitigated by robust FDI inflows and limited exposure to portfolio capital flows.

Implementing structural reforms continues along a gradual path. Although the pace of the equitization process has picked up, but many transaction involve divestment of minority shares, hampering the expected impact on investment and enterprise performance. Meanwhile, Vietnam's ranking in the Doing Business survey has risen from 93rd in DB2015 to 90th in DB2016 among 189 economies. But its competitiveness is still ranked below the average for the ASEAN-4 countries, with slow improvements in infrastructure, the institutional framework, and the business environment. Highlighted are problems with tax payment times, protections for minority investors, access to electricity, and dealing with business insolvency. In 2015 the government also made further progress in improving the business climate with the issuance of resolution 19/NQ-CP/2015, which aims to lower the tax payment period to 121.5 hours/year 7 and rapidly decrease processing times for clearing exports and imports of goods to 13 and 14 days, respectively.

Outlook

The medium-term outlook for Vietnam remains positive. GDP growth is expected to stay at around 6.5 percent in 2015, underpinned by further recovery in domestic demand, in turn reflecting robust private consumption and investment growth. Growth is projected to strengthen further over the medium term. Inflation is expected to remain low on account of low global energy and food prices before rebounding somewhat in medium term. The trade balance is projected to narrow significantly this year due to a combination of moderating exports and sustained import growth stoked by stronger domestic economic activity. Robust remittances will keep the current account in surplus, if at much lower level than last year. External capital inflows are expected to cover balance-of-payment financing needs as Vietnam's favorable economic prospects usher in additional FDI. The fiscal deficit is expected to remain high this year, but adjust starting next year due to consolidation efforts to avoid further increases in public debt.

While the baseline outlook for Vietnam is positive on balance, downside risks dominate. On the domestic front, slow structural reform progress poses significant risks to the medium-term growth prospects. Delays in implementing fiscal consolidation could undermine debt sustainability, especially given contingent liabilities associated with SOE debt and state-owned banks. With credit growth accelerating, risks in the banking sector, including possible overheating, are also intensifying and—if not managed prudently—could result in renewed instability. On the external front, slower-than-expected growth in key export markets, notably the US, EU, Japan, and China, may pose a risk to export performance and growth. In addition, the anticipated policy rate liftoff in the United States may cause sovereign spreads to rise, a concern for Vietnam given its large gross public financing needs, which are expected to be met at least partly by international bond issuances. Against the backdrop of these uncertainties, sound macroeconomic management remains crucial to rebuild policy buffers and safeguard against future shocks. Fiscal consolidation, structural reforms, a more flexible exchange rate, and a further build-up of reserves could help reduce the vulnerabilities.

Special topic: The Trans Pacific Partnership Agreement

The TPP is expected to generate considerable benefits for Vietnam. Among the current TPP signatories, Vietnam—as the economy with the lowest per capita GDP—has unique comparative advantages, particularly in labor-intensive manufacturing. By enhancing access to key export markets, the TPP is expected to create trade diversion since Vietnamese exports would be expected to replace an increasing share of Chinese exports to TPP markets, notably the US and Japan – a trend already started even before the TPP's conclusion. The TPP is also expected to lead to further increases in (already considerable) FDI inflows to build up export capacity, including that in upstream suppliers to sectors subject to strict rules of origin. By contrast, higher environmental and labor requirements may raise the costs of production in Vietnam, at least in the sort-run.

On the economic impacts, simulations suggest that the TPP could add as much as 8 percent to Vietnam's GDP, 17 percent to its real exports, and 12 percent to its capital stock over the next 20 years. About half the benefits are generated by tariff reductions and half by non-tariff measures (NTMs), including the liberalization of key service sectors. Labor-intensive manufacturing and especially sectors that currently face high import tariffs in the TPP markets will benefit most. These include textile, apparel, and footwear and to less extent food processing and electronics. In contrast, primary export sectors, including agriculture and services, are expected to decline mainly as a result of accelerated structural transformation (with production factors reallocating to manufacturing).

While the impact of the TPP on Vietnam is expected to be positive, implementation challenges remain. The TPP is expected to serve as an external anchor for structural reforms. It is not only removing trade barriers and enhancing market access to key export markets, but it will also have tangible impacts on regulatory quality, intellectual property rights, investor protection, competition, SOE management, labor and environmental standards, food safety, public procurement and the liberalization of services, including financial services and telecommunications. Implementing these commitments will be particularly challenging for Vietnam—given its gradual reform path and institutional legacies, such as a large SOE sector and incomplete market institutions. But it has shown in its accession to the WTO that it can leverage external commitments to advance domestic reforms, especially in challenging areas. To make the most of the opportunities, implementing TPP commitments could be accompanied by further steps to enhance Vietnam's competitiveness, investing in roads, power, ports, and logistics services and enhancing the efficiency of border clearance procedures.

SECTION I: RECENT ECONOMIC DEVELOPMENTS

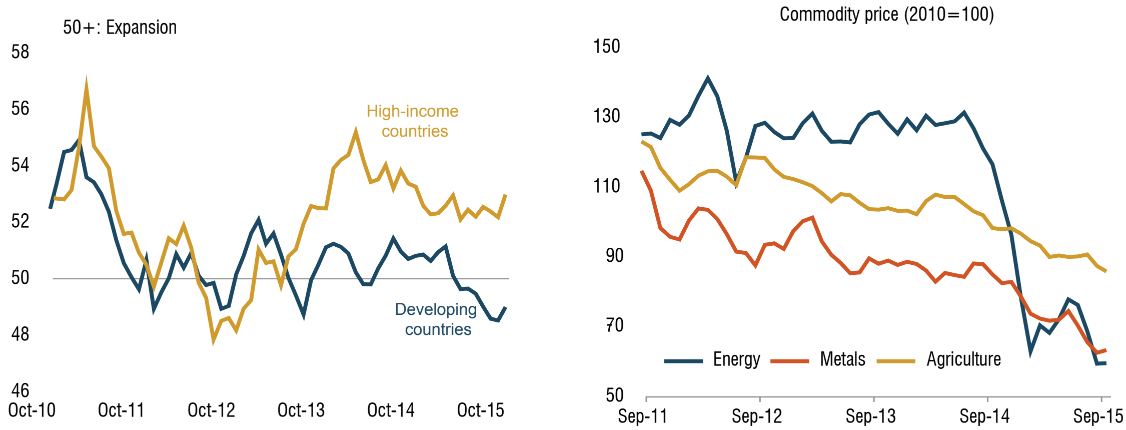
I.1. External Economic Environment

1. **Global growth remained weak in the first half of the year on account of a further slowdown in emerging markets and a weaker recovery in advanced economies.** While purchasing managers surveys suggest a moderately positive outlook in high-income countries, they point to a contraction in low- and middle-income countries.[1] Growth in advanced economies is expected to increase modestly next year, with firmer growth especially in the Euro area and Japan. Meanwhile, prospects for developing economies remain challenging due to a weak outlook for commodity exporters, tightening capital flows and subdued trade growth.

[1] The Markit purchasing managers' index (PMI) tracks business conditions in more than 30 countries.

Figure 1: Uncertain economic environment

Purchasing managers' index (PMI) **Commodity price (2000=100)**



Source: World Bank

2. **Growth in developing East Asia and Pacific (EAP) countries eased over the first half of the year.** This mostly reflected a gradual slowdown in China, stemming from policy efforts to tighten nonbank credit and from a buildup of excess industrial capacity and decelerating exports. Looking ahead, growth in developing EAP is expected to ease, from 6.8 percent in 2014 to 6.5 percent in 2015 and 6.3 percent over 2016–17. Aggregate growth in the Association of Southeast Asian Nation (ASEAN) economies will be roughly stable at 4.3 percent in 2015, rising to 4.9 percent by 2017, with increasing support from global growth and export demand, particularly from high-income economies. Over the medium term, regional growth will be conditioned by accelerating demand in high-income economies, gradually tightening external financing conditions, and still-subdued international commodity prices.

3. **Risks to the global outlook remain tilted to the downside.** Major downside risks are centered on China's transition to slower, less investment driven growth, weak commodity prices, potential capital flow reversals, and rising external financing costs. Sharp asset price adjustments, financial turmoil and sharper-than-expected increases in borrowing costs in response to an expected hike in the U.S. Federal Reserve's rate could also take a toll on global activity, especially among developing economies. And crisis legacies, including high public debt ratios and private debt overhang, could weigh on the recovery in high income economies.

Table 1.1: East Asia and Pacific GDP growth

	2013	2014	2015/f	2016/f
Developing East Asia and Pacific	7.1	6.8	6.5	6.4
China	7.7	7.3	6.9	6.7
Indonesia	5.6	5.0	4.7	5.3
Malaysia	4.7	6.0	4.7	4.7
Philippines	7.1	6.1	5.8	6.4
Thailand	2.8	0.9	2.5	2.0
Vietnam	5.4	6.0	6.5	6.6
Cambodia	7.4	7.1	6.9	6.9
Lao PDR	8.5	7.5	6.4	7.0
Myanmar	8.5	8.5	6.5	7.8
Mongolia	11.6	7.8	3.3	4.1
Memo: Developing East Asia excl. China	5.2	4.6	4.6	4.9
Memo: ASEAN	5.0	4.4	4.3	4.7

Source: World Bank staff estimates.

4. **The strengthening recovery in high-income economies should further boost Vietnam's already strong export performance.** But strong trade linkages expose Vietnam's economy to a possible slowdown in global growth, especially in the United States—its main export market. Heightened exchange rate volatility poses a risk against the backdrop of Vietnam's still limited exchange rate flexibility, weakening current account and low external reserve coverage. In addition, the anticipated policy rate liftoff in the United States is expected to cause sovereign spreads to rise in the international capital market. This could be a concern to Vietnam, given its large gross public financing needs, which are expected to be partially met by international bond issuances. These risks call for a continuing focus on sound macroeconomic management to mitigate external and fiscal vulnerabilities. With limited scope for countercyclical fiscal and monetary policy, macroeconomic policies will need to begin adjusting to rebuild policy buffers to safeguard against future shocks. Fiscal consolidation, structural reforms, a more flexible exchange rate, and a further build-up of reserves could help reduce the vulnerabilities.

I.2. Recent Economic Developments in Vietnam

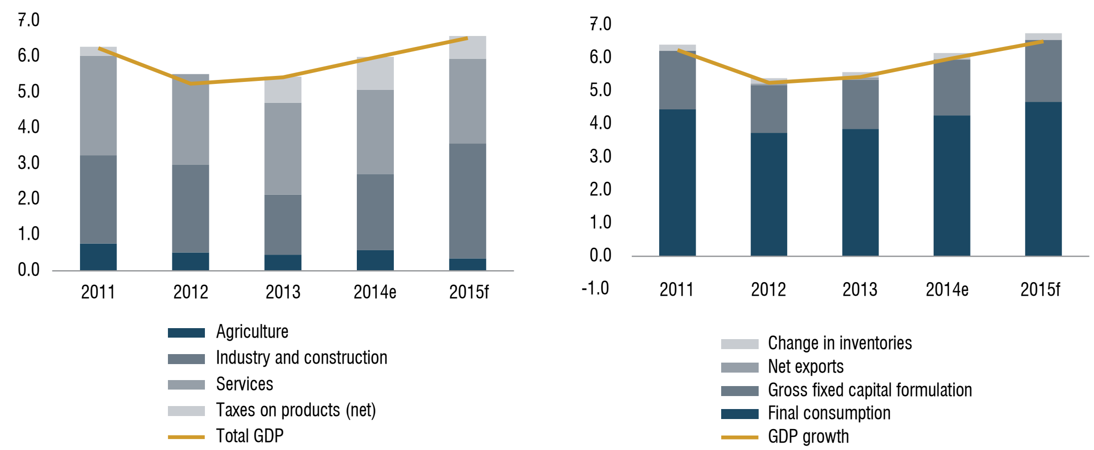
I. 2.1. Vietnam's economic recovery has been resilient in the face of external volatility

5. **Vietnam's economy has weathered recent turbulence in the external environment fairly well, reflecting resilient domestic demand and robust export-oriented manufacturing.** After a slowdown during 2012 and 2013, growth started to recover to 6 percent in 2014 and further accelerated to 6.5 percent (year-on-year) in first three quarters of 2015. Low inflation and strengthening consumer confidence supported an uptick in private consumption while investment was lifted by robust foreign direct investment, rising government expenditures marking completion of the current five-year planning cycle, and a recovery of credit growth. In the first nine months of 2015, total investment is up 8.5 percent compared with the same period last year. Exports of foreign-invested manufacturing also accelerated, but this was offset by a slowdown of commodity exports and a surge in imports of capital and intermediate goods, reflecting stronger investment and the high import content of manufacturing exports.

6. **On the production side, growth was led by industry, which benefitted from strong foreign-invested manufacturing and construction owing to a gradual recovery in the property market and higher investment.** Service performance also picked up, growing by 6.2 percent thanks to buoyant retail sales (up 9.1 percent, y/y), only partially offset by slowing growth in the tourism sector (down to 3.8 percent, y/y). In contrast, agricultural production slowed (to 2.1 percent, y/y), reflecting lower food prices and less favorable climatic conditions related to El Nino.

Figure 2: Growth momentum is picking up, driven by domestic demand and strong export oriented manufacturing

Contribution to GDP growth—Supply side (%) **Contribution to GDP growth—Demand side (%)**



Source: World Bank staff based official data.

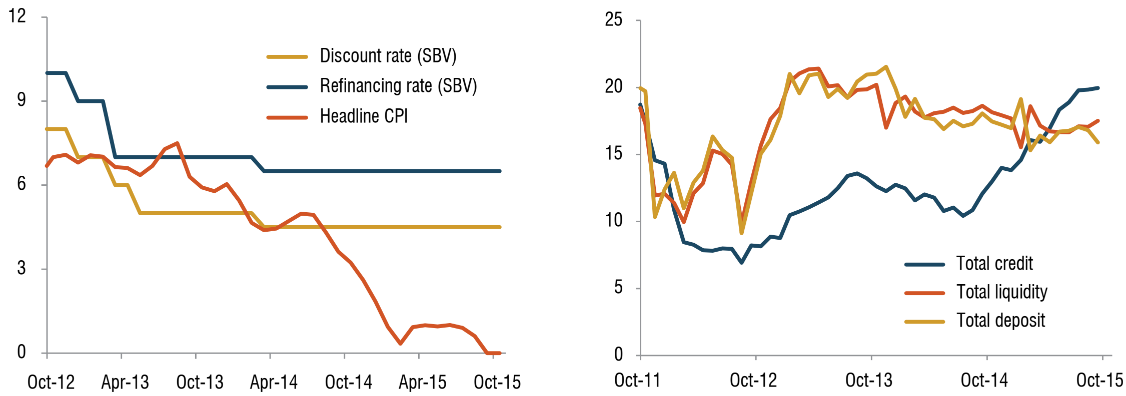
7. **Reflecting lower oil and food prices and stable core inflation, headline consumer price inflation has moderated.** Average inflation stood at 0.7 percent in the first ten months of 2015, down from 4.6 percent in the same period last year. Energy inflation is easing, thanks to lower international oil prices, which have been pushing fuel and transport prices down. Food inflation also remains lower this year, growing just 1.6 percent in the first nine months of 2015.

I.2.2. Credit growth is resuming, supported by low inflation and accommodative monetary policy

8. **Low inflation has provided scope for accommodative monetary policy.** Against the backdrop of declining inflation and weak domestic demand, the SBV has cut its policy rates by a cumulative 850 basis points since 2012, including a 50 basis point reduction in October 2014. The discount rate and refinancing rate now stand at 4.5 percent and 6.5 percent, respectively. Concurrently, the SBV also relaxed macro prudential measures with Circular 36 (issued in November 2014), which increased the lending limit on short-term deposits (to 60 percent from 30 percent) and lowered risk weights for certain lending activities, including real estate loans. While there has been no further monetary easing this year, credit growth has picked up markedly, coming in at around 12 percent (year-to-date) in September 2015—the highest expansion since 2011. Although supporting investment growth, the resumption of faster credit growth raises concerns over asset quality, particularly given the unresolved balance sheet risks related to bad debts accumulated during previous years.

Figure 3: Low inflation provided scope for accommodative monetary policy, inducing a turnaround in credit growth

CPI and central bank policy rate (%) **Monetary aggregates (% change, yoy)**



Source: World Bank staff based official data.

9. **Better macroeconomic conditions have helped maintain stability in the banking system, though deep-seated vulnerabilities continue to pose risks.** While reported system-wide non-performing loans have declined to about 3 percent of total loans, some of the decline is due to transfers of NPLs to the Vietnam Asset Management Company (VAMC), which has purchased VND 226 trillion (roughly USD 10 billion) of bad debts as of October 2015. The VAMC purchased these distressed assets in exchange for VAMC bonds. So far, around 7 percent of the bad debts were resolved either through selling of the debts or their underlying collaterals. Further progress has been hampered by a lack of legal ownership of bad assets by the VAMC, the absence of an adequate enabling legal framework for insolvency, asset titling, and collateral seizures, and the personal liability of VAMC staff for selling assets for less than their book value.

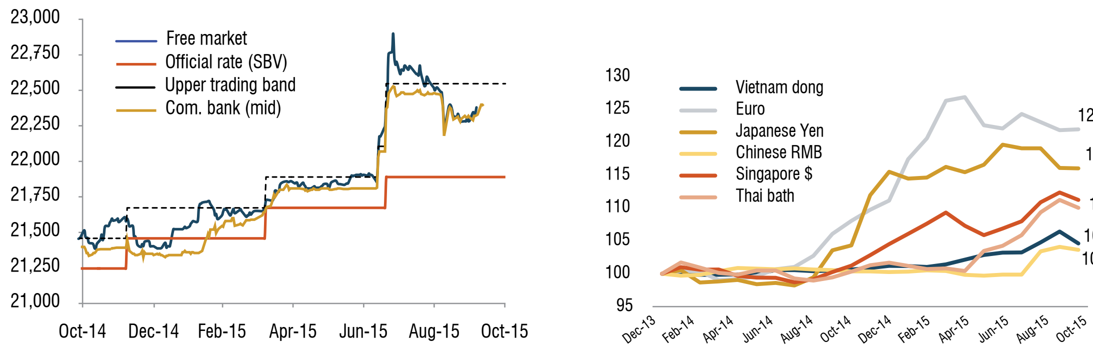
I.2.3. Exchange rate pressures were alleviated by gradual devaluation

10. **Amid volatility in international currency markets, rising exchange rate pressures were alleviated by a gradual devaluation and more exchange rate flexibility.** Vietnam continues to operate a crawling peg system, with the exchange rate as the main nominal policy anchor. Pressures on the currency had been building since early 2015 on account of a rising trade deficit and weakening currencies across Asia. These pressures were exacerbated by the depreciation of the Chinese renminbi in early August. Reluctant to raise interest rates and with

limited forex reserves at its disposal (less than three months of import cover), the SBV responded by devaluing the dong three times, in January, May, and August 2015 by a cumulative 3 percent—and by widening the trading band from +/-1% to +/-3%. Overall in 2015, the dong fell by about 5 percent against the US dollar in nominal terms or roughly 3 percent in real terms. The SBV also lowered the deposit rate for US dollars and tightened the foreign currency transactions of credit institutions to avoid speculation and hoarding of the US dollar. This helped preserve currency market stability and ward off pressures on export competitiveness.

Figure 4: Exchange rate pressures were accommodated by progressive devaluation, but the dong has gained relative strength

VND/USD exchange rate | **Average exchange rate vs US dollar (Dec 2013 = 100)**



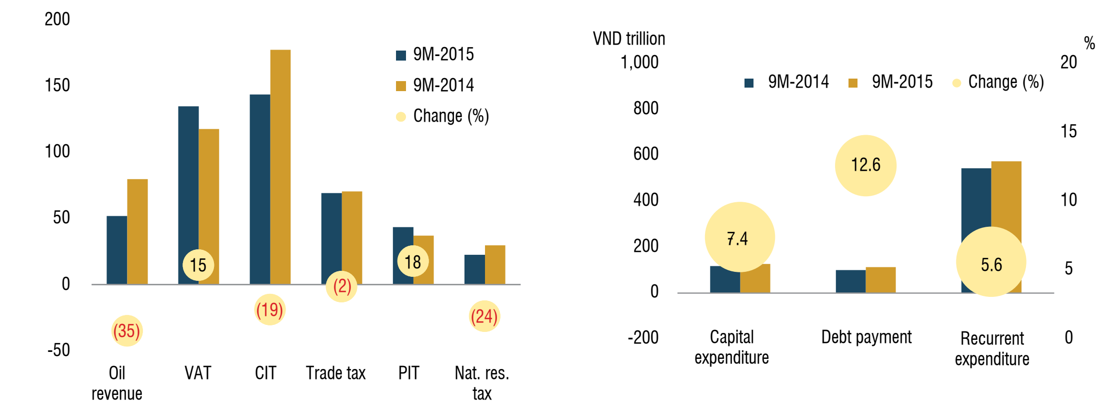
Source: SBV and World Bank.

I.2.4. Fiscal consolidation remains important

11. **A combination of declining oil revenue and a further CIT rate cut dampened revenue performance in the first nine months of 2015.** Oil revenue fell by 35 percent (year-on-year) while corporate income tax (CIT) and trade tax receipts were down 19 percent and 2 percent, respectively, due to further reduction in tax rates. Among key taxes, the value added tax (VAT), which makes up around a third of total tax revenue, increased 15 percent (year-on-year) thanks to strong private consumption. Personal income tax (PIT) collections increased by 18 percent thanks to an expanded tax base. Overall revenue increased by around 7 percent in nominal terms compared with the same period last year.

Figure 5: State budget outturn

Revenue by taxes (9M-2015 vs. 9M-2014, dong trillion) | **Expenditure by economic categories (9M-2015 vs. 9M-2014, dong trillion)**



Source: MOF

12. **Expenditure expanded faster than revenue, driven mostly by an increase in recurrent spending, which accounted for 70.5 percent of total expenditure.** During the first nine months, total expenditure was 7.8 percent higher than in the same period last year, with recurrent and capital spending (excluding off-budget items) increasing by 5.6 and 7.6 percent, respectively. Debt service payments from the state budget (both principal and interest) rose 12.6 percent, reflecting an increased public debt burden. But the share of capital spending in total expenditure (on-budget only) declined to 15.6 percent of total spending in the first nine months of 2015, compared with an average of 26.5 percent over 2011–2014.

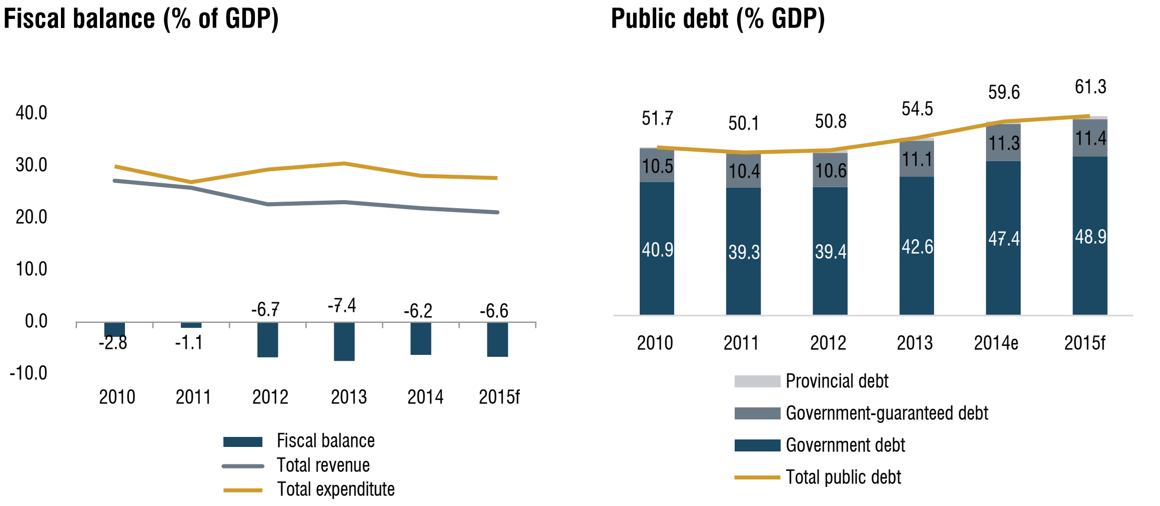
13. **In the first nine months of 2015, the fiscal deficit was estimated at 4.9 percent of GDP (government definition), financed primarily by domestic debt.** Note that this does not include off-budget capital spending, which means that the overall deficit in the first nine months was likely higher. Due to regulations set by the National Assembly last year restricting debt issuance of less than five years maturity, the Ministry of Finance has faced difficulties in issuing Treasury bonds. In the first nine months of 2015, the State Treasury issued just 127 trillion dong of Treasury bonds (about 51 percent of the annual plan), down 39 percent year-on-year. The MOF borrowed VND 30 trillion from the SBV in the form of short-term monetary financing. This may offset efforts at lowering the cost of borrowing by administratively restricting Treasury bond issuances.

14. **Growing fiscal imbalances resulting from countercyclical fiscal policy in past years need to be addressed to ensure sustainable public finances.** The government is seeking to strengthen fiscal discipline by improving tax administration and broadening the tax base. Efforts are also afoot to rein in growth of recurrent spending and further tighten controls over new public investment projects. The revised State Budget Law offers important opportunities to further strengthen fiscal management.

15. **Vietnam's public-debt-to-GDP ratio has increased rapidly over the past few years.** While Vietnam's overall fiscal stance has been countercyclical, sizable fiscal deficits raise concerns about the medium-term sustainability of the current fiscal position and corresponding public debt path. The Ministry of Finance reported that Vietnam's total public debt (government, government-guaranteed, and provincial debt) increased markedly from 51.7 percent of GDP in 2010 to an estimated 61.3 percent in 2015. Of this, 48.9 percent of GDP is debt directly owed by the central government, 11.4 percent of GDP is debt guaranteed by the central government, and about 1 percent of GDP is debt of provincial governments. The debt level is fast approaching Vietnam's statutory limit of 65 percent of GDP. With access to concessional external financing increasingly constrained due to a gradual withdrawal of donors, the government has mainly relied on domestic debt to meet its growing financing needs.

16. **The greater reliance on domestic debt, while reducing exchange rate risks, has increased the average interest rate and significantly shortened the maturity profile of public debt.** The share of domestic debt in total public debt increased from 45 percent in 2010 to 53 percent in 2014. The limited availability of longer term financing reflects a relatively shallow domestic debt market with few participants (mainly from the banking sector). As a result, debt service payments pose an increasing burden on the budget. Interest expenditures have risen sharply both as a share of GDP and a share of government revenue. In 2014 the government spent about 8 percent of its total revenue (including grants) on interest payments (up from 4.3 percent in 2010), crowding out more productive spending and investment. Debt service payments—including amortization—rose to more than a quarter of government revenue in 2014, highlighting the intensified refinancing risks.

Figure 6: Accumulated fiscal imbalances have pushed up public debt



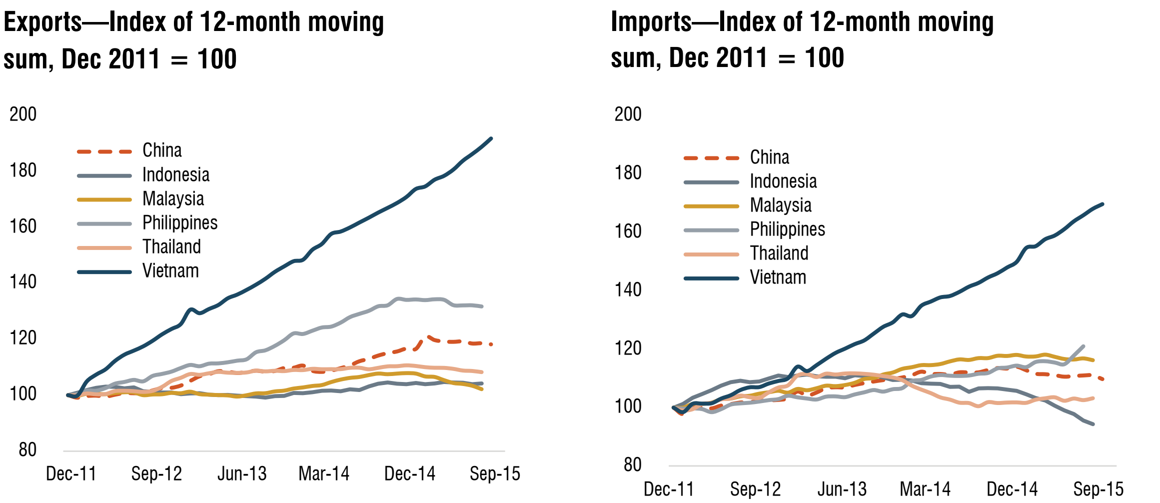
Source: World Bank staff based official data.

Source: MOF

I.2.5. Resilient external sector

17. **Despite subdued global trade growth, Vietnam's export performance remains resilient.** Vietnam's total export turnover between January and September 2015 is estimated at $120 billion, up 9.2 percent from the same period last year. Primary commodity exports decreased significantly because of falling prices. Oil exports fell by nearly half in value terms, and exports of agricultural commodities by about 10 percent. But manufacturing exports continued to grow robustly, especially in such technology categories as cell phones, electronics, and computers. Key labor-intensive manufacturing exports like garments, footwear, and wood products also continued to do well growing at an average of 10 percent. There are concerns, however, that the share of imported inputs in these products continues to be relatively high, with limited technological spillover from foreign to domestic enterprises and the inability of domestic manufacturers to move along the supply chain to capture higher value.

Figure 7: Vietnam trade growth relative to selected Asian countries

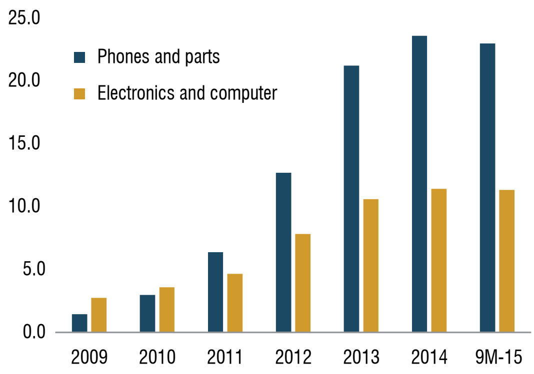


Source: World Bank

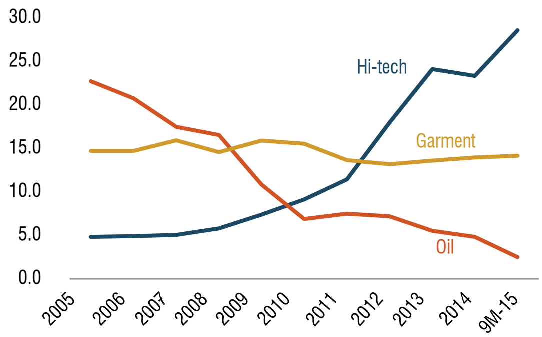
18. **Vietnam's strong export performance is underpinned by impressive diversification of its export basket over the last ten years.** Manufacturing exports now account for 84 percent, up from a little more than half in 2005. Higher value exports, such as phones, computers, and related components have increased from a less than 5 percent share ten years ago to almost one third now. By the same token, the share of primary commodities has steadily fallen—with oil exports down from nearly 23 percent of total exports in 2005 to around 2.5 percent in September 2015.

Figure 8: Vietnam's hi-tech exports

Exports of high-tech (US$ billion)



Share of export value (% of total)

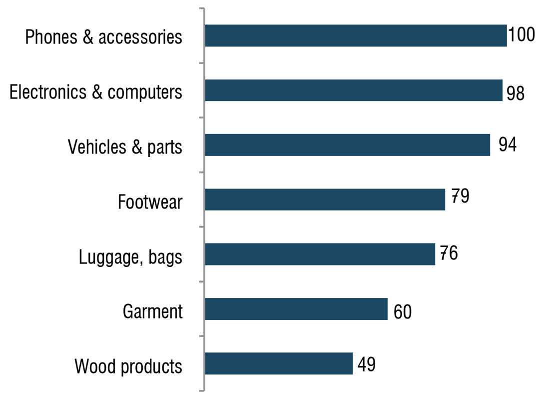


Source: General Department of Customs.

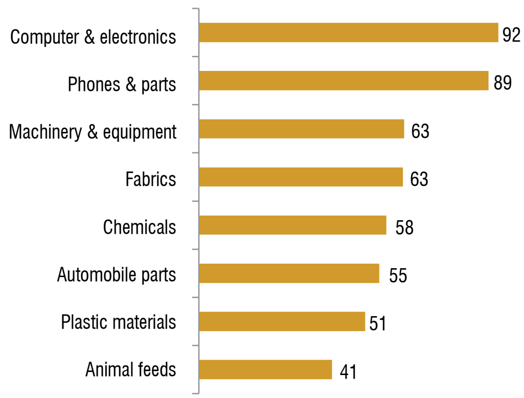
19. **Vietnam's trade performance reflects its increasing integration in global value chains.** The engine of strong export performance generally originated in the foreign-invested sector, which contributed 68.2 percent of total non-oil exports and grew at 20.8 percent in the first nine months of 2015. The sector is also boosting import demand for machinery and equipment for investment expansion as well as materials and intermediate goods for export processing and manufacturing. While the sector records a significant trade surplus (about 9 percent of GDP in 2015), its increasing share of imported intermediate inputs reflects the limited domestic value addition.

Figure 9: Increasing share of the foreign-invested sector in exports and imports

Exports by FDI sector (% of total)



Imports by FDI sector (% of total)



Source: General Department of Customs.

20. **Vietnam's export performance, while moderating somewhat this year, still outpaced its regional competitors.** Vietnam recorded the highest rate of export growth in developing East Asia in 2014 and through the first three quarters of 2015. Its merchandise trade performance has benefited from dynamism in the foreign-invested manufacturing sector, as leading international manufacturers have expanded production of electronics, mobile phones, and associated goods. Exports of mobile phones and spare parts topped US$ 23 billion in the first nine months, a 33.2 percent increase year-on-year, making up Vietnam's single biggest export item. Exports of computers, electronics items, and spare parts stood at $11.3 billion, up 51.5 percent over the same period last year.

Table 2: Vietnam's merchandise exports

	Share of total (%)			Growth (%)		
	2014	9M-2014	9M-2015	2014	9M-2014	9M-2015
Total export value	100.0	100.0	100.0	13.8	14.4	9.2
Crude oil	4.8	5.3	2.5	-0.2	9.1	-48.4
Non-oil	95.2	94.7	97.5	14.6	14.7	12.4
Agriculture and fishery	14.7	15.3	12.6	12.1	15.1	-9.9
Rice	2.0	2.1	1.6	0.4	-2.0	-15.0
Low-value manufacturing	26.6	17.6	25.5	18.1	22.1	12.0
Garment	13.9	6.8	14.1	16.6	24.5	10.0
High-value manufacturing	27.1	26.3	32.2	10.6	7.2	33.2
Phones and parts	15.7	15.7	19.1	11.1	11.3	33.2
Others	26.7	35.5	27.2	16.7	17.1	5.4
Domestic sector	*32.6*	*33.0*	*29.3*	*11.8*	*13.1*	*-3.2*
Foreign-invested sector (excl. oil)	*62.5*	*61.7*	*68.2*	*16.1*	*15.6*	*20.8*

Source: General Department of Customs

21. **Imports, especially of capital and intermediate goods, continued to surge, reflecting the uptick in investment activity and high import content of some exports.** The import bill in the year to September is estimated at $124 billion, up 15.6 percent year-on-year compared to 11.6 percent growth in the same period in 2014. Imports of machinery, equipment, and intermediate goods have increased by nearly 30 percent. Such growth indicates ongoing capacity extensions of production facilities, reflecting positive investor sentiment. But the emerging trade deficit also points to underlying structural weaknesses in Vietnam's export sector where major exports—including garments, electronics, and footwear—have high import content requiring imports of raw material and intermediate inputs.

Table 3: Vietnam's merchandise imports

	Share of total (%)			Growth (%)		
	2014	9M-14	9M-15	2014	9M-14	9M-15
Total import value	100.0	100.0	100.0	12.0	11.6	15.6
Machinery and equipment	15.2	15.0	16.7	20.0	21.0	29.3
Intermediate goods	21.6	21.1	23.5	8.1	2.3	28.6
Materials	22.8	23.0	21.1	12.2	13.6	6.0
Petroleum products	5.1	5.9	3.2	8.0	22.7	-35.8
Products	8.0	7.8	8.5	23.9	22.9	25.3
Others	27.3	27.2	26.9	8.3	7.2	18.6
Domestic sector	*43.0*	*43.6*	*40.9*	*10.5*	*13.1*	*8.8*
Foreign-invested sector	*57.0*	*56.4*	*59.1*	*13.1*	*10.5*	*20.8*

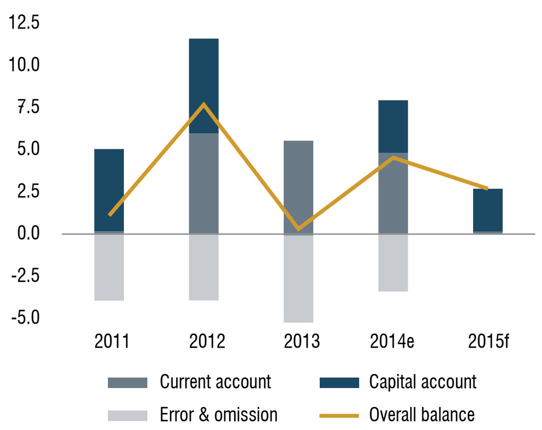
Source: General Department of Customs

22. **Overall Vietnam's trade position weakened during 2015, narrowing the current account surplus.** Imports grew faster than exports in the first nine months, resulting in an emerging trade deficit of nearly USD 4 billion, compared with a surplus of US$ 2.6 billion in the same period of 2014. After posting a current account surplus of about 5.4 percent of GDP in 2011–14, the current account narrowed to an estimated 0.2 percent of GDP at the end of the first half of 2015. The trade deficit (for goods and services) and transfer payments related to the repatriation of profits in the FDI sector were only partly offset by robust remittance inflows.

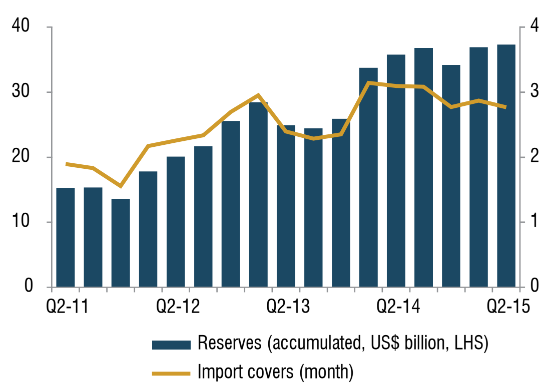
23. **Despite a weaker current account, external financing risks were mitigated by robust FDI inflows and long-term concessional borrowing.** Strong and diversified FDI inflows and external loans bolstered the financial account and allowed for a further build-up of reserves. FDI disbursements rose 16.3 percent to about USD 11.8 billion in the first ten months of 2015. External debt rollover rates also remained solid, aided by stable official inflows. This allowed for a continued gradual build-up of international reserves to about 2.8 months of imports by the end of Q2 in 2015—up slightly from 2.7 months at the end of 2014.

Figure 10: Current account surpluses and robust FDI have allowed for a gradual build-up of reserves, if from a low level

Balance of payments (% of GDP)



Foreign reserves



Source: SBV and WB estimates.

I.3. Medium-term Economic Outlook and Risks

24. **The medium-term outlook for Vietnam is on balance positive.** GDP growth is expected to accelerate to around 6.5 percent in 2015 and to strengthen further in 2016, underpinned by a continuing recovery in domestic demand, particularly private consumption and investment growth. On the supply side, growth is expected to continue to be led by manufacturing and construction. Moderate inflation expectations reduce the likelihood that the SBV will tighten monetary policy over the short term. Inflation is expected to remain low on account of low global energy and food prices before rebounding somewhat in the medium term. The trade balance is projected to narrow significantly this year due to a combination of moderating exports and sustained import growth stoked by stronger domestic economic activity. However, robust remittances will keep the current account in surplus, if at a much lower level than last year. The fiscal deficit is expected to remain high this year, but start adjusting through consolidation efforts to avoid further increases in public debt, which remains sustainable but hinges on the envisaged fiscal consolidation program and is subject to substantial risks.

25. **While the baseline outlook for Vietnam is positive, downside risks dominate.** Given limited policy buffers, external and domestic shocks could jeopardize macroeconomic stability. On the domestic front, slow structural reform poses significant risks to the medium-term growth prospects. Fiscal risks are also substantial, and delays in implementing fiscal consolidation could seriously undermine debt sustainability. Growing expenditure pressures from high recurrent expenditures, including the wage bill, could make efforts to reduce the deficit challenging. Fiscal risks are further aggravated by contingent liabilities associated with SOE debt and state-owned banks. With credit growth accelerating, risks in the banking sector, including possible overheating, are also intensifying and—if not managed prudently—could result in renewed instability with adverse impacts on growth. The external environment remains broadly favorable for Vietnam, but emerging external risks call for a continuing focus on sound macroeconomic management to safeguard against possible shocks. Fiscal consolidation, more exchange rate flexibility, and further bolstering of reserves could all help reduce vulnerabilities.

Table 4: Vietnam short-term economic indicators

	2013	2014	2015/e	2016/f
GDP growth (%)	5.4	6.0	6.5	6.6
CPI (annual average, %)	6.6	4.1	1.5	3.0
Current account balance (% of GDP)	5.6	4.8	0.1	-0.2
Fiscal balance (% of GDP) - *GFS definition*	-7.4	-6.2	-6.9	-6.4
Public debt (% of GDP) – *MOF definition*	54.5	59.6	61.3	63.2

Source: GSO, MOF, SBV, and WB.

I.4. An Update of Structural Reform Progress

I.4.1. The business environment

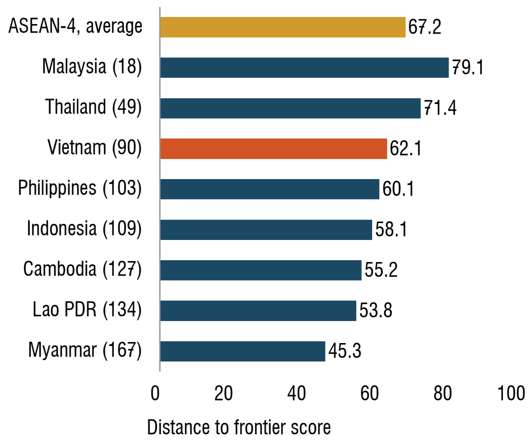
26. **Vietnam's ranking on the Doing Business survey has risen from 93rd position in DB2015 to 90th in DB2016 among 189 economies.** But its competitiveness is still ranked below the average for ASEAN-4 countries, with slow improvements in the institutional framework, infrastructure, and business environment. Highlighted are problems with tax payment times, protections for minority investors, access to electricity, and dealing with business insolvency.

27. **Legislative reforms do not always translate into effective implementation, reflected in discretionary application of laws and regulations.** In particular, the tax administration remains cumbersome and imposes high compliance costs on the private sector. While the process for obtaining business permits has improved, weak investor protections and insolvency frameworks continue to undermine incentives for productive firms to invest. Despite Vietnam's trade openness and the move toward the ASEAN single window, border clearance procedures remain less efficient than in other ASEAN economies.

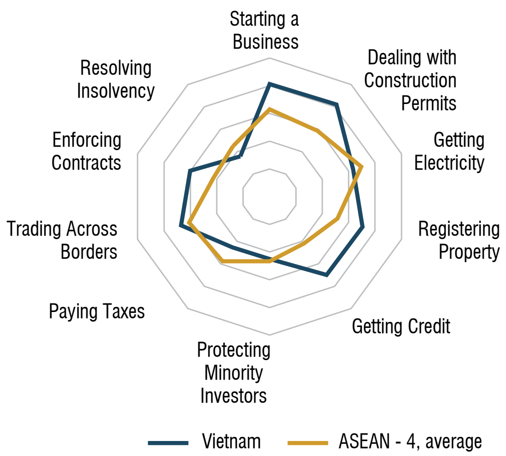
28. **The government continued to take steps to improve the investment climate.** In 2015, it made further progress with the issuance on March 12, 2015 of resolution 19/NQ-CP/2015 on key duties and solutions to improve business environment and national competitiveness in 2015–2016. This resolution aims to lower tax payment period to 121.5 hours a year as maximum, develop and disclose the database on VAT refunds, and rapidly shorten processing times for clearing exports and imports of goods to 13 and 14 days, respectively.

Figure 11: Despite recent improvements, challenges remain across several dimensions of the business climate

Overall scores



Score by components

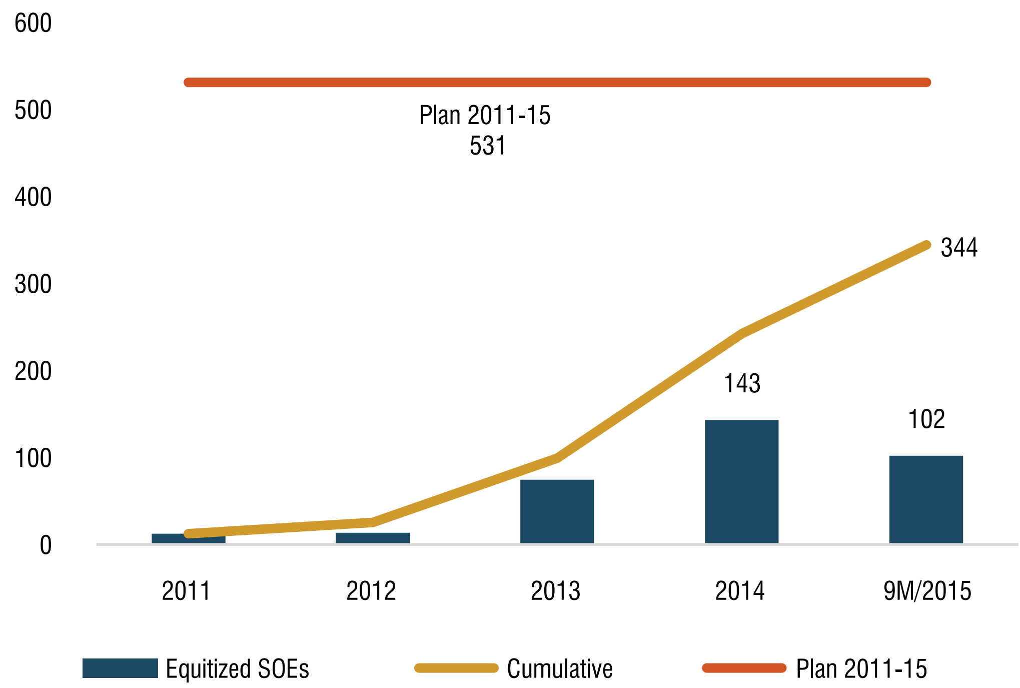


Source: World Bank Doing Business 2016.

I.4.2. Reform of state-owned enterprises

29. **The pace of the equitization process has picked up but appears to be inadequate for meeting the government's 2015 target.** By the end of September 2015, Vietnam equitized 344 SOEs, including several mother companies of the large State Economic Groups and General Corporations. While it is unlikely that Vietnam will meet its target to equitize 531 SOEs in 2011–15, the performance is considerably better than the achievement in the previous SEDP 2006–10, during which Vietnam could achieve only 30 percent of its equitization target. Recently, the government announced a plan to disinvest fully from big and well-performing SOEs such as Vinamilk and FPT (Corporation for Financing and Promoting Technology). This move could provide a good momentum to speed up the slower-than-expected process of SOE reform in Vietnam.

Figure 12: SOE equitization progress: 2011–15



Source: Government authorities.

30. **Progress in improving corporate governance depends largely on the effective implementation of newly adopted legal documents.** At present, the government is yet to prepare all the necessary implementation decrees and circulars. Some decrees became effective recently, such as Decree 87 (from December 1, 2015), Decree 91 on the Management of State Capital Invested in Enterprises (from December 1, 2015), and Decree 81 on public disclosure of operational and financial information of SOEs (from November 5, 2015). These three decrees imposed a sound M&E framework for SOEs, relating not just to financial performance but also to nonfinancial information such as corporate governance or strategic plans. The adoption of new requirements in information disclosure has already begun in some SOEs, and a further roll-out of these practices is expected in 2016. The SEDP 2016-20 also makes clear that objectives of the SOE reform will include further separation of state regulatory functions from exercise of state ownership, improved professionalism of the board, and separation of SOE commercial objectives from social obligations.

I.4.3. Banking sector reformt

31. **Strengthening oversight and regulation of the banking sector continues to be one of the top priorities of financial sector reform.** The SBV has concentrated on promulgating stricter prudential regulations, applying better risk management for the system (by gradually phasing in Basel II principles), and following a multi-pronged approach to NPL resolution (in which the establishment of the Vietnam Asset Management Company—VAMC is a key tool). Circular 02 (issued in 2013 and fully in force in April 2015) is a good step toward international good practices in calculating NPL classifications. In addition, Circular 36 (issued in late 2014) sets better standards for transparency in banking operations and helps address cross-ownership issues believed to pose a systemic threat to sector stability. The Circular shows the SBV's good effort in phasing in Basel II principles in Vietnam's banking sector.

32. **Consolidation in the banking sector accelerated during the first half of 2015, mainly through forced mergers and acquisitions (M&As).** Unlike previous years, when consolidation was driven mostly by mergers of smaller (and weaker) banks, 2015 witnessed acquisitions of smaller banks by major state-owned commercial banks (SOCBs). Moreover, rather than allowing weak banks to declare bankruptcy, the SBV also took over three smaller banks and placed experienced SOCB management in key positions to turn their operations around. There were also a few mergers among healthier joint-stock commercial banks. Most, if not all, of the M&As are facilitated by the regulators to consolidate the banking sector, address cross-ownership, and reduce systemic risks. Despite the increasing number of M&As, the target of reducing the total number of commercial banks to 15–17 by 2017 remains a challenging task (currently, there are 34 commercial banks, compared with 42 before the sector reform, due to 8 M&As).

33. **Despite the authorities' efforts, resolving bad debts in the banking sector remains a critical challenge.** The Vietnam Asset Management Company (VAMC) continued to absorb bad assets, but the workout has been slow. While reported systemwide non-performing loans have declined to about 3 percent of total loans, some of the decline is due to transfers of NPLs to VAMC, which had purchased VND 226 trillion (roughly USD 10 billion) of bad debts as of October 2015. New regulations that take effect on October 15, 2015, will introduce a fair-market-value mechanism for NPL purchases by VAMC and allow it to be more flexible in the disposal of NPLs, such as through direct sale of bad debts. These are positive steps that could help resolve NPLs quickly, without too much loss of value.

34. **Looking forward, banking regulation and supervision are still under development, and the room for improvement is considerable.** The level of compliance with the Basel Core Principles (BCPs) is still low. The combination of the prudential supervision function (focused on the safety and soundness of the banking system) and the "general inspectorate" function (focused on investigating violations of administrative procedures) has undermined the core prudential supervision function performed by the SBV. On-site inspections of SOCBs by the SBV have not been conducted for several years, partly to avoid overlap with inspectorate visits by the General Inspectorate and State Audit Office. Off-site monitoring is still in its inception. The regulatory framework contains some provisions related to cross-border banking supervision, but there are still significant supervisory gaps regarding the overseas operations of local banks. The SBV has multiple objectives, and its independence is limited, compromising the capacity of the supervisor to exercise the powers that are granted by legislation. On the positive side, Vietnam has an adequate framework for permissible activities, providing a base for appropriate coverage of regulatory framework over deposit-taking institutions.

SECTION 2: TRANS PACIFIC PARTNERSHIP AGREEMENT

II.1. Background

35. **After more than five years of negotiations, the Trans-Pacific Partnership (TPP) was concluded on October 5, 2015, at a meeting of Trade Ministers in Atlanta, United States.** The TPP brings together 12 prospective members, including Australia, Brunei Darussalam, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, and the United States, along with Vietnam. The combined GDP of the TPP market is equal to US$ 28 trillion, or about 36% of world GDP, and accounts for more than a quarter of world trade.

Table 5: Vietnam and TPP members

	Nominal GDP 2014 (US$ billion)	GDP per capita 2014 (US$)	Share of Vietnam's exports (%)	Share of Vietnam's imports (%)	Share of Vietnam's FDI stock (%)
Australia	1,454	61,887	1.9	1.3	0.7
Brunei Darussalam	17	41,344	0.0	0.0	0.6
Canada	1,787	50,271	1.5	0.3	1.9
Chile	258	14,528	0.4	0.2	0.0
Japan	4,601	36,194	8.7	8.7	14.3
Mexico	1,283	10,230	1.0	0.3	0.0
Malaysia	327	10,933	2.3	2.5	4.1
New Zealand	188	42,409	0.2	0.2	0.0
Peru	203	6,551	0.1	0.0	0.0
Singapore	308	56,287	2.1	3.8	12.6
United States	17,419	54,629	20.6	4.8	4.2
Vietnam	186	2,052			
Total			*38.8*	*22.2*	*38.3*

Note: GDP and per capita GDP for 2014, New Zealand for 2013.

Source: World Bank WDI 2015, MPI, and Vietnam General Department of Customs.

36. **Vietnam has strong trade and investment links with TPP members.** They account for 38.8 percent of exports, 22.2 percent of imports, and 38.3 percent of foreign direct investment stock of Vietnam. The US, Japan, Malaysia and Singapore are among Vietnam's top ten investors and trading partners. Vietnam's participation in the TPP, in line with its continuing efforts toward increased global integration, follows on from major trade liberalization efforts over the past two decades. In addition to lowering tariffs on goods trade are agreed measures to lower barriers to service trade and non-tariff measures (NTMs), enforce intellectual property rights, and reduce the role of state-owned enterprises in markets—all improving the basis for further structural and institutional reforms in Vietnam.

37. **The TPP opens new trade and investment opportunities for Vietnam in the Asia-Pacific region.** The TPP is being promoted as a high standard trade agreement, which will improve market access for goods and services through the reduction of tariff and non-tariff measures (NTMs). As a leading supplier of light and medium manufactures in the Asia-Pacific region, Vietnam stands to obtain preferential access to some of the wealthiest markets in that region, such as the United States and Japan. The benefits are potentially considerable, but so are the costs and the risks, particularly during implementation of wide-ranging commitments. The following analysis, based on available references, presents a preliminary snapshot of the opportunities and challenges facing Vietnam as a TPP signatory. Further in-depth analytical work will be needed based on recently disclosed detailed commitments under the TPP.

II.2. Scope of the TPP

38. **The TPP is a comprehensive and deep trade agreement, comprising not only enhanced market access but also wide-ranging commitments on government procurement, regulatory quality, workers' rights, environmental protection, and intellectual property rights.** The TPP includes 30 chapters covering trade and trade-related issues. While the specific commitments have been published only recently, the agreement broadly covers tariff barriers to trade in goods, customs and trade facilitation; sanitary and phyto-sanitary measures; technical barriers to trade; trade remedies; investment; services; electronic commerce; government procurement; intellectual property; labor; environment; 'horizontal' chapters meant to ensure that the TPP fulfils its potential for development, competitiveness, and inclusiveness; dispute settlement, exceptions, and institutional provisions.

39. **In addition to updating traditional approaches to issues covered by previous free trade agreements (FTAs), the TPP incorporates new and emerging trade issues and cross-cutting issues.** These include issues related to the Internet and the digital economy, the participation of state-owned enterprises in international trade and investment, and the ability of small businesses to take advantage of trade agreements. Recognizing the depth of the related policy commitments, the agreement is expected to be accompanied with capacity-building for the less-developed TPP countries, and in some cases special transitional periods and mechanisms that offer some TPP partners additional time, where warranted, to develop capacity to implement new obligations.

40. **Trade liberalization remains a significant component of market access under trade agreements such as the TPP, particularly for Vietnam.** While many countries have lowered average tariffs to below 10 or even 5 percent, tariff peaks remain. For example, in the US market, tariffs on wearing apparel imports range between 10 and 32 percent, depending on the class of good (man-made fiber knit products generally draw the highest tariffs). Agricultural goods are still governed by tariff rate quota systems, which can lead to tariff rates that may be prohibitive in products such as dairy, meat, and rice. Finally, Vietnam is at an earlier stage of development than many TPP countries; tariffs are still employed to protect infant industries, leading to tariffs which can exceed an average of 10 or 20 percent on a wide range of products.

41. **In addition, the TPP is being heralded as a comprehensive agreement that also covers significant commitments on the reduction of non-tariff measures.** Barriers to service trade can include local laws and regulations or licenses and registrations (perhaps available only to local companies), or outright prohibition of foreign-service providers practicing outside their home countries and markets. In goods trade, non-tariff measures can include sanitary and phyto-sanitary regulations and technical barriers to trade, which might include labeling requirements, testing mandates, or other specifications that prove a barrier to importing goods.

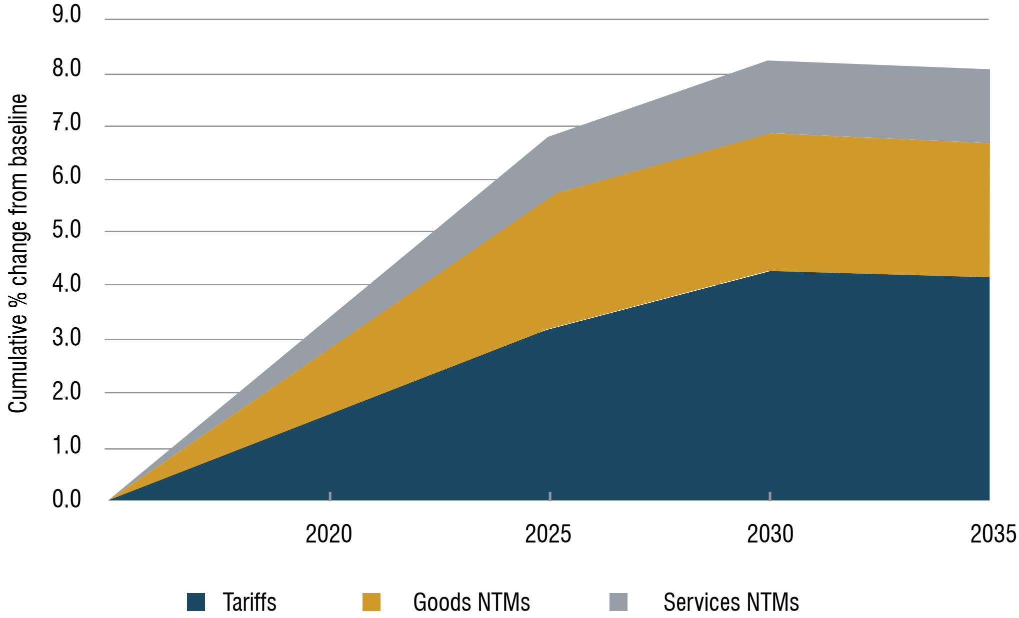
II.3. Estimating the impact of the TPP

42. **The TPP is expected to generate considerable benefits for Vietnam in trade, investment, growth and job creation.** Among the current TPP signatories, Vietnam—as the economy with the lowest per-capita GDP—has unique comparative advantages, particularly in labor-intensive manufacturing and in sectors currently subject to high tariffs, such as textiles and garments. By enhancing access to key export markets, the TPP is expected to boost overall trade. It is also expected to lead to further increases in (already considerable) FDI inflows to build up export capacity, including in upstream suppliers to sectors subject to strict rules of origin (such as textiles and garment).

43. **Preliminary results suggest that the TPP could add as much as 8 percent to Vietnam's GDP, 17 percent to its real exports, and 12 percent to its capital stock over the next 20 years.**[2] TPP projections suggest that this regional trade agreement could increase cumulative real GDP in Vietnam by more than 8 percent in 2030 (box 1). The main source of this increase in real GDP for Vietnam is projected to be tariff reductions in the TPP region—textiles and apparel in particular, where US tariffs remain high at over 17 percent ad valorem. Reductions in goods and services NTMs also promise to contribute significantly to Vietnam's growth (figure 13). Investment in Vietnam is projected to increase by more than 20 percent under the TPP, substantially increasing capital stocks and long-term growth. Wages are projected to increase in five occupational categories over 2020–2035, with the highest growth in wages for low-skilled workers.

[2] These estimates were originally prepared on March 2015 (Minor, Walmsley, and Strutt 2015). Negotiations to finish the TPP concluded on October 5, 2015, and the near-final text was released on November 5, 2015. Differences between the TPP as finally agreed and the TPP as anticipated in the analysis could yield alternative estimates of TPP impacts, as noted in the text box.

Figure 13: TPP impacts (2015–35) on GDP



Note: Cumulative percent change relative to mid-growth baseline.
Source: Minor and others, 2015.

Box 1. Results from the GTAP model

The results in this note are based on the Dynamic Global Trade Analysis Project (GTAP) model, a multiregion, multisector, computable general equilibrium model, with perfect competition and constant returns to scale. The specification for this simulation included consumer demand specifications and intersectoral factor mobility. The dynamic model incorporates investment behavior that allows for the gradual equalization of rates of return over time. The choice of sectors and regions in the aggregation reflects the focus on the Vietnamese economy: important sectors and trading partners of Vietnam have been selected, with the rest of the world divided into low-middle, upper-middle and high income, based on World Bank classifications.

The results of this simulation need to be interpreted with caution. They depend on the underlying assumptions of the model both in the macroeconomic parameters and the policy changes, including the speed and quality of implementation of commitments.

Assumptions

The results consider the impacts of reductions in tariffs on goods and in non-tariff measures on goods and services. Given that the detailed commitments were only published recently, the simulations are not based on specific commitments. Instead, the model incorporates the following assumptions:

- **Tariffs:** Reduction of tariffs to zero with 1 percent sensitive products (approximately 50 HS6 lines), a 15 year phase-out, and 65 percent of tariff lines free. Phase-out starts 2016.
- **Goods non-tariff measures:** Reduction to match the top quintile in the TPP region phased in over five years from 2016 to 2020.
- **Services non-tariff measures:** Reduction to match the top quintile in the TPP region, phased in over five years from 2016 to 2020

Differences between these assumptions (adopted for estimates completed in March 2015) and the TPP as finally agreed in October 2015 and published in November 2015 would yield alternative results if the actual provisions had been incorporated into the analysis. These differences are in the following areas, among others:

- The market access provisions of the TPP specify the actual products shielded from tariff reductions, or subject to tariff rate quotas. The identities of these products were not known when the simulation analysis was completed. Instead, a proxy for the list of exempted products was based on the assumption stated above. Moreover, the ability to exploit increases in market access may be modified in the actual TPP by the operation of rules of origin, also not known precisely when the estimates were made and which are challenging to model.
- In the area of goods NTMs, the TPP as finally agreed provides for a series of consultations to promote common regulatory practices, focused on an enumerated list of sectors (chapter 8, "Technical Barriers to Trade"). Actual harmonization or mutual recognition of regulations, which could lead to reduction or elimination of NTMs, will presumably emerge from these consultations. For the simulation, it was necessary to estimate the overall reduction in the economic effect of NTMs in the absence of this information, based on the above-stated assumption.
- In the area of services NTMs, the extent of actual liberalization achieved by the TPP is defined in the provisions and annexes of chapter 10, "Cross-Border Trade in Services," which specify the application of national treatment, most-favored-nation treatment, and market access on a "negative list" basis. This information also was not available when the simulation analysis was conducted, and was proxied by the above-stated assumption.

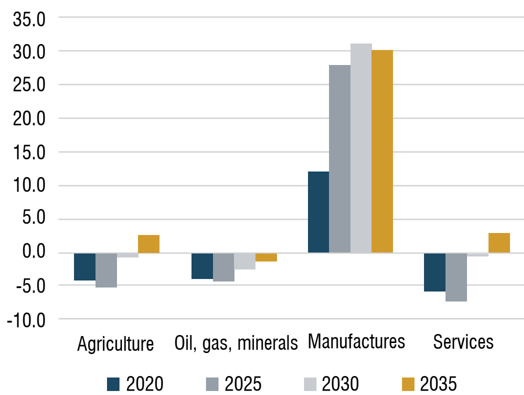
Source: Minor and others, 2015.

44. **The TPP will facilitate market access and improve export opportunities for Vietnam.** Most tariffs and many non-tariff barriers on industrial goods will be eliminated and reduced almost immediately, and tariffs and other restrictive policies on agricultural goods will be eliminated or reduced over time. Both exports and imports are projected to rise under the impact of the TPP agreement, as a result of lower trade costs (table 6). Market access, especially to the United States and Japan, is particularly important to Vietnam. While boosting overall trade (trade creation), the TPP would also result in opportunities for trade diversion, as Vietnamese exports would likely replace a share of exports of non-TPP countries (including China) to the US market. At the same time, imports would surge, reflecting a pick-up in investment and intermediate goods.

Table 6: TPP impacts on key economic indicators, 2015–35

	2020	2025	2030	2035
Real GDP	3.6	6.8	8.2	8.1
Real exports	5	13.4	16.8	17.1
Real imports	7.6	15.7	16	14.2
Real investment	13.6	21.3	15	6.3
Capital stock	3.1	9.3	12.9	11.9
Change in trade balance (billions US$)	-4.9	-9.1	-6.1	-.2

Figure 14: Real exports change, by major sector, 2020–35



Note: Cumulative percent change relative to mid-growth baseline.
Source: Minor and others, 2015.

45. **The TPP would be expected to reinforce the further diversification of Vietnam's export basket toward manufacturing exports.** As discussed in more detail in the main section of this taking stock report, Vietnam experienced a rapid transformation of its export basket over the past decade - away from primary exports toward higher value manufacturing exports. The TPP is expected to further accelerate this process, with real exports expected to rise, especially in manufacturing. Manufactured exports - about 58.1 percent of Vietnam's exports today - are expected to increase by about 30 percent over the baseline in 2035, while all other sectors - agriculture, services, oil, gas, and minerals - would decline modestly.

- **The textiles, apparel, and leather (including footwear) sector is expected to realize considerable gains in export growth.** Tariffs on these products in the TPP region are among the highest, averaging 17.1 percent on US imports of these products from Vietnam and averaging from 7.7 percent in the TPP-Asia region to 20.6 percent elsewhere in the TPP region. As a result, Vietnam's exports of textile and apparel products are projected to increase by about 60 percent above baseline real exports in 2035. The United States is the primary destination in the TPP region (20.9 percent) with the highest increase in exports (218.8 percent). The sector's high labor intensity and strong export orientation make it extremely important for employment creation. The Vietnam textile apparel association (VITAS) estimates that every $1 billion increase in textile and apparel exports creates 150,000 to 200,000 jobs. So the sector is strategic for both exports and jobs. But the TPP's rules of origin could limit the potential positive impacts (see below).

- **Commodity exports are expected to continue to decline.** Oil, gas, and mineral exports - about 16.5 percent of Vietnam's exports in 2015 - would continue to decline as a result of TPP. Agricultural exports - about 15.4 percent of exports in 2015 - would also decline, underpinned by a broad-based contraction of major export commodities from rice and grain to processed food and forestry products (wood) during 2015 - 2025. This is mainly reflecting accelerated structural transformation with more production factors reallocating to manufacturing.

46. **The TPP would also boost Vietnam's imports, reflecting Vietnam's integration in global value chains.** Imports of manufactured goods, mainly intermediate products (with a two-thirds share of the baseline 2015 imports), would increase at a much higher rate than agriculture (10 percent share of the baseline 2015 imports) and services (figure 17). Under the baseline scenario, textile, apparel, and leather imports (14.9 percent of total imports) would grow to more than 50 percent of baseline imports. The rapid rise in textile, apparel, and leather imports mirrors the increased production and exports of these products, which in turn require imported intermediate products and materials of fabric, dyes, and rubber. Again, rules of origin would impose limitations on the use of inputs from non-TPP countries in the textile, apparel and leather sectors. Given the strict rules of origin, these imports would originate predominately from the TPP region. Imports of textiles and apparel from the TPP region would grow by 151.3 percent and 203.7 percent from TPP countries in Asia and the US, respectively.

Figure 15: Percent change in real imports, by major sector, 2020–2035

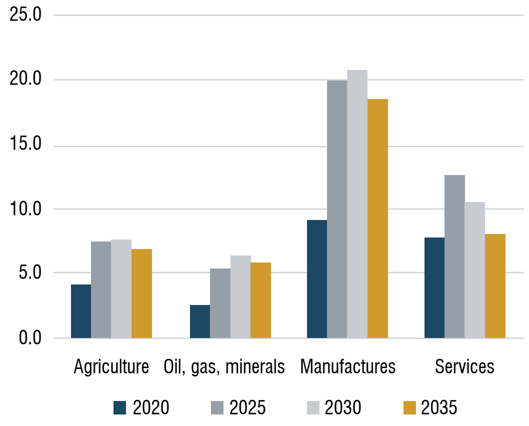
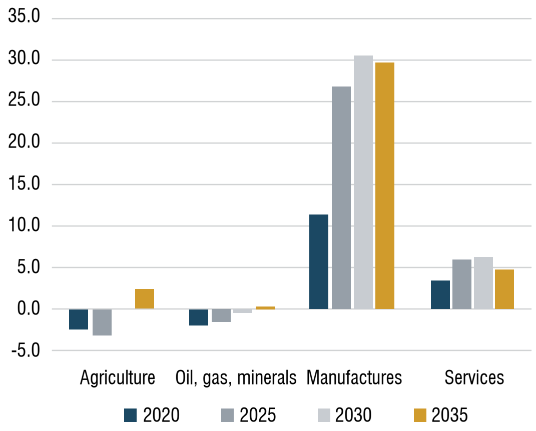


Figure 16: Change in real output, by major sector, 2020–2035



Note: Cumulative percent change relative to mid-growth baseline.
Source: Minor and others, 2015.

47. **The TPP is expected to facilitate further structural transformation of Vietnam's economy.** Real output in manufacturing could grow by a cumulative 30 percent above the baseline level (figure 18). Services would grow by about 5 percent over the baseline. Agricultural output and oil, gas and minerals both are expected to decline slightly from baseline growth, but as investment increases, and capital prices decline, output recovers somewhat. The projected decreases in agricultural output are greatest in the first few years of the TPP, before investment and capital stocks respond. In the long run of 2025-35, changes in investment and factor costs attenuate the initial decreases in production from baseline growth.

48. **The TPP is also expected to stimulate investment.** It is projected that investment would increase significantly relative to the baseline from 2015 through 2025, peaking at nearly 23 percent above the baseline. But this stimulation would diminish in 2025–35. The rise in investment is driven by the increasing rate of return, a function of capital costs and the rental rate of capital, in turn influenced heavily by the rise in manufacturing exports to TPP markets. As a participant in the TPP, Vietnam can be expected to attract even larger flows of quality foreign investments, especially FDI allocated in upstream clusters of beneficial sectors, such as textiles, apparel, and leather.

49. **Perhaps most important, the TPP is expected to anchor and accelerate domestic structural reforms.** The TPP is not only removing trade barriers and enhancing market access to key export markets, but it will also have tangible impacts on regulatory quality, intellectual property rights, investor protection, competition, SOE management, labor and environmental standards, food safety, public procurement, and liberalization of services, including financial services and telecommunications. Many TPP chapters will stimulate institutional reforms to strengthen and standardize rules and transparency and support the creation of modern institutions in Vietnam. Implementing these commitments will be particularly challenging for Vietnam—given its gradual reform path and institutional legacies (large SOE sector, incomplete market institutions). But it has shown in its accession to WTO that it can leverage external commitments to advance domestic reforms, especially in challenging reform areas.

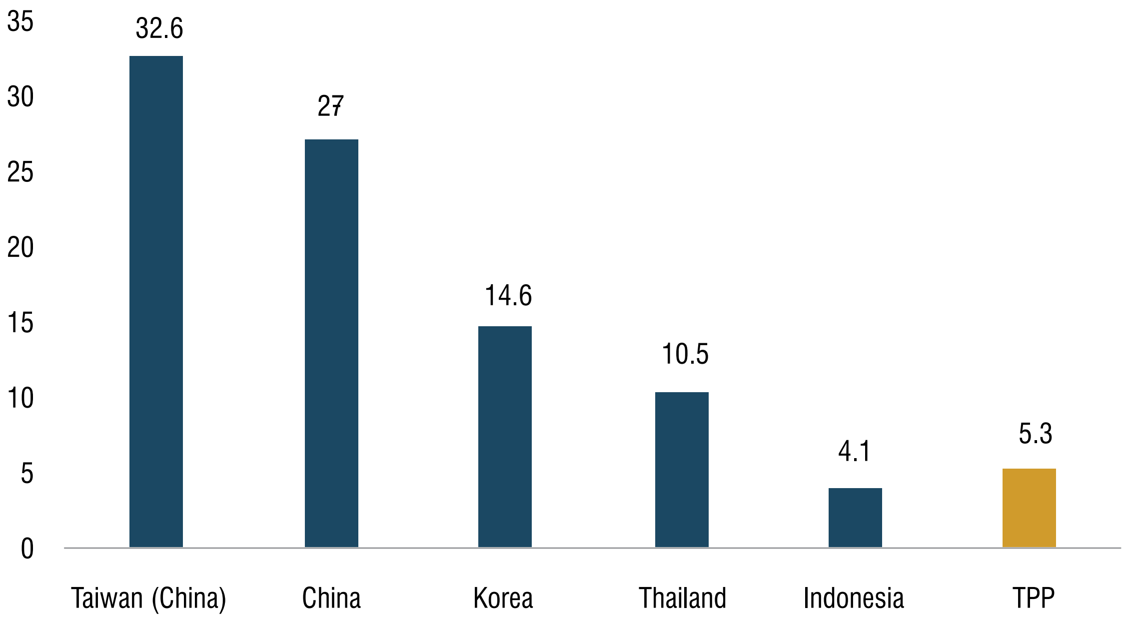
50. **So the TPP could support a more competitive and innovative economy.** Over the longer term, it is not just the growth rate of exports that matters—it is also the composition of exports, particularly the level of technology they embody. Despite Vietnam's good performance in recent years, such as between 2008 and 2013, high technology exports increased from 5 percent of manufactured goods exports to 28 percent, comparable with China and higher than the ASEAN average. But domestic value added is still relatively limited. As mentioned, under the TPP, larger flows of quality foreign investment can be expected in Vietnam, directed particularly to ancillary industries of beneficial sectors, such as textile, apparel, and leather. That will shape appropriate domestic supply

chains while stimulating domestic private firms to integrate more into global value chains and further boost value added exports.

51. **Given Vietnam's high dependence on imported materials in key sectors, the TPP's restrictive rules of origins could limit Vietnam from maximizing TPP benefits, at least in the short term.** Most imported yarn and fibre used by Vietnam's garment producers are sourced from non-TPP territories (figure 20). Some 60-90 percent of Vietnam's textiles come from other countries, mostly from China and Taiwan. A large part of Vietnam's current exports in the sector would likely not comply with TPP rules of origin requirements. The textile sector would have to restructure toward backward integration to maximize the TPP benefits. While this poses a challenges in the short term, FDI in upstream businesses is expected to build up needed production capacity.

52. **Rules of origin also create opportunities for industrial restructuring and deepening of domestic value added in Vietnam.** The need to restructure textile and apparel toward backward integration could facilitate domestic enterprises, including SMEs to expand domestic supply chains and take part in global value chains (GVCs). This move would enable capturing more value-added and lead to learning and the accumulation of knowledge capital. This is underpinned by increased FDI. As the private sector responds to take advantage of the TPP, Japanese, Chinese and South Korean firms are investing heavily in fibre production in Vietnam. The Texhong Textile and Garment Group (Hong Kong) is building a $300 million yarn plant for the first phase in Quang-Ninh province. The 100-percent Korean-owned Kyungbang Company started construction on a $40 million spinning mill in Binh Duong. VINATEX Kien Giang is investing VND 150 billion in a garment factory in Binh Duong. And another $1 billion in FDI is in the pipeline.

Figure 17: Imported yarn and fiber (% of import value)



Source: Vanzetti and Pham 2014.

53. **But the investment in upstream and ancillary industries, especially in textiles, needs to be accompanied by sound regulation to mitigate environmental impacts.** Investments in textile manufacturing—particularly the dyeing and finishing of fabric— can have enormous environmental impacts. These industries are not only extremely water intensive, but also heavily polluting, discharging waste water and pollutant loads. There is a risk that Vietnam's use of polluting textile chemicals could increase sharply. To mitigate these impacts, Vietnam will need to adopt environmental policies to encourage the use of advanced environmentally friendly technology.

II.4. Policy implications

54. **Delivering commitments under the TPP means implementing a comprehensive and decisive domestic reform program.** Behind-the-border issues matter. Among other things, the TPP commitments will affect SOE management, reforms to improve transparency in government procurement, regulatory quality and enforcement, competition policy, and labor and environment standards.

55. **The TPP includes a general commitment by signatories to respect the labor rights enumerated in the International Labour Organization (ILO) Declaration on Fundamental Principles and Rights at Work.** Vietnam made more specific commitments in a TPP side agreement, entitled the United States—Viet Nam Plan for the Enhancement of Trade and Labour Relations. If fully implemented, these commitments would mark a sharp shift from the current structure of labor relations, which has all unions falling under the umbrella of the Vietnam General Confederation of Labour (VGCL), to the leadership of the Communist Party of Vietnam. The key provision is as follows:

> *Viet Nam shall ensure that its laws and regulations permit workers, without distinction, employed by an enterprise to form a grassroots labour union (in Vietnamese to chuc cua nguoi lao dong) of their own choosing without prior authorization…. A grassroots labour union registered with the competent government body shall have the right autonomously to elect its representatives, adopt its constitution and rules, organize its administration, including managing its finances and assets, bargain collectively, and organize and lead strikes and other collective actions related to the occupational and socio-economic interests of the workers at its enterprise.*

56. **The agreement commits Vietnam to put this provision into effect before the date of the TPP's entry into force.** Through a separate provision, Vietnam has committed to allowing grassroots labor unions to form larger organizations across enterprises, within five years from the date of the TPP's entry into force. The agreement foresees technical assistance from the ILO to implement the agreement.

57. **While Vietnam is doing well in terms of competitiveness, there connectivity challenges.** Vietnam's investment in connective infrastructure has shortened many economic distances. In manufacturing and agriculture, trade costs are much lower than expected for the economy's development, and these costs have fallen sharply, particularly in manufacturing. Today, Vietnam is ranked 48 of 160 countries in the 2014 Logistics Performance Index, highest among the lower middle-income countries (outperforming Indonesia, India, Philippines, etc.) and improved from the 2012 ranking (53). But it lags behind its higher-income competitors, including China, Malaysia and Thailand. To make the most of the opportunities in the TPP, implementing these commitments could be accompanied by furthers steps to enhance Vietnam's competitiveness, including investments in roads, power, ports, and logistics services and further efforts to enhance the efficiency of border clearance procedures. Despite the recent progress in customs reform and the implementation of the National and ASEAN Single Window, the compliance costs in time and money for goods clearance on and behind the border remain high in Vietnam. Recent research outcomes show that most of the high compliance costs relate to non-customs barriers, or NTMs. More than 200 trade-related procedures and NTM-related licenses are regulated and required through a complex set of legislative documents and regulations. These licenses, managed and granted by a number of state management agencies, are not always consistent, and the state management agencies do not always coordinate with each other well.[3]

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[3] Including but are not limited to the Ministry of Industry and Trade (MOIT), the Ministry of Agriculture and Rural Development (MARD), the Ministry of Transport (MOT), the Ministry of Planning and Investment (MPI), the Ministry of Resources and Environment (MORE), the Ministry of Health (MOH), the Border Defense Force of the Ministry of Defense (MOD), the Economic Police of the Ministry of Public Security (MPS), the Ministry of Science Technology and Environment (MOSTE), the Ministry of Culture, Sports, and Tourism (MCST), the Ministry of Construction (MOC) and the State Bank of Vietnam (SBV)

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