

Macro Dev

Vietnam at a
crossroads: avoiding
the middle-income
trap while addressing
climate challenges

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Summary: Following three decades of strong growth (7% on average) which enabled the country to eradicate extreme poverty and reach middle-income status, Vietnam continues to offer highly attractive prospects. Socio-political stability, a cautious policy mix, continually high economic growth, and the size of the domestic market of 100 million inhabitants are all major assets. Vietnam also benefits from a limited public debt ratio. Finally, the economy will continue to build on its strong integration into international trade, where recent upheavals (reconfiguration of value chains related to the Covid-19 crisis and the US-China trade war) have largely benefited Vietnam.

While the economy should rapidly reach upper-middle-income status (by 2025), it will continue to be undermined in the short term by a banking sector that remains undercapitalized, and by structural external liquidity pressures. These two pillars – financial and external – therefore call for particular vigilance, although the associated risks have been substantially lower since the crisis which hit them almost simultaneously in the early 2010s.

In the longer term, the economy could be caught in the middle-income trap if the authorities fail to address two structural issues: firstly, productivity and, more importantly, the fight against climate change. The latter would now appear to be taken very seriously in Vietnamese planning, which has set the target of achieving carbon neutrality by 2050. However, the numerous strategies which have been issued now need to be harmonized to avoid contradictions, and they must especially be followed up by concrete action. But the heavy bureaucracy and decision-making process related to the vertical power structure remain constraints that hinder the project implementation. Corruption, transparency, and the fragmented nature of statistics also continue, despite some improvements, to weigh negatively on country risk. Public authorities will have a major role to play in addressing these challenges, both through an increase in public investment and improvement in implementation capacity.

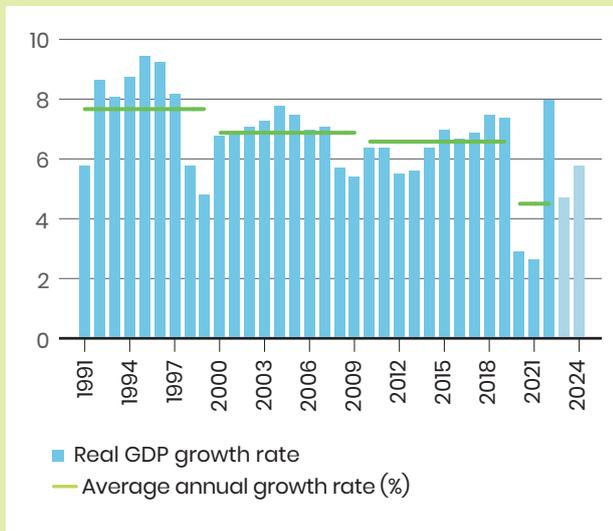
Thematic area: **Macroeconomics**

Geographical area: **Vietnam**

1. Thirty years of success and continuous positive prospects

Three decades of strong growth (7% per year on average) have enabled Vietnam to eradicate extreme poverty and reach middle-income status. This remarkable success lies in both strong socio-political stability and a cautious policy mix (fiscal and monetary policy). These fundamentals are still in place and continue to make Vietnam a prime destination for foreign investors seeking to diversify outside China. In the medium term, the economy should therefore continue to offer attractive growth prospects.

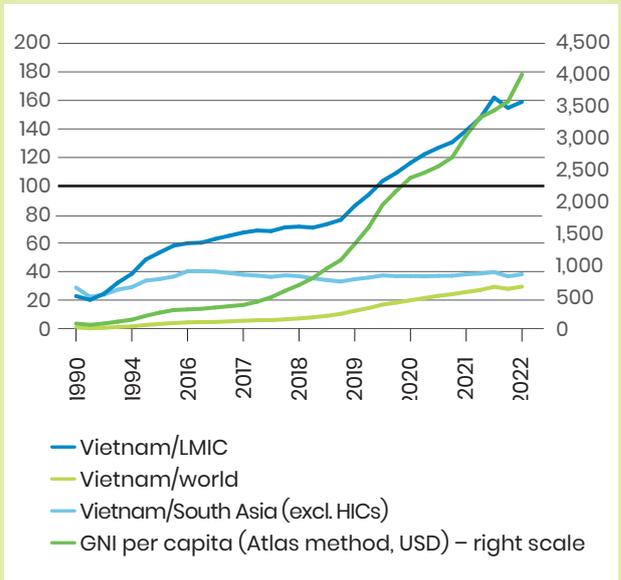
Graph 1: Very robust growth over the long term



Source: IMF (WEO), AFD calculations.

On the heels of the economic opening launched in the late 1980s (*Đổi mới*), Vietnam experienced three decades of robust growth, with an average annual growth rate of 7% (see Graph 1), which enabled it to classify as a middle-income country. Thanks to numerous free trade agreements, the country has managed to position itself in global value chains, partly replacing China which has become less competitive. Exports (in particular textiles, shoes and electronics) are thus one of the spearheads of the economy, along with foreign direct investment (FDI) attracted by a competitive workforce.

Graph 2: Quite remarkable improvement in per capita income



Source: WDI, AFD calculations.

Since 1990, this economic boom has resulted in a 30-fold increase in per capita income (calculated using the World Bank Atlas method) to \$4,000 at the end of 2022, thus firmly establishing Vietnam as a lower-middle-income country (LMIC, see Graph 2). At the expected growth rate, the country will move to the upper-middle-income category (UMICs) by 2025. This growth has been coupled with considerable socioeconomic progress. Extreme poverty has been eradicated in 30 years (45% of the population in 1990, 0.7% at the end of 2020)¹ and the country is now in the category of countries with a high level of human development, just behind Indonesia. Furthermore, the unemployment rate is low (2.3% in June 2023), and there is a moderate level of inequality (Gini coefficient at 35.7% at the end of 2019, prior to the Covid-19 pandemic). These very good results have in particular been facilitated by a stable socio-political environment and a cautious macroeconomic framework, which remain solid foundations for the continued development of the Vietnamese economy.

¹ There has also been a sharp decline in the poverty headcount ratio at the national poverty line (30% in the early 2000s, 4.8% at the end of 2020).

Strong socio-political stability.

Vietnam has a stable socio-political environment based on three pillars: (i) the almost certain continuity of the regime, (ii) a robust social pact, and (iii) a policy of balance and diversification of partnerships in the face of major geopolitical issues.

First, political continuity is ensured by the Communist Party of Vietnam (CPV). This single party, which faces no checks and balances (Vietnam ranks 178th out of 180 in the World Press Freedom Index)^[2] and makes the most strategic decisions behind closed doors, historically ensures great political stability. At this stage, nothing seems to fundamentally call this into question. The major changes at the head of the party and State in early 2023 (including the resignation of President Nguyen Xuan Phuc and the dismissal of two Deputy Prime Ministers) are a case in point. This reshuffle has taken place in the context of an acceleration of the fight against corruption conducted by the CPV for several years. The central political issue is the succession of the General Secretary of the CPV, Nguyen Phu Trong, in office since 2011 and in poor health. Despite the temporary freeze on several investment decisions brought about by this anti-corruption campaign, the latter is also a means of reasserting the primacy of the party over the State, as well as its unity, thereby helping maintain stability.

Second, this political stability is helped by the robustness of the social pact, which the three decades of socioeconomic progress have largely contributed to strengthening. Despite the lack of transparency, persistent corruption, and governance indicators that remain weak (42nd lowest percentile of the World Bank's governance indicators at the end of 2021), risks of social unrest appear limited, especially as the population prioritizes continuity of economic and social progress. The quality of the social pact is also maintained because, despite the firm hand of the CPV over the country, the authorities continue to listen to society. **The defense of national sovereignty is particularly emphasized, a sensitive issue in public opinion and which constitutes the third pillar of the country's stability.**

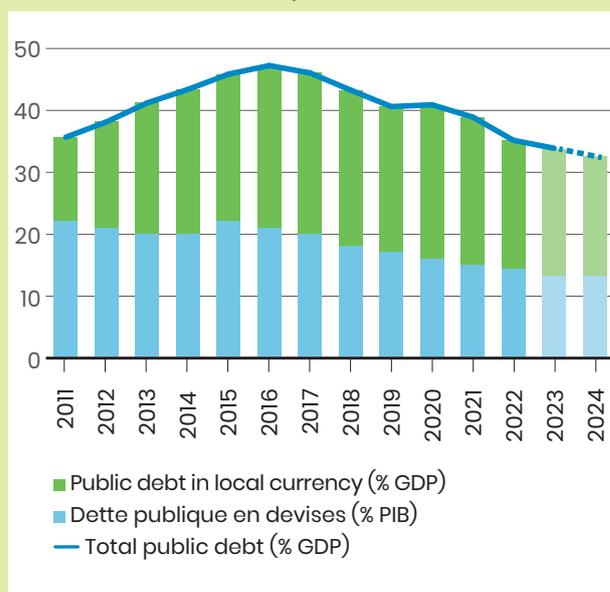
National sovereignty is both territorial (in particular due to issues related to the South China Sea – called the East Sea in Vietnam – with frequent incidents involving fishing boats) and economic. It is inextricably linked to the relations with China. To limit the influence of the latter, Vietnam has strengthened its ties with a number of countries, including the US, both economically (see Section 2) and in terms of security. However, the historical, cultural, ideological and commercial ties (China accounts for 20% of Vietnam's exports and 38% of its imports) are such that China will remain a special partner which it should also avoid offending. In all likelihood, Vietnam will therefore continue a balancing act, consistent with its strategy referred to as "bamboo diplomacy": a flexible and pragmatic strategy, tinged with neutrality and non-alignment (in particular from a military standpoint). By and large, this allows it to protect itself from sources of external instability.

The policy mix remains cautious.

Economic and social progress should also be attributed to cautious and steadily improving fiscal and monetary policies.

First, fiscal policy has led to an improvement in Vietnam's sovereign profile for half a decade.

Graph 3: A moderate and sustainable level of public debt

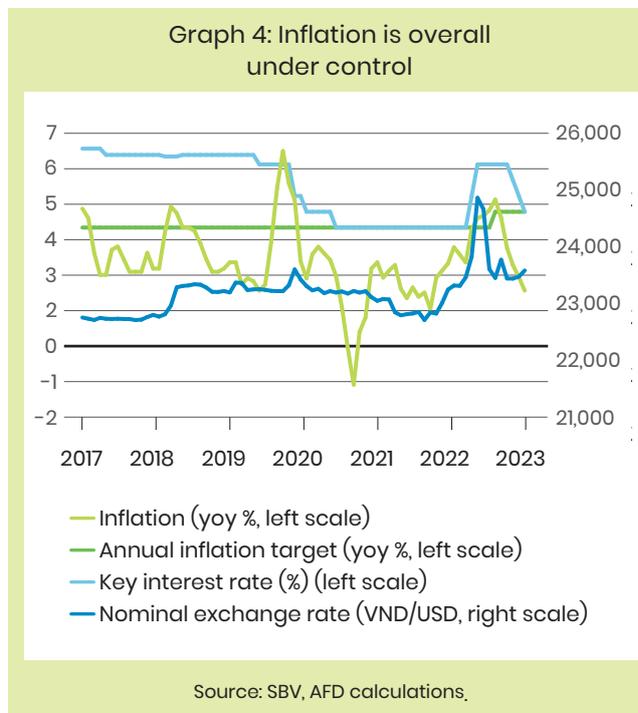


Source: IMF (WEO, Art. IV)

² Reporters Without Borders, 2023 ranking. Only China (179th) and North Korea (180th) are behind Vietnam.

Fiscal consolidation, which started in 2016, is continuing, with in particular primary surpluses in 2018 and 2019 (+0.7% of GDP per year on average). This maintained the overall balance close to balance prior to the outbreak of the Covid-19 crisis (-0.7% of GDP per year on average over 2018-2019). The recovery plans since the pandemic have reversed the situation, but only to a limited extent, as the budget deficit was held at -1.3% of GDP per year on average over 2020-2022. While this consolidation is also helped by chronic under-execution (see Section 3), the budget now appears to be well under control, with the overall deficit falling from -4.1% of GDP per year on average over 2010-2015 to -1.5% of GDP per year over 2016-2022. The deficit is now expected to level off at around -2% of GDP (IMF projection of -1.3% of GDP in 2023). This budget deficit under control, coupled with high economic growth, low interest rates and a fairly stable exchange rate, has helped stabilize then reduce the public debt ratio. It is expected to remain at around 35% of GDP from now until 2025, well below the 60% ceiling set by the authorities (see Graph 3). In addition to the reduction in public debt, the overall sovereign debt profile has improved: decline in the external and foreign currency-denominated share of public debt (less than 40% in 2022, against over 60% in the early 2010s) reducing foreign exchange risk; very long maturities (9 years for local bonds, against 2.4 years in 2013) limiting refinancing risk; low and declining cost of debt (5.8% of government revenue per year on average over 2021-2022, against 7.6% on average over 2013-2020); public financing needs contained at around 4% of GDP per year over the next three years; annual external public debt service limited at ~5% of foreign exchange reserves, minimizing any external public solvency risk. Contingent liabilities remain difficult to estimate due to the still fragmented nature of statistics and a structural lack of transparency. They may in particular arise from the banking sector (see Section 2). However, the risk involved appears to have receded, with a reduction in explicit guarantees (3.2% of GDP at the end of 2022, against 5.3% in 2019). These improvements, coupled with progress by the tax administration in terms of maturity management, have been hailed by the rating agencies (upgrade from BB to BB+ by S&P in mid-2022 and from Ba3 to Ba2 by Moody's in September 2022), while the IMF continues to consider the risk of public debt distress as low (DSA September 2023).

Monetary policy, the second leg of the policy mix, is also generally well conducted.



A rule regulating annual credit growth helps reduce overheating risks seen in the early 2010s (35% per year on average over 2005-2010, against 16% over 2015-2019). But it does remain sufficiently generous and flexible to adjust to economic shocks (target of 14% in 2022 raised to 16% at the end of the year, target of 14% for 2023). Monetary easing measures maintained relatively high annual credit growth during the Covid-19 crisis (12.6% on average over 2020-2021), while the Central Bank (SBV) carried out a tightening of 200 bps in 2022 to limit the return of rising inflation (4.9% yoy at the end of 2022, against 2.6% on average over 2019-2021). However, inflation remains contained (3.7% yoy at the end of September 2023), as Vietnam has been largely shielded from rising food prices since 2021, in particular due to a preference for rice, which is cheaper than most cereals, and abundant local production. With inflation around its target (4% in 2022, 4% forecast for 2023), and faced with an uncertain global environment and tensions on the bond and real estate markets (see Section 2), the SBV has initiated a new easing cycle (-150 bp since March 2023, see Graph 4), well ahead of its Southeast Asian neighbors. The monetary policy framework could be further improved, notably by switching from quota mecha-

nisms to prices and rates more directly determined by the market, and improving communication to anchor inflation expectations. However, the SBV has achieved convincing results: since the last episode of double-digit inflation in 2011, inflation has not exceeded 7.5% yoy, and has even stood at 3.2% (yoy) on average over the last decade. The SBV's primary objective of price stability has therefore been achieved.

In this context, the economy remains attractive with strong growth prospects. The dynamism of the economy and improvement in its fundamentals since the dual crisis in the early 2010s (see Section 2) enabled Vietnam to enter the Covid-19 crisis with several safety buffers. The "Zero Covid" strategy allowed the economy to be one of the few in the world to record positive growth in 2020 (+2.9%), but it also limited the recovery in 2021 (+2.6%). The change of course ("living with Covid") in late 2021 led to the strongest rebound seen in 25 years in 2022 (+8%), driven by private consumption (57.5% of GDP over the last decade) and an ambitious fiscal stimulus package.^[3] Despite China's reopening, marked in particular by an increase in tourism, after three years of a strict "Zero Covid" policy,^[4] growth is projected at 4.7% by the World Economic Outlook

of October 2023, below the potential of ~7%. It is expected to be adversely affected in 2023 by the slowdown of the main trade partners (US, EU), and the internal political upheavals that have paralyzed investment decisions (growth reduced to 3.3% yoy in Q1 2023 according to the General Statistics Office). In the medium term, foreign multinationals, which are increasingly seeking diversification outside China, should continue to be attracted by the political and macroeconomic stability offered by the country, an enviable geographical location close to global value chains, a workforce at a cost that remains competitive, and a vast market (100 million inhabitants). In this context, an annual growth rate of around 7% (at the level of potential) over the next five years appears to be a realistic and achievable central scenario.

3 Program estimated at 4.1% of GDP, comprising a temporary 2 pp reduction in the VAT rate, liquidity injection for corporates, an increase in spending on health and education, and an ambitious infrastructure plan.

4 The Chinese accounted for 30% of total visitors before the pandemic.

2. In the short to medium term: financial and external vulnerabilities should not be underestimated

The sound fundamentals of the economy should not obscure concerns over transparency, contingent liabilities, and the legacy of the financial and external crises in the early 2010s which continue to negatively affect Vietnam's risk assessment. While the banking system has become sounder since the banking crisis of 2011-2012 and systemic risk has receded, banks remain notoriously undercapitalized and the amount of non-performing loans is underestimated. The difficulties related to the real estate sector since 2022, which have led to a liquidity dry-up on the capital market and a (small) bank run, have once again shed a harsh light on these financial vulnerabilities. External liquidity also requires heightened vigilance in the short to medium term: foreign exchange reserves are structurally under pressure, despite the accumulation of positive current and financial accounts. The main reasons for this are the relatively high external financing needs (EFN), the size of the "errors and omissions" item of the balance of payments, and a crawling-peg exchange rate regime. The situation is not comparable to that of 2010-2011 (close to a balance of payments crisis), but with reserves covering three months of imports at the end of June 2023, transfer & convertibility risk remains high.

A sounder but still fragile financial system.

Since the banking crisis of 2011-2012, the banking system has been cleaned up but remains the Achilles heel of the Vietnamese economy. The banking crisis of 2011-2012, marked by bank runs and bankruptcies among the weakest institutions, had highlighted all the vulnerabilities of the sector. The crisis had in particular been fueled by excessive credit growth during the 2000s, encouraged by the authorities through the financing of state-owned enterprises by state-owned banks. But it was also fueled by lax risk management policies, a serious lack of supervision and transparency, and corruption scandals. In addition to this situation, the macro-

economic environment had deteriorated, with a sharp interest rate hike to counter double-digit inflation, which had negatively affected the sector's profitability and asset quality. Several consolidation measures have since been implemented in the context of five-year plans dedicated to the banking sector. There have been several bank mergers to reduce the fragmentation of the sector and absorb the weakest institutions. A bad debt structure was set up in 2013 (Vietnam Asset Management Company, VAMC). Banking supervision has improved, with an obligation to implement Basel II criteria by the end of 2023 (some banks have also started adopting Basel III standards), while there is more transparency (e.g.: reporting to the IMF for the publication of financial soundness indicators). These measures, coupled with the overall sound health of the economy over the last decade, have in particular helped reduce the rate of non-performing loans (NPLs) net of provisions from 16.2% of bank capital in 2014 to 7.5% in 2019. Banks' foreign exchange risk has declined due to an increase in confidence in the local currency (Vietnamese dong, VND): the share of foreign currency deposits fell from nearly 30% in the early 2010s to 10% per year on average over 2018-2021. The sector also showed resilience during the Covid-19 crisis, helped by the Central Bank's easing measures (interest rates cuts, reduction in banking fees, relaxation of classification rules for NPLs and their provisioning). Despite this, there are still several persistent vulnerabilities identified a decade ago: the sector is still far too fragmented with 47 institutions, and excessively large given the size of the economy,^[5] with barely adequate capitalization ratios,^[6] and the level of NPLs is in all likelihood underestimated. The IMF estimates in particular that "problem" loans accounted for over 6% of total outstanding loans at the end of 2021, against an official rate of 1.6%. The asset-liability mismatch (high proportion of short-term deposits in the liabilities side of the balance sheet) increases liquidity risk in the sector. Above all, cross-ownership (banks belonging to the same conglomerate) also increases the risk of bank runs, as was the case again in 2022.

5 Credit to the private sector of over 120% of GDP at the end of 2021, a level comparable to several OECD countries.

6 Several banks, mainly State-owned, are undercapitalized.

In the short term, the stabilization of the bond and real estate markets requires close supervision.

The onset of the bank run in late 2022 served as a reminder of the vulnerabilities of the banking and financial sector as a whole. In September 2022, a decree to strengthen regulation and transparency on the local financial market (Decree 65) forced bond issuers in breach of these new rules to make early repayments. This pushed the largest issuers (including real estate groups) to immediately search for refinancing. Above all, in late October, an anti-corruption campaign leading to the arrest of the chairwoman of Van Thinh Phat Holdings Group – a conglomerate with a large real estate portfolio – for misappropriation on the financial markets, triggered a run of depositors of Saigon Commercial Bank (SCB), suspicious of the extent (at least alleged) of the business relationship between the bank and the other entities of Van Thinh Phat Group which it is suspected of excessively lending to. The fire was rapidly extinguished by the SBV, which announced a guarantee for all of SCB's deposits and placed the institution under restructuring. While the panic did not spread to other banks, the lack of confidence subsequently reached the bond market, which was suddenly more cautious towards a real estate sector it had largely contributed to financing for the last five years (total assets of the bond market at 1.5% of GDP at the start of 2018, against 8% in mid-2022). In a context of interest rate hikes (fight against inflation, see Section 1), which reduced demand in the real estate sector, repayment difficulties of developers have been compounded by the impossibility of refinancing on the bond market which was suddenly in a liquidity crisis. An estimated 50 bond defaults by developers have been reported since the beginning of 2023, including by the second largest real estate group in the country in February, which has increased the risk of asset quality deterioration in the banking sector. The weight of contingent liabilities which could arise from this is hypothetical at this stage, but this type of event serves as a reminder of the significant risk that the financial sector can pose for public

finances. However, systemic risk would appear to be limited, as banks' exposure to real estate companies only amounts to 7% of total outstanding loans. The SBV's swift response has also reduced liquidity risks on the bond market (relaxation of bond issuance rules, extension of repayment deadlines for borrowers, etc.). But this could delay the strengthening of the supervision of this still immature market, running counter to the intentions of Decree 65.

In the medium to long term, convergence towards international standards needs to continue.

With capital adequacy ratios significantly lower than certain regional peers (11-12% in Vietnam, against 16% in the Philippines and 23% in Indonesia), and certain banks whose capital is only just above Basel II thresholds, strengthening banks capitalization remains the priority (see Table 1). This could involve opening up capital to foreign investors, but at this stage, only the banks that will receive the forced transfer of institutions in difficulty will be able to increase their foreign ownership limit from 30% to 49% (decree under preparation). At the same time, the additional time given to banks to provision NPLs accumulated since the Covid-19 crisis – firstly June 2022, then an extension to the end of 2023, against the end of 2021 initially – will allow to build up capital buffers and absorb the shock in the event of a materialization of NPLs. However, it will be necessary to avoid a further extension of the deadline, otherwise risky credit policies may increase again. The SBV, whose supervision is now considered adequate, intends to have all Basel II standards adopted by 2025. Meanwhile, the IMF is encouraging the constitution of additional capital buffers, limits to the size of loans (in terms of loan-to-value and debt-service-to-income ratios), and a revision of the resolution framework for company bankruptcies. The rules of Decree 65, which have been suspended for a year to give the bond market time to stabilize, will also probably need to be put back on the agenda in order to develop a deeper and more sustainable capital market.

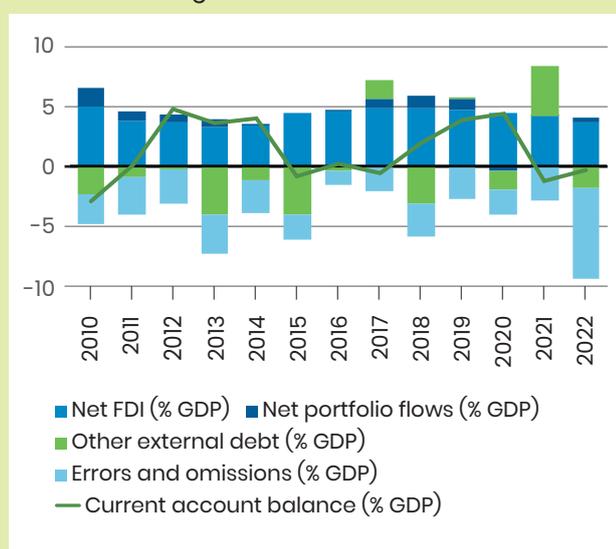
Table 1: Financial soundness indicators remain fragile

%	Dec-2016	Dec-2017	Dec-2018	Dec-2019	Dec-2020	Dec-2021	Dec-2022
Solvency							
Capital-to-risk weighted assets ratio	12.6	12.1	11.9	11.8	11.1	11.3	11.5
Net NPL on capital	11.7	10.9	9.3	7.5	8.0	4.3	9.1
Profitability							
Return on assets (ROA)	0.7	0.8	1.2	1.2	1.2	1.5	1.1
Return on equity (ROE)	6.8	8.2	12.3	12.4	11.9	14.9	13.9
Asset quality							
Non-performing loan ratio	2.6	2.1	2.1	1.8	1.9	1.6	1.9
Provision rate (as % of NPL)	46.4	41.3	50.7	52.5	44.5	64.1	nd
Liquidity							
Deposits/Loans	122.9	117.7	115.9	115.8	114.8	110.8	nd

Source: IMF (FSI).

External liquidity pressures persist, despite the accumulation of current and financial accounts surpluses.

Graph 5: Structurally positive current account and high level of financial inflows



Source: IMF (WEO, IFS), AFD calculations.

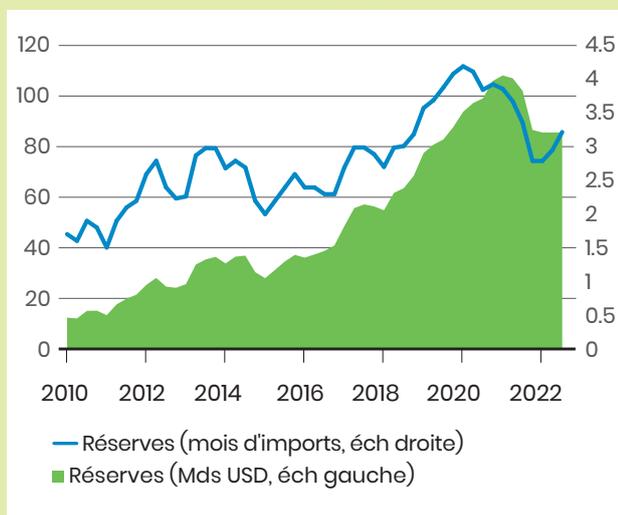
Vietnam has been accumulating current and financial accounts surpluses for a decade.

The Vietnamese current account has been structurally in balance or in surplus since the early 2010s, with an average current account surplus of 2.2% of GDP during the 2010s. Accession to the WTO in 2007 and the signing of a number of free trade agreements

over the last 15 years have strengthened Vietnam's integration into international trade and boosted its exports (manufacturing industry, then tourism). This trend has gathered pace in recent years, with the entry into force of the free trade agreement with the EU (EVFTA, 2020), the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP, 2019), and the Regional Comprehensive Economic Partnership (RCEP, 2022) around the Pacific. The Vietnamese economy has thereby continued to rely on its traditional exports (textiles, shoes, agricultural products). But it has also experienced an upscaling since 2018, due to the reconfiguration of value chains exacerbated by two events: the US-China trade war, then the Covid-19 pandemic. Vietnam has therefore on the one hand confirmed its position as the main alternative to China (already ongoing due to China's loss of competitiveness), for both exports and foreign direct investment (FDI), and on the other hand, it has increased its share in exports of electronic products (smartphones, computers). Between 2010 and 2012, its market share in global smartphone exports rose from 0.6% to 12%, in particular driven by US imports (US market share of nearly 20%, a fourfold increase between 2018 and 2022). In recent months, Apple and its suppliers have announced major investment plans to increase the production capacity in the country. The same goes for Samsung, which also opened a research and development center in Hanoi in late 2022. These examples reflect the high level of FDI (4.2% of GDP per year on average since 2010, see Graph 5) which contributes to a financial account that is also in surplus (3.3% of GDP per year on average over the same period).

However, external liquidity remains a cause for concern.

Graph 6: External liquidity requires close monitoring again



Source: IMF (IFS), AFD calculations.

The accumulation of current and financial accounts surpluses has significantly improved external liquidity since the currency crisis in 2010–2011 (inflation, crisis of confidence towards the VND) when the level of foreign exchange reserves fell to 1.6 months of imports. However, the increase in reserves remains weighed down by the size of the “errors and omissions” item (nearly 3% of GDP since 2010). This has maintained doubts about statistical quality^[7] and reflects a remaining lack of confidence among Vietnamese in their currency. Indeed, the high level of this item is in particular due to holdings of dollars by residents outside the formal financial system. Above all, while the level of foreign exchange reserves was adequate at the end of 2021 (107% of the IMF’s ARA metric), this was not the case throughout the 2010s and it could once again be barely satisfactory. Indeed, after exceeding four months of imports cover at the end of 2020, foreign exchange reserves cover fell to less than three months of imports at the end of

2022 (–\$23 billion in 2022 alone, *i.e.* a 21% drop, see Graph 6) due to a combination of factors. First, exports plummeted in 2021 as a result of Covid-19 related restrictions and supply chains disruptions, driving the current account balance into negative territory (–1% of GDP, see Graph 5). Second, despite an improvement in 2022 (current account deficit estimated at –0.3% of GDP by the SBV), monetary tightening in advanced economies (US, EU) and the substantial outflow of dollars it prompted (“errors and omissions” item at 7.7% of GDP), forced the SBV to numerous interventions to support the VND against the dollar (depreciation of –8% over the first 10 months of 2022, before recovering the losses at the end of the year), and thereby defend the crawling-peg regime. Finally, a relatively high EFN at ~11% of GDP per year on average over 2021–2025 (external debt is limited at 37% of GDP, but a third is short-term) adds to external liquidity pressures.

In this context, to stem the decline in reserves while supporting the foreign exchange regime, the SBV ended up widening the VND/USD trading band from ±3% to ±5% to limit its FX interventions (October 2022). While no transfer and convertibility restrictions have been introduced, recurring pressures on the VND and external liquidity, the absence of concrete prospect for increased flexibility of the exchange rate regime, and the total lack of independence of the Central Bank serve as a reminder that transfer and convertibility risk is high. In the short to medium term, the outlook is more uncertain: the recovery in tourism (9.2% of GDP before the pandemic) may not be sufficient to offset the expected decline in exports of goods related to a slowdown in consumption among the main trade partners. However, the IMF forecasts a current account slightly above balance over 2023–2024 (+0.5% of GDP on average) and a renewed improvement in FX reserves. At the end of June 2023, they had increased by \$4.6 billion compared to December 2022 (+5.3%, three months of imports coverage). A factor of resilience should be noted: at over 20% of GDP at the end of 2022, FX reserves amply cover (more than twice) the EFN, mitigating external solvency risks.

⁷ The absence of a net International Investment Position also contributes to doubts about statistical quality and data transparency.

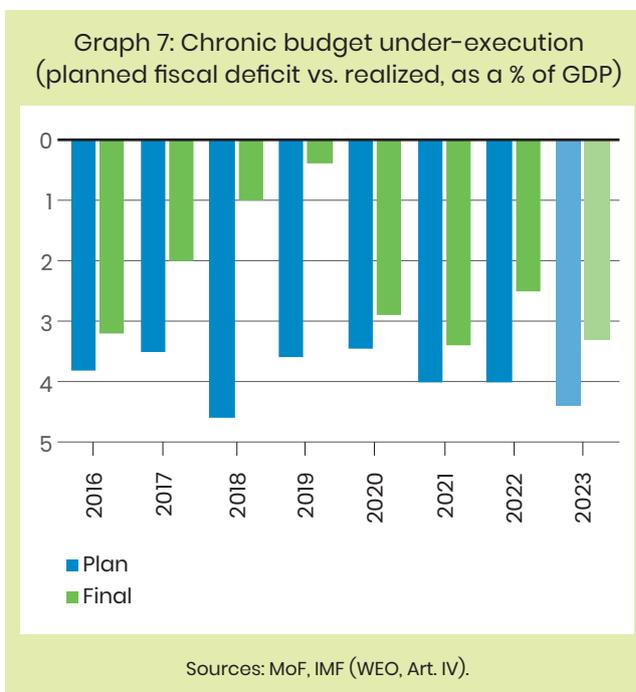
3. In the medium to long term: reconciling continued development and the fight against climate change

Vietnam should move to the ranks of UMICs relatively rapidly (by 2025). But it could be caught in a middle-income trap if the authorities do not address two structural issues: productivity and, more importantly, the fight against climate change. Public authorities could step up their action on these two issues, by both increasing public investment and improving implementation capacity.

Continuing development through public investment and improved productivity.

Public investment could provide more extensive support for development.

In view of the quality of the sovereign profile and the fiscal space available, public authorities could provide more extensive support for the development of the Vietnamese economy. It is even encouraged to do so, in particular by the IMF.^[8] This will involve reducing budget under-execution, which reflects structural institutional weaknesses in Vietnam, including the cumbersome nature of a very vertical decision-making process, and relative implementation capacities. While this under-execution contributes to good overall control of total fiscal deficit by containing expenditure, it also restricts the multiplier effect of public investment on growth. Under-spending even appears to be becoming chronic (see Graph 7). This can be seen with the latest recovery plans: only 57% of the fiscal stimulus of 4.5% of GDP per year on average, announced in 2020 and 2021 to address the Covid-19 crisis, has been implemented, while at the end of 2022, only 20% of the spending planned in the 2022-2023 recovery plan had been disbursed.



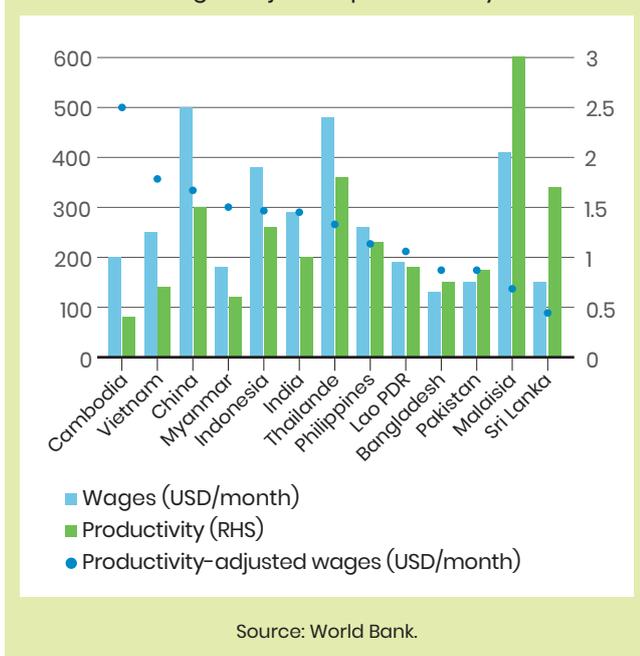
Productivity will need to improve. To achieve the authorities' objective of becoming a high-income country (per capita income threshold in 2022 of over \$13,800) by 2045, average annual growth rate of ~6.5% will be necessary. At the current pace, this is achievable (see Section 1), but in addition to public investment, it will require the effective implementation of announced structural reforms^[9] (reduction of bureaucracy and corruption, improvement in the business environment, facilitating land access) and improvement in productivity. Indeed, in 2022, the World Bank considered that despite its attractiveness for foreign investors, Vietnam had no specific advantage in terms of wage-adjusted productivity compared to its peers (Bangladesh, Philippines, Sri Lanka, see Graph 8). It confirmed a study (VEPR, 2021) indicating productivity 3.5 to 4 times lower than in Indonesia or the Philippines. The situation is probably more nuanced for foreign companies which find a young and skilled workforce, thereby reflecting a

⁸ "The authorities could [...] consider boosting spending to address infrastructure, strengthen the social safety net, and address other social needs." (IMF, End-of-Mission press release, June 2023).

⁹ Nine economic laws (Enterprise law, PPP law, Law on public investment, etc.) were revised in early 2022.

heterogeneity of skills^[10] and an equally strong duality on the labor market. However, to continue the upscaling, the focus will need to be on improving skills by increasing university and vocational training participation rates, expanding the adoption of digital technology, and increasing incentives for the formalization of both workers^[11] and companies. In this respect, the reform of the Enterprise Law (comprising a simplification of administrative procedures) and the Labor Code of 2021 (which requires formal companies to include informal workers in social security systems) are steps in the right direction. Finally, climate change, both for its effects on productivity and on the economy in general, will need to be better integrated to support the continued development of the Vietnamese economy.

Graph 8: Relatively low wage-adjusted productivity



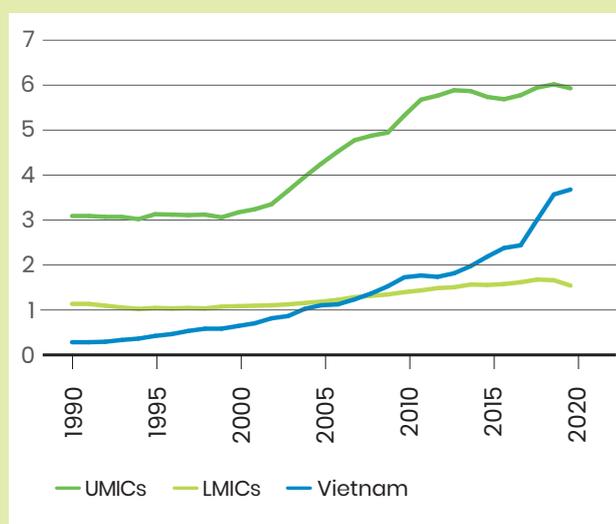
Addressing climate change challenges

Vietnam is one of the countries most vulnerable to climate change. With a coastline over 3,200 km long, the country is particularly exposed to climate change through (i) the acceleration of natural disasters (cyclones, floods, but also periods of drought) and (ii) sea-level rise – with this chronic phenomenon exacerbating the effects of more occasional disasters. As with several countries in Asia, Vietnam is also exposed to an increase in the frequency of droughts related to the El Niño phenomenon (last drought in 2016, high risk in 2023), part of the trend of rising temperatures. Vietnam therefore ranks 7th in terms of exposure to the risk of natural disasters (and 1st for exposure to floods, Inform Climate Change Risk Index 2022). It is also 13th in terms of losses (human and financial) related to climate change for the period 2000–2019 (Germanwatch Global Climate Risk Index 2021). These changes could have substantial human and economic consequences: the World Bank estimates losses associated with climate change at 3.2% of GDP for 2020 alone. As most of the large cities and areas of economic activity are located in coastal areas, rising water levels and associated salinization, as well as climate hazards, affect activities such as fishing and agriculture (which still employs nearly 40% of the workforce), which could ultimately threaten food security (rice). A continuous rise in the water levels of the Mekong Delta by 100 cm would flood nearly 20% of Ho Chi Minh City and 40% of the Delta (NDC, 2020). Without adaptation measures, 45% of the Delta would be affected by salt water intrusion by 2030. Under these circumstances, 10 to 12% of the country's population would be directly affected by these changes. In addition, it is estimated that air pollution, related to the greenhouse gas (GHG) emissions boom which came along with economic development (7.9% annual increase since 2005), is responsible for 60,000 premature deaths a year and considerably affects labor productivity, with losses estimated at 1% of GDP in 2020 (World Bank, CCDR 2022).

¹⁰ Labor market mismatches affect about 40% of the workforce. It is estimated that 25% is under-qualified compared to the skills required.

¹¹ Informal employment rate estimated at 56% in 2018.

Graph 9: A clear catch-up of CO₂ emissions (tons) per capita



Source: World Bank (ESG data).

However, the economy is moderately exposed to low-carbon transition risk. At COP26 in 2021, the authorities made ambitious commitments towards the decarbonization of the economy: coal exit by 2040, and net-zero emissions by 2050. Indeed, the energy and electricity mix relies heavily on carbon, which accounts for the sharp rise in GHGs for more than two decades: in 2019, more than three-quarters of primary energy production was based on coal (43%), oil (20%) and gas (13%). Without a paradigm shift, the increase in GHG emissions is expected to continue with growing demand from households (increase in wealth, rural exodus) and industries (including manufacturing), exacerbated by climate change (rising temperatures). In this context, a low-carbon transition could especially be envisaged, as it would have relatively moderate effects on the economy. Indeed, only ~10% of fiscal and external revenues are exposed to “sunset” industries (oil, coal), as oil revenues have declined significantly over the last decade (less than 5% of government revenue since 2016, against 21% per year on average between 2002 and 2013). In addition, the banking sector has limited exposure to sunset industries, and the economy is sufficiently

diversified to absorb a reconfiguration of sectoral priorities: industry accounts for 35% of GDP, a share similar to services and trade (40%). The consequences would probably be heavier for the population used to fuel subsidies, 21% of which receive their salaries from sunset sectors, hence the need to improve social safety nets, both in terms of volume and targeting.

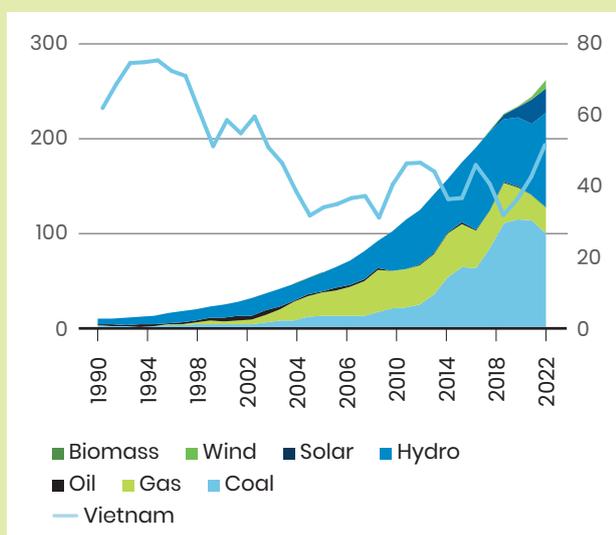
The authorities have a window of opportunity to make changes to the development model, but doubts remain over their implementation capacity. Given climate change issues, international momentum, and domestic room for maneuver (high growth, sound public finances), the authorities have a window of opportunity to make the economic growth model more sustainable. They should focus their efforts on two typical pillars: a climate change adaptation strategy (including the Mekong Delta regional program), and a mitigation policy, which sets out the objective of carbon neutrality by 2050. The latter would appear to be all the easier to implement since low-carbon transition risk is moderate, and in late 2022, Vietnam signed a Just Energy Transition Partnership (JETP) with several advanced countries^[12] to help it with this transition. The JETP will mobilize at least \$15.5 billion of public and private financing to accelerate the achievement of more ambitious objectives (advance the date of peak GHG emissions, accelerate the development of renewable energies, etc.). The authorities appear to be showing a real willingness, as seen with several strategies and concrete achievements. In terms of planning, in recent years, the authorities have published a Green Growth Strategy 2021-2030 (VGGS, 2021), a National Climate Change Strategy for 2050 (NCCS, 2022)^[13] a National Energy Efficiency Program (VNEEP 3), and a National Climate Change Adaptation Plan for 2030 (2020). The NDC was also updated in late 2022 with much more ambitious targets than the last version in 2020: unconditional reduction of GHGs by 15.8% (9% in the 2020 NDC) and conditional reduction of 43.5% (27% in 2020). At the same time, real progress has been achieved in recent years, including a strong development of renewable energies (see Graph 10).^[14]

¹² EU, G7 members, Denmark and Norway.

¹³ Following on from the VGGS and NCCS of the last decade.

¹⁴ As a result of an attractive framework for investors between 2017 and 2021, Vietnam has become the ASEAN country with the highest installed capacity for REN: 20.7 GW (mainly solar), i.e., 27% of total generation capacity, in addition to 29% for hydropower, amounting to 56% of total generation capacity in 2021 from renewable resources, against 41% in 2016.

Graph 10: Substantial and recent development of renewable energy (electricity production by source, in TWh)



Source: Our World in Data, AFD calculations.

However, there are doubts over whether the ambitious objectives can be achieved. First, because while the carbon neutrality strategy has been announced by the Prime Minister, there is no consensus among all the leaders. Indeed, some are in favor of maintaining cheap energy (therefore coal) to supply industries and protect household purchasing power. The announcement by the public operator EVN of its intention to increase the use of coal – albeit temporarily, in a period of risks of power cuts – for power generation therefore runs counter to the coal exit strategy for 2040. Second, because there does not appear to be strong inter-ministerial coordination of all the strategies published.^[15] Finally, because implementation capacity remains constrained by the structural problems mentioned above: verticality, bureaucracy, but also a lack of legal clarity. For example, power purchase agreements for public-private partnerships (in particular for wind energy, which has strong potential) are not considered bankable enough. The publication of the 8th National Power Development Plan (PDP8), in May 2023, after a three-year wait, could provide

a welcome response to legal uncertainty and catalyze new investments. Similarly, the submission by the authorities of a credible resource mobilization plan by the end of 2023 for the JETP is an important challenge: it would make it possible to move towards the implementation of the JETP in a coordinated manner.

Financing the transition towards a new model poses a further challenge. The World Bank estimates total adaptation and mitigation costs at \$368 billion between 2022 and 2040, *i.e.*, 6.8% of GDP per year. Half of this would be financed by private investors, and 35% by the State (the remainder by international creditors). This last point, which would mean that public finances would bear the burden of 2.4% of GDP per year, would involve two major components: an increase in revenues through a carbon tax (which could generate ~1.5% of GDP per year according to the World Bank), and additional borrowing on domestic markets. While an increase in the primary deficit of ~1 GDP point per year today seems quite conceivable in view of the level of public debt,^[16] at this stage, the introduction of a carbon tax remains very hypothetical.^[17] Financing from international donors – or markets – could therefore be crucial to close the gap. The marked difference between the unconditional and conditional targets (*i.e.*, with external support) of the NDC should also be noted.

¹⁵ For example, the climate objectives are not clearly set out in the other planning documents including, in particular, the Social Economic Development Strategy (SEDS) 2021–2030.

¹⁶ All else being equal, public debt would increase by ~15 pp to ~55% of GDP over the next 20 years (AFD estimate).

¹⁷ However, the authorities are considering introducing a cap-and-trade system, with a pilot project in 2025, prior to general implementation in 2028.

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Table 1: Financial soundness indicators remain fragile

List of acronyms and abbreviations

ARA	Assessing Reserve Adequacy	NDC	Nationally Determined Contribution
BN	Billion	NPLs	Non-Performing Loans
CCDR	Country Climate and Development Report	OECD	Organisation for Economic Co-operation and Development
CPTPP	Comprehensive and Progressive Agreement for Trans-Pacific Partnership	PDP	Power Development Plan
CPV	Communist Party of Vietnam	RCEP	Regional Comprehensive Economic Partnership
EU	European Union	SBV	State Bank of Vietnam
EVFTA	European Union–Vietnam Free Trade Agreement	SCB	Saigon Commercial Bank
FDI	Foreign direct investment	SEDS	Social Economic Development Strategy
FSI	Financial Soundness Indicators	UMIC	Upper-Middle-Income country
GHG	Greenhouse gas	VAMC	Vietnam Asset Management Company
HIC	High-Income Country	VGGS	Vietnam Green Growth Strategy
IFS	International Financial Statistics	VND	Vietnamese dong
IMF	International Monetary Fund	VNEEP	Vietnam Energy Efficiency Program
JETP	Just Energy Transition Partnership	WB	World Bank
LMIC	Lower-Middle-Income Country	WDI	World Development Indicators
M	Million	WEO	World Economic Outlook
NCCS	National Climate Change Strategy	yoy	Year-on-year

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