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HARNESSING THE POTENTIAL OF THE SERVICES SECTOR FOR GROWTH

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ABBREVIATIONS

BPO	Business Process Outsourcing
BSA	Banking Supervisory Agency
CIF	Cost, insurance, freight
CPI	Consumer Price Index
EMDEs	Emerging markets and development economies
FAT	Firm-level Adoption of Technology
FDI	Foreign Direct Investment
FOB	Free-on-board
FTAs	Free Trade Agreements
GDP	Gross Domestic Product
GFS	Government Finance Statistics
GI	Greenfield investment
GSO	General Statistics Office
IMF	International Moneytary Fund
LMICs	Lower middle income countries
MOF	Ministry of Finance
NEER	Norminal effective exchange rate
NSA	not seasonally adjusted
OECD	Organization for Economic Cooperation and Development
PPI	Producer Price Index
SBV	State Bank of Vietnam
SD	standard deviation
SEDS	Socio-Economic Development Strategy
SME	Small and medium enterprises
STI	Science, technology, and innovation
STRI	Services Trade Restrictiveness Index

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OVERVIEW

Heightened uncertainties continue to weigh on the prospects of the global economy

In 2022, the global economy continued to grapple with low growth, high inflation, the lingering effects of COVID-19, and the war in Ukraine. The global economy registered a weak (2.9 percent) expansion in 2022, with the U.S. and the euro area registering 1.9 percent and 3.3 percent GDP growth, respectively. Global economic headwinds are expected to continue, and growth is projected to decelerate to 1.7 percent in 2023, the third weakest pace in nearly three decades.[1] This reflects simultaneous policy tightening to contain high inflation, worsening financial conditions, and continued effects of of the war in Ukraine.

Vietnam's economy rebounded strongly in 2022

Vietnam's GDP grew by 8.0 percent (y/y) in 2022, above its average rate of 7.1 percent in 2016-2019. The strong growth was partly due to the low base effect, driven by a rebound of the domestic private consumption post-COVID-19 and solid performance of export-oriented manufacturing in the first nine months of the year. Overall, private consumption contributed about 4.3 percentage points to growth in 2022, compared to the 1.1 percentage point contribution in 2021, and in line with contributions in the pre-COVID-19 period. The contribution of the public sector to growth remained limited (one percentage points), given the implementation challenges in public investment and continued efforts by the authorities to reduce current expenditures. Net exports contributed 2.7 percentage points to growth, mostly due to the strong performance of exports in the first three quarters of the year.

Employment and labor income recovered to pre-COVID-19 levels in 2022, contributing to poverty reduction. Employment recovered to pre-COVID-19 levels (50.6 million) and labor incomes in 2022 (VND 6.2 million average real monthly income) surpassed 2019 numbers, while labor participation reached 68.5 percent of total population, an increase of 1.2 percentage points compared to Q4-2021, still below the pre-COVID-19 rate of 71.1 percent. These improvements in the labor market contributed to the poverty rate declining from an estimated 3.6 percent in 2021 to a projected 3.3 percent in 2022.[2]

However, weaker global demand led to renewed labor market pressures in Q4-2022. The economic slowdown in U.S. and European markets led to slowing orders and exports in Q4-2022, with a reported impact on employment in major export manufacturing centers such as the Ho Chi Minh City area. The underemployment rate rose (from 1.92 to 1.98 percent) among working-age persons, and the share of workers with informal employment increased from 65.0 in Q3-2022 to 65.4 in Q4-2022.

The balance of payment showed signs of weakening in 2022

The current account registered a deficit of US$4.9 billion in the first nine months of 2022 and is expected to remain in deficit in 2022, the second year in a row. While the goods trade balance registered US$6.7 billion in surplus in the first three quarters of 2022, exports contracted by 9 percent (y/y) in November and 14 percent (y/y) in December 2022 due to weakening

1 World Bank. *Global Economic Prospects*, January 2023.

2 As measured by the World Bank's lower middle-income country poverty line US$3.65/day 2017 PPP.

demand from the U.S. and EU. Services trade balance remained in deficit (-US$6.9 billions) as service exports have not fully recovered from the pandemic. While FDI disbursements reached US$15.4 billion by the end of the third quarter, the financial balance surplus narrowed to US$7.5 billion in Q3-2022 compared to a US$26.4 billion surplus in Q3-2021. The third quarter deterioration was mostly connected to short-term capital outflows (estimated at US$8 billion) resulting from the impact of monetary tightening in the United States.

To help stave off pressure on the exchange rate, the SBV responded with a combination of FX interventions, some depreciation, and monetary tightening. FX interventions led to the sales of an estimated US$22 billion in foreign reserves, leaving the reserves at an estimated US$88 billion (or about three months' import equivalent) by September 2022. To avoid further depletion of reserves, the SBV also introduced measures for greater exchange rate flexibility, allowing the reference rate to depreciate by 3.4 percent y/y (albeit much less than comparator countries). It also tightened monetary policy with a 200-bps hike in discount and refinancing rates from 2.5 percent to 4.5 percent and from 4.0 percent to 6.0 percent, respectively.

Following the commodity-price shock of March 2022, Consumer Price Index (CPI) inflation increased from 1.8 percent in December 2021 to 4.5 percent in December 2022, breaching the 4 percent policy target. The inflation was driven mainly by supply side factors, particularly during the first half of the year. Global oil prices led to 21.4 percent y/y higher transport costs by June and contributed 60 percent of the CPI in the same month, subsequently passing through to domestic prices of products. Inflationary pressures were compounded by the recovery of domestic demand with private consumption accelerating from 6.5 percent y/y in H1-2022 to 9.5 percent y/y in H2, or around 2 percent (y/y) above trend.

Vietnam's financial sector experienced increased pressure in 2022

A combination of external and domestic factors contributed to heightened uncertainty and volatility in the financial sector. Global inflation and interest-rate increases in the U.S. and other countries had an impact on the monetary policy stance. Higher domestic interest rates (200 bps increase in policy rates), raised banks' cost of fund (180-220 bps increase in 12-month deposits) and, in turn, the borrowing cost for individuals and the corporate sector. The brief run on the Saigon Commercial Bank (SCB) in October 2022, triggered by the arrest of several individuals accused of fraud in real-estate and corporate bond deals associated with the bank, shook confidence in the banking sector and capital markets. Risk perception increased, and investors sought higher yields for domestic investment across the board, including equity prices (prices dropped by 32.8 percent in 2022), bonds (government bond yields increased by 324 basis points (bps) on average in 2022'), and bank deposits. Small banks appeared to suffer disproportionately from tightening liquidity, as there was a flight-to-quality amidst this safety concern. While the authorities took swift action to address financial markets, the events underscore deep-seated financial sector vulnerabilities, including weakness in supervision and corporate governance.

Intended expansionary fiscal policy was thwarted by budget implementation challenges

While the government planned for a fiscal deficit of 4.2 percent of GDP, the budget

registered monthly surpluses during most of 2022, culminating in an estimated overall fiscal surplus of 1.4 percent of GDP. The surplus was partly driven by the higher-than-planned collection of revenues (+26.4%). While planned revenues were set at 14.5 percent of GDP, collections reached an estimated 18.9 percent of GDP. Slow procurement and issues associated with land acquisition led to the under-execution of public investments, which also contributed to the fiscal surplus. Capital expenditures were also affected by lengthy timelines for preparation of new projects and rigid contract management (including revisions in design and cost of ongoing projects). While planned expenditures were set at 18.8 percent of GDP for the year, execution is estimated at 17.5 percent of GDP. As a result of fiscal surplus and high growth, debt is estimated to have fallen from 39.3 percent of GDP in 2021 to 35.7 percent of GDP in 2022, significantly below the 60 percent debt-to-GDP threshold set by the National Assembly.

The near-term outlook remains favorable but subject to risks

Reflecting domestic and external headwinds, GDP is expected to grow by 6.3 percent in 2023. While the tourism sector continues to recover, services-sector growth will moderate as the post-COVID-19 low base-effects fade. Domestic demand is expected to be affected by higher estimated inflation (4.5 percent average) in 2023, which may erode household purchasing power. Rising interest rates may weigh on private investment. Amid softer external demand, contribution of net exports to growth is estimated to be negative (-0.6 percentage points). The economy is expected to benefit from the partial roll out of the investment component of the recently adopted government support program (about 1.6 percent of GDP). The current account is expected to register a 0.1 percent of GDP surplus in the medium-term, thanks to the recovery of goods export performance, return of foreign tourism, and resilient remittances.

Table 0.1. Selected economic indicators, Vietnam, 2020-25

Indicator	2020	2021e	2022e	2023f	2024f	2025f
GDP growth (%)	2.9	2.6	8.0	6.3	6.5	6.5
Consumer Price Index (average, %)	3.2	1.8	3.1	4.5	3.5	3.0
Current account balance (% of GDP)	4.3	-1.0	-1.7	-0.3	0.1	0.1
Fiscal balance (% of GDP)	-2.9	-3.4	1.4	-0.3	0.8	1.4
Public debt (% of GDP): MOF a/	43.7	42.7	38.0	39.0	---	---
Public debt (% of GDP): GFS b/	41.3	39.3	35.7	35.0	33.2	31.0

Source: GSO, MOF, SBV, IMF, and World Bank staff calculations

Note: The revised GDP is used in all calculations unless otherwise stated. e = estimate; f = forecast.

a/ As reported by the MOF

b/ Following GFS

Risks to the outlook are broadly balanced. On the downside, weaker than expected growth in Vietnam's major export markets – the U.S., China, and the eurozone- could affect export prospects. Persistent inflation in the US and the eurozone could lead to tighter financial conditions, affecting Vietnam's financial sector. Geopolitical tensions and risks also remain high potentially affecting investor sentiments in the short to medium run. Domestically, persistent price increases could cause inflation expectations to rise, feeding into destabilizing pressures on nominal wages and production costs and affecting domestic demand. Weaknesses in the policy and supervisory framework of the financial sector and the balance sheets in the corporate, banking and household sectors could amplify risks, affecting domestic investor and consumer sentiment. Implementation challenges could also hamper the execution of the planned public investment program. On the upside, improved growth prospects in China, the US, or EU and stronger than expected global demand could lift exports and hence growth above the baseline projection.

Domestic and external headwinds warrant coordinated and data-driven policy responses from the authorities

A supportive fiscal policy stance could hedge against downside-risks to growth. Vietnam has fiscal space to act and in the short run and the focus is appropriately on the implementation of the capital budget, including the projects identified in the Recovery and Development policy package program that prioritize digital and physical infrastructure.

An agile monetary policy—closely coordinated with fiscal policy objectives—would help to keep domestic inflation under control. Following last year's tightening measures, monetary policy will need to continue balancing inflation, financial stability, and growth objectives. While rate hikes were necessary to contain inflation and exchange rate pressures, ensuring adequate liquidity is crucial to ensuring the proper functioning of key funding markets in the context of heightened risk sentiment. Externally, further monetary tightening in the U.S. and other advanced economies could induce further capital outflows from Vietnam and create pressure on the exchange rate. In such a case, increased exchange rate flexibility could help accommodate external pressures.

Strengthened policy and supervisory frameworks in the financial sector will help address emerging financial risks. Six areas of reform stand out. First, enhance the framework for risk-based supervision by the SBV. Second, strengthen the framework for resolving weak or insolvent banks. Third, establish strong frameworks and policies for supervising consolidated banking groups, including a clear separation between banks and company groups. Fourth, amend the Law on Credit Institutions and the State Bank Law to ensure supervisors have a robust legal mandate while discharging their duties in good faith. Fifth, enhance corporate bond market standards, including promoting a more-transparent public offer market (vis-à-vis private placement) and using credit ratings to strengthen investor protection and prevent market abuse. Sixth, increase the overall transparency of the financial sector by regularly publishing banking sector and financial market indicators promptly with sufficient granularity. The lack of transparency of the banking sector data and information might have contributed to market uncertainties and volatility. Many of these long standing reforms would benefit from a proactive government approach as they take time to complete and may require changes in legal foundations and culture within and among regulatory/supervisory authorities.

SPECIAL TOPIC: HARNESSING THE POTENTIAL OF THE SERVICES SECTOR FOR GROWTH

The services sector has been a critical contributor to economic growth in Vietnam but its performance lags comparators

The services sector has been the economy's largest sector for the past decade. The services sector grew from 40.7 percent of GDP in 2010 to 44.6 percent of GDP in 2019. Moreover, as Vietnam's economic structural transformation progressed, the share of workers employed in services increased from 19 percent in 1991 to 35.3 percent in 2019, absorbing a large share of workers leaving the agriculture sector and making the services sector the second largest source of jobs in the country, after agriculture.

Looking ahead, services could play a crucial role in supporting Vietnam to sustain productivity growth and achieve its ambition to become a high-income economy by 2045. All high-income economies boast large services sectors as the most significant source of job creation and the generation of economic value. For example, in 2019, services (by value-added) constituted 70.8 percent of the GDP in Singapore and 57.2 percent in the Republic of Korea. Employment in services constituted 84 percent and 70 percent of total employment in Singapore and Korea, respectively. Services could also play an essential role in upgrading Vietnam's development model by increasing value addition in the other sectors of the economy.

However, the performance of Vietnam's services sector lags peer countries. Productivity and employment in the services sector in Vietnam remain lower than many regional, structural, and aspirational peers. For example, Vietnam's services sector labor productivity (measured by value added per worker) has increased by 34.3 percent between 2011-19. However, at US$5,000 (constant dollar) per worker in 2019, it is still well below comparators, including Malaysia (US$20,900), the Philippines (US$9,300), and Indonesia (US$7,300). Exports of high-skilled, knowledge-rich services (called global innovator services) only constitute 9 percent of total services exports. Only 6.4 percent of total employment in the services sector is in this sub-sector, including ICT, finance and professional services which are usually among the most productive in the economy.

Small scale of firms, restrictions to services trade, low technological adoption and few inter-sectoral linkages affect productivity. Vietnam's services sector is dominated by small scale firms, employing an average of only 1.5 workers. This firm scale is about half the size of what is expected based on its level of GDP. Also, the 2021 OECD's Services Trade Restrictiveness Index (STRI) for Vietnam is relatively high compared to most aspirational peers (Singapore, South Korea, Malaysia), mostly due to restrictions on foreign entry for service delivery. In addition, According to the Firm-level Adoption of Technology (FAT) survey, both average and frontier services firms in Vietnam are far from the global frontier in terms of technology adoption. Finally, Vietnamese manufacturing firms are relatively limited in their use of services—the value of services as domestic inputs is only 14 percent with a mere 1.6 percent of manufacturing firms using global innovator services (ICT, professional, and financial services).

Unlocking the services sector's potential

Based on the preliminary analysis presented in this special focus section, the following broad policy directions can be identified. First, Vietnam could further reduce restrictions to services trade and foreign investment. OECD's STRIs indicate that certain "backbone" services sectors—including telecommunications, logistics, aviation, legal services, banking, and insurance—still face high restrictions and that little progress has been made in removing or mitigating them in recent years. For instance, foreign investment in freight transport is restricted in various ways, including in internal waterways freight and road freight (FDI up to 49 percent and 51 percent ownership, respectively). Going forward, the authorities may wish to consider (i) reducing restrictions to FDI as innovation and technology adoption relies on access to knowledge and to the networks, people, goods, and services that disseminate that knowledge globally; and (ii) undertaking business environment reforms to enhance competition and access to finance for domestic firms.

Second, Vietnam should encourage further adoption of digital technologies within firms to spur innovation. A recent assessment of Vietnam's science, technology, and innovation (STI) policies by the World Bank indicates that great focus has been on promoting foreign R&D-based innovation and the government has tried to 'push the technological frontier" by supporting university and research institutions over domestic firms. These policies have a limited focus on non-R&D-based forms of innovation, such as technology adoption (Akhlaque, Cirera & Frias 2020). Going forward, it would be useful to further investigate questions such as: (i) how should STI policies and funding bias towards R&D be rebalanced to focus more on upgrading firm capabilities through business technology adoption and diffusion? (ii) which policy instruments could support further knowledge and technology transfers to small and medium enterprises (SME)? (iii) what are the policy and funding instruments that could support a larger number of firms engaging in incremental innovation of products and processes and adoption of existing technologies?

Third, **focus should be on strengthening workers skills (especially basic digital skills) and the capabilities of firms and managers**. Going forward, it would be useful to further investigate questions such as (i) how can policy makers support an upgrade of managerial skills and practices; who will drive this reform agenda and who will provide resources for such training? (ii) how to incentivize partnership between universities and private sector firms to enhance training; and who would shoulder the costs of such training programs?

Lastly, Vietnam should leverage services to promote further growth of other sectors, especially manufacturing. For example, digital services play a prominent role in bringing new technologies and innovations to manufacturing, where currently, only a minuscule number of firms use "Industry 4.0" digital technologies (Cirera et al. 2020).

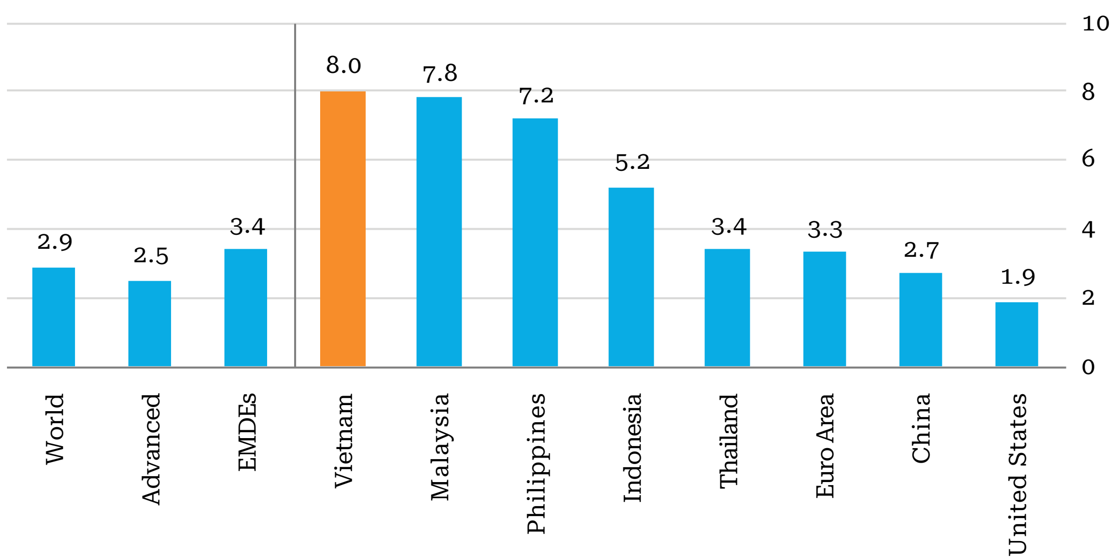
CHAPTER 1. RECENT ECONOMIC DEVELOPMENTS AND PROSPECTS

I. RECENT ECONOMIC DEVELOPMENTS

Heightened uncertainties weighed on the global economy in 2022, as it grappled with low growth and high inflation, the lingering effects of COVID-19, and the ongoing war in Ukraine. Despite these challenges, the global economy registered a weak (2.9 percent) expansion, with the U.S. and the euro area registering 1.9 percent and 3.3 percent GDP growth, respectively (Figure 1.1). On the other hand, Vietnam (8 %) and some other East Asian economies (such as Malaysia and the Philippines) registered strong economic performances, well above advanced economies (2.5 percent), EMDEs (3.4 percent) and China (2.7 percent).

Figure 1.1. Economic growth in 2022

(Percent)



Source: Haver analytics

A strong economic rebound in 2022—partly due to low base effects—with signs of weakening by year-end

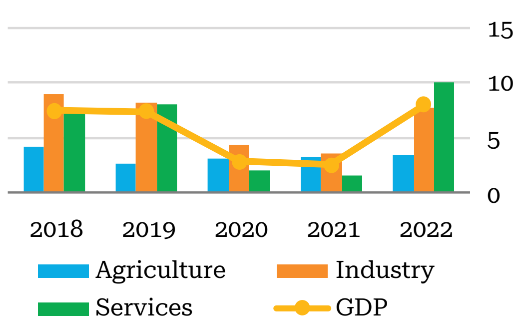
Despite the uncertain global environment, Vietnam's economy grew by 8 percent in 2022—its highest rate in the past decade. The rebound in growth was partly due to the low base effects after a significant COVID-19-related slowdown in 2021. Retail sales expanded by 17.1 percent and the service sector recorded 10 percent growth, driven by private demand (Figure 1.2). In addition, fueled by external demand, manufacturing exports grew by 8.1 percent (the overall industrial sector grew by 7.8 percent) and supported the recovery, particularly during the first three quarters of the year. The agricultural sector continued to perform on trend, growing by 3.4 percent in 2022.

While the overall annual growth was strong in 2022, services and manufacturing sectors showed signs of slowing down in the fourth quarter (Figure 1.4). The services sector slowed from a peak of 19.3 percent y/y growth in Q3-2022 to 8.1 percent growth in Q4-2022, mostly due to base effect. Manufacturing exports started slowing in Q4-2022 in response to weaker demand from U.S. and the euro area economies. Vietnam's Manufacturing Purchasing Managers' Index (PMI)[3] trended down from 52.5 in September to 46.4 in December, signaling three months of contraction in the manufacturing sector (Figure 1.6).

On the demand side, 2022 GDP growth was driven by strong private consumption, a solid contribution of net exports and investment, and a limited contribution by the public sector. Overall, private consumption contributed about 4.3 percentage points to growth in 2022, compared to the 1.1 percentage point contribution in 2021, and in line with contributions in the pre-COVID-19 period (Figure 1.3). This contribution was evident in the first three quarters of 2022, when private consumption of goods and services recovered from the low base effect experienced during COVID-19 restrictions (Figure 1.5). Net exports contributed 2.7 percentage points to growth, primarily due to the strong performance of exports in the first three quarters of the year. The positive contribution of the net exports is due to the fact that while exports and imports growth moderated from 18.9 percent and 26.1 percent, respectively, in 2021 to 10.4 percent and 8.4 percent, respectively in 2022, imports decelerated more sharply than exports. Investment contributed two percentage points to economic growth. Given the slow disbursement of public investment, private domestic and foreign direct investment (FDI) constituted the main drivers of gross capital formation, with 2022 FDI disbursement reaching over US$22.4 billion, compared to US$19.7 billion in 2021 and the highest amount since 2018. Overall, public sector contribution to growth was limited, given the implementation challenges in public investment and continued efforts by the authorities to reduce current expenditures (see discussion below).

Figure 1.2. Real GDP growth by sector

(Percent, y/y)

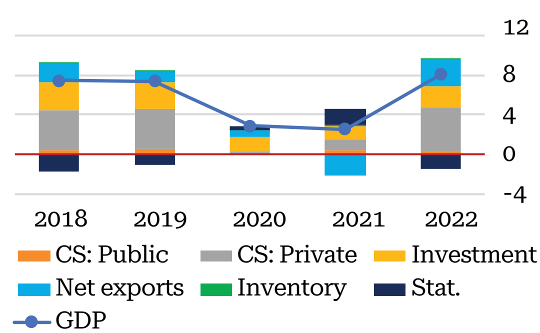


Source: GSO and World Bank staff calculations

Note: Industry includes construction

Figure 1.3. Contribution to GDP growth from the demand side

(Percentage point, y/y, NSA)



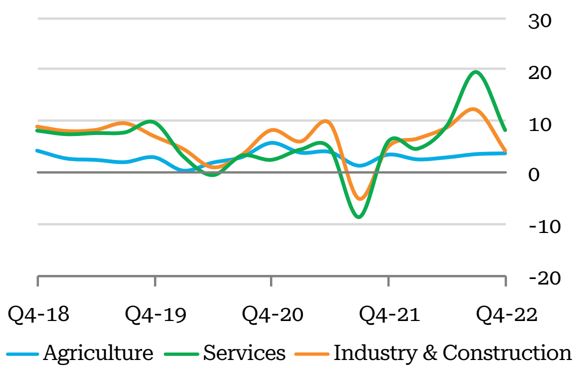
Source: GSO and World Bank staff calculations

Note: 'CS' is consumption; 'Stat' is statistical error

3 The S&P Global Vietnam Manufacturing Purchasing Managers' Index measures the performance of the manufacturing sector and is derived from a survey of 400 manufacturing companies. The Index is based on five individual indexes with the following weights: New Orders (30 percent), Output (25 percent), Employment (20 percent), Suppliers' Delivery Times (15 percent) and Stock of Items Purchased (10 percent), with the Delivery Times Index inverted so that it moves in a comparable direction. A reading above 50 indicates an expansion of the manufacturing sector compared to the previous month, below 50 represents a contraction, while 50 indicates no change.

Figure 1.4. GDP growth by sector

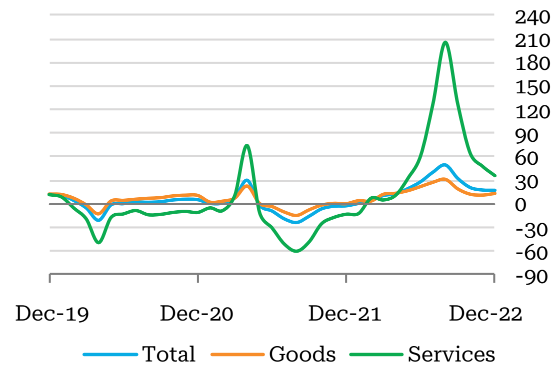
(Percent, y/y)



Source: GSO and World Bank staff calculations

Figure 1.5. Retail sales by sector

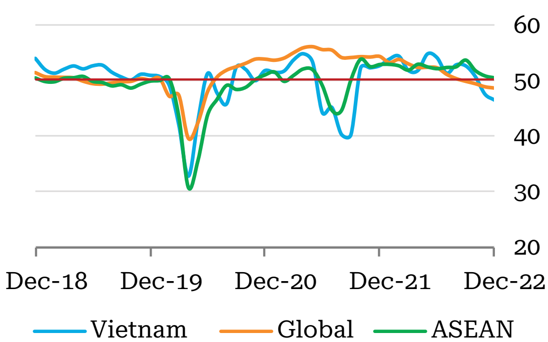
(Percent, y/y, NSA)



Source: GSO and World Bank staff calculations

Figure 1.6. Manufacturing PMI index

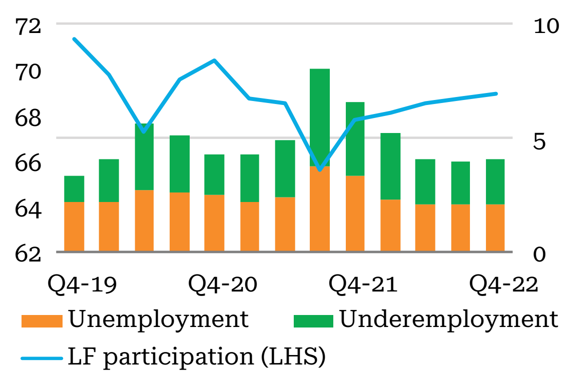
(SA, 50+ = Expansion)



Source: IHS Markit and Haver Analytics

Figure 1.7. Labor market

(Percent, NSA)



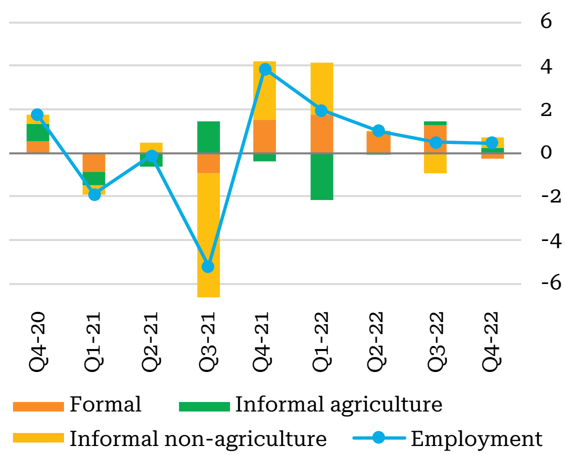
Source: GSO and World Bank staff calculations

The labor market improved in 2022, but signs of renewed weakening emerged

Employment reached pre-COVID-19 levels in 2022 but labor market participation and underemployment rate are still recovering. Employment increased by 4.0 percentage points compared to Q4-2021, returning to pre-pandemic level (Q4-2019). Figure 1.7 shows that the unemployment rate declined from a peak of 3.7 percent in Q3-2021 and leveled at 2.1 percent throughout 2022, comparable to pre-pandemic rates. The labor force participation rate improved gradually in 2022, reaching 68.9 percent by Q4-2022, compared to 67.7 percent in Q4-2021. However, it has not yet reached the average levels recorded for 2019 (71.1%). The underemployment rate remained at 1.9 percent for three quarters in 2022, following a sharp decline from 3.3 percent recorded in Q4-2021. Although the current underemployment rate is only half the peak at 4.2 percent (Q3-2021), it is still about 60 percent higher than in pre-pandemic periods.

Figure 1.8. Change in formal and informal employment

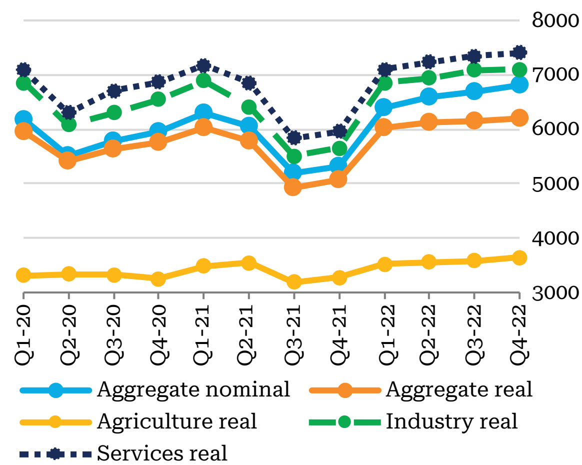
(Percentage points, NSA, Q/Q)



Source: GSO and World Bank staff calculations

Figure 1.9. Average monthly income

(Thousands of dongs, NSA)



Source: GSO and World Bank staff calculations

Note: real is in 2019 constant prices (deflated by CPI inflation rate)

The improvements in the labor market were mirrored by a recovery in average income in 2022, particularly in the industry and services sectors, and poverty rates declined. After dropping by 15.0 percent (quarter-over-quarter [q/q]) in Q3-2021 due to COVID-19-related lockdowns, average real income recovered as the economy re-opened and recovered, accelerating from just 3.1 percent (q/q) in Q4-2021 to 18.8 percent (q/q) in Q1-2022 (Figure 1.9). By the end of 2022, the average monthly real income of wage workers was 6.2 million VND/month, compared to Q4-2020 (6.0 million VND/month). According to the General Statistics Office of Vietnam, household nominal income per capita in 2022 increased to 4.6 million VND/person per month, rising 9.5 percent compared to 2021. The poverty rate declined from an estimated 3.6 percent in 2021 to a projected 3.3 percent in 2022.

However, slowing export markets in Q4-2022 may have jeopardized some of these recent employment and income gains. The General Statistics Office of Vietnam reported the pace of recovery of the labor market slowed in the fourth quarter. One the one hand, the labor force, the number of employed people, and the average income of employees in Q4-2022 continued to increase compared to Q3-2022 and Q4-2021. On the other hand, Q4-2022 saw the unemployment rate, the underemployment rate among working-age persons, and the rate of informal workers increase compared to Q3-2022.[4]

4 General Statistics Office of Vietnam, January 2023, https://www.gso.gov.vn/tin-tuc-thong-ke/2023/01/thong-cao-bao-chi-tinh-hinh-lao-dong-viec-lam-quy-iv-va-nam-2022/. Labor force rose to 52.1 million people in Q4 compared to 51.9 million in Q3-2022; number of employed workers rose from 50.8 million in Q3 to 51 million in Q4-2022. The share of workers with informal employment Q4- 2022 was 65.4%, up 0.4 percentage points from the previous quarter but down 2.4 percentage points from when compared to Q4-2021. Underemployment rose to 1.98 percent (898 thousand) in Q4-2022 compared to 1.92 percent (872,000) in Q3-2022.

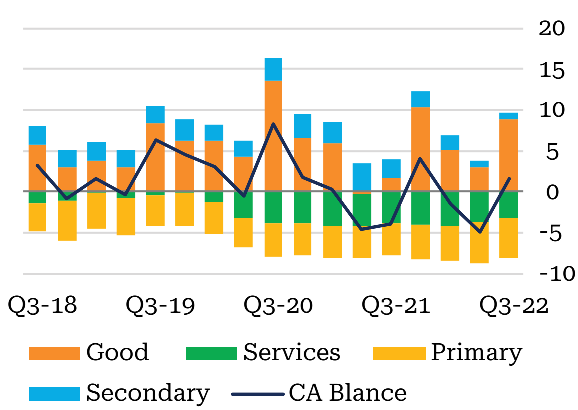
The balance of payment showed signs of weakening in 2022

The current account registered a deficit of US$4.9 billion in the first nine months of 2022 and is expected to remain in deficit for the year (Figure 1.10). While the goods trade balance registered US$6.7 billion in surplus in the first three quarters of 2022, exports contracted by 9 percent (y/y) in November and 14 percent (y/y) in December 2022 due to weakening demand from the U.S. and EU. Services trade balance, which has been showing steady improvement during the year, remained in a sizable deficit (US$11 billion) as service exports have not fully recovered from the pandemic. Both net investment income (primary) and transfers (secondary) worsened in the first three quarters of 2022 compared to the same period in 2021. Nevertheless, the World Bank estimates that remittance inflow increased by 5.1 percent y/y, reaching US$19 billion in 2022.[5]

Meanwhile, despite robust FDI inflows, the financial account surplus deteriorated in the first nine months of 2022[6] due to portfolio outflows in the third quarter. While FDI disbursements reached US$15.4 billion by the end of the third quarter, the financial balance surplus narrowed to US$7.5 billion in Q3-2022 compared to US$26.4 billion in Q3-2021. The third quarter deterioration was mostly connected to large short-term capital outflows resulting from the impact of monetary tightening in the United States (Figure 1.11).

Figure 1.10: Current account balance

(US$ billion, NSA)

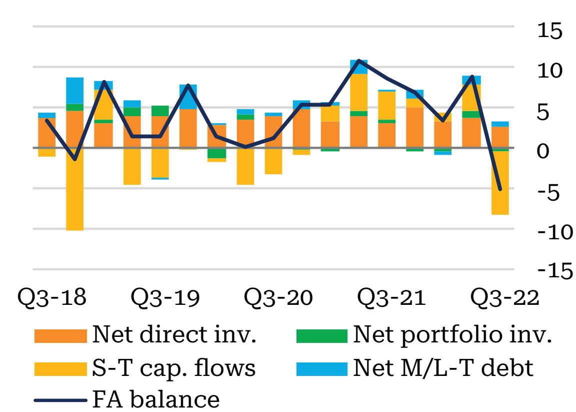


Source: SBV, IMF and World Bank staff calculations

Note: GNFS = goods and non-factor services

Figure 1.11. Financial account balance

(US$ billion, NSA)



Source: IMF and World Bank staff calculations

5 The increase in the remittance inflow in 2022 would be comparable to the increase in 2021 and higher than the average of lower-middle income countries, though lower than the pre-pandemic rate of over 6 percent.

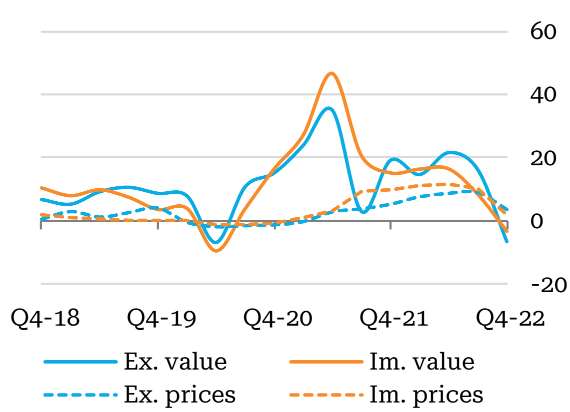
6 Latest official data available. Next data release is end of March 2023.

The 2022 growth in merchandise trade was mostly due to price effects and expansion in the first half of the year

Merchandise exports (free-on-board [FOB]) and imports (cost, insurance, freight [CIF]) grew by 10.4 percent and 8.4 percent in 2022, respectively (Figure 1.12). These rates exceeded those in 2019-20 and were comparable to the growth rate of global trade in 2022 (10 %)[7]; however, they were primarily due to price effects as export and import prices grew by 7.1 percent and 8.6 percent, respectively.[8] Mirroring the trend in global trade, Vietnam's merchandise exports expanded in the first half of 2022, but slowed down in the second half.[9] The second-half slowdown is due to deteriorating economic conditions and rising uncertainties in some of Vietnam's main export markets—the U.S., the eurozone, and China. Nevertheless, the U.S. and the EU remained the main drivers of Vietnam's merchandise export growth (Figure 1.13). The contribution from exports to the eurozone to overall export growth rose slightly (from 1.8 percentage points (pps) in 2021 to 2.1 pps 2022), while contribution from exports to the U.S. market softened (from 6.8 pps to 3.8 pps in the period). On the other hand, exports to China fell sharply as the zero-COVID-19 policy disrupted economic activities in the world's second-largest economy.[10]

Figure 1.12. Merchandise trade

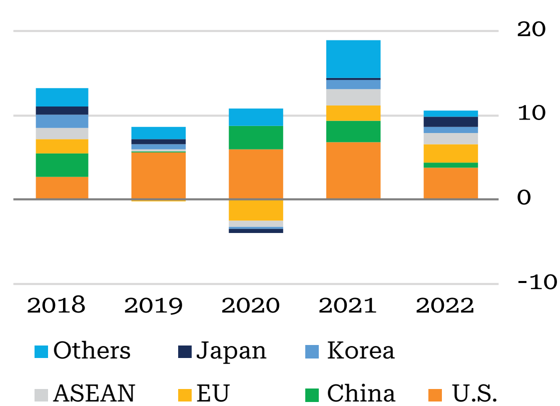
(Percent, y/y, NSA)



Source: GSO, Haver Analytics, and World Bank staff calculations

Figure 1.13. Contribution to total merchandise export growth by market

(Percentage points)



Source: GSO, Haver Analytics, and World Bank staff calculations

7 UNCTAD 2022 Global Trade Update, December 2022. UNCTAD estimated the global trade in goods to increase by about 10 percent in 2022, which was largely due to robust growth in the first half of the year. Trade growth has been subdued during the second half partly due to a decrease in the prices of primary products. The volume of trade continued to increase throughout the year.

8 These price effects softened in Q4-2022, with export prices falling 3.37 percent q/q and import prices falling by 3.88 percent q/q (compared to increases of 1.19 and 0.65 percent q/q respectively in Q3), leading to a slight terms of trade gain for Vietnam.

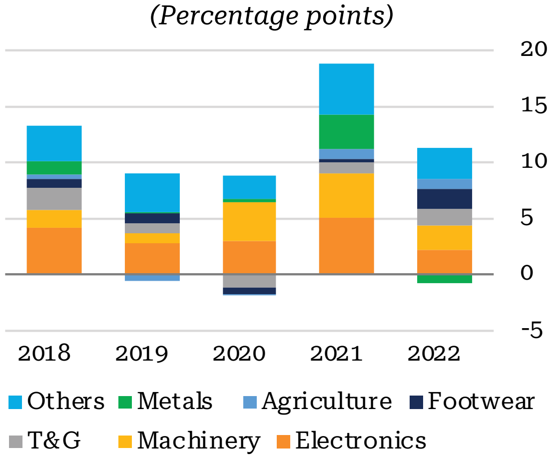
9 Exports contracted by 9 percent (y/y) in November and 14 percent (y/y) in December 2022.

10 China's total merchandise import growth declined from +19.8 percent (y/y) in January 2022 to -10.6 percent (y/y) in November 2022.

Electronics, machinery, footwear, and textiles remained the main drivers of exports, while higher fuel prices raised the import bill. The contribution of electronics and machinery to exports growth moderated compared to 2021. Electronics exports moderated as the pandemic-driven demand for consumer technology appeared to have been sated in 2022, especially in the US, Vietnam's primary market for electronics exports.[11] The slowdown in machinery exports is due to the 2022 lockdowns in China, its main destination. On the other hand, exports of textiles, garments, and footwear, which had been heavily affected in 2020-21 by the pandemic, rebounded strongly, growing by 21.7 percent, and contributing 3.3 percentage points to the total export growth in 2022 (Figure 1.14). Soaring global energy prices increased the fuel import bill, making fuels a third of overall import growth. Vietnam's net imports of fuels doubled, from US$9.5 billion (2.6 percent of GDP) in 2021 to an estimated US$18.6 billion (4.6 percent of GDP) in 2022.

Figure 1.14. Contribution to total merchandise export growth by product

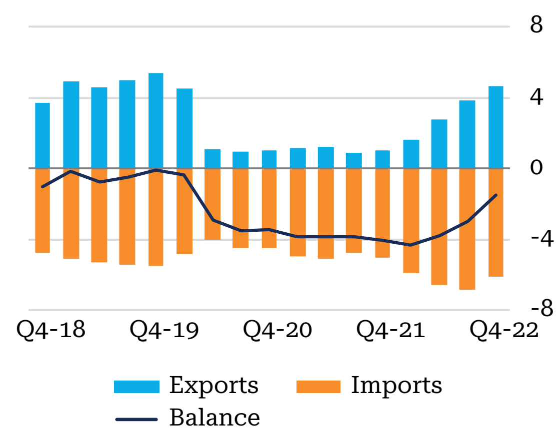
(Percentage points)



Source: GSO, Haver Analytics, and World Bank staff calculations

Figure 1.15. Trade in services

(US$ billion, NSA)



Source: GSO, Haver Analytics, and World Bank staff calculations

Service exports started to recover with the resumption of international tourism

Export of services increased after Vietnam eased border restrictions on international visitors in March 2022 (Figure 1.15). Total service export receipts reached US$12.9 billion in 2022, triple the 2021 values but still only 65 percent of the pre-pandemic level. This increase was due to recovery of exports of travel services and transportation (two major components). As of Q4-2022, exports of transportation services exceeded their pre-pandemic level, while exports of travel services reached 57 percent of the Q4-2019 level. The country received 3.7 million international visitors in 2022 (about 20 percent of the number observed in 2019), with three-quarters of these visitors arriving in the second half of the year. On the other hand, services imports (primarily logistics, freight transport and travel services) were less affected by the

11 Media Play News. "NPD: U.S. Consumer Technology Sales Dropped 8 Percent in 2022, but TV Sales to Grow." Media Play News. January 18, 2023. https://www.mediaplaynews.com/npd-us-consumer-technology-sales-dropped-8-percent-in-2022-but-tv-sales-to-grow/.

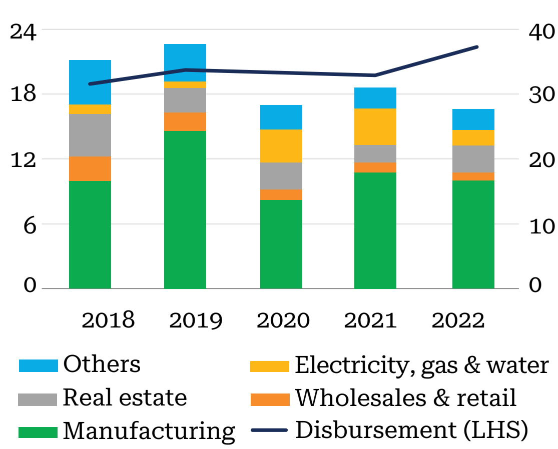
pandemic than services export. They increased by 28.2 percent in 2022 due to rising payments for imported transportation services (up 21.3 percent) and travel services (up 80.2 percent).

New FDI commitments fell to a five-year low while FDI disbursements registered a strong uptick in 2022

Foreign investors committed US$27.7 billion in direct investment in 2022, an 11 percent decrease compared to 2021 and the lowest amount in five years. This decline was driven by lower committed investment in manufacturing (down 7.3 percent) and in power supply (down 60.4 percent) (Figure 1.16).[12] By type, both greenfield investments (GI) and mergers and acquisitions (M&A) continued to fall while investment in the expansion of existing production facilities continued to rise (Figure 1.17). Changes in FDI commitments in Vietnam during 2020-2022 fit international patterns: 2020 was marked by low levels of FDI commitment, which increased in 2021 as many economies started to recover from the COVID-19 crisis, but commitments were projected to fall again in 2022 given heightened risk aversion in the aftermath of the war in Ukraine.[13] In contrast to decreasing commitments (which are expressions of intent) FDI disbursement in Vietnam (which is materialization of intended investment) recovered from the dip in 2020-21, reaching US$22.4 billion in 2022, which is 9.9 percent higher than in 2019. The increased implementation of FDI is due to improved confidence in the economy's potential and resilience through the bruising COVID-19 years and the 2022 crisis.

Figure 1.16. FDI Commitment by sector

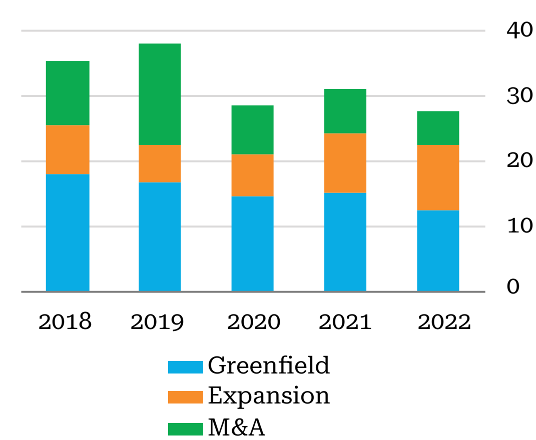
(US$ billion)



Source: MPI, Haver Analytics, and World Bank staff calculations

Figure 1.17. FDI commitment by type

(US$ billion)



Source: MPI, Haver Analytics, and World Bank staff calculations

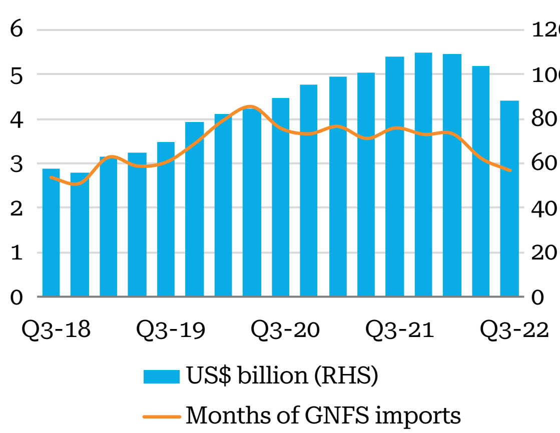
12 In 2021, 2 newly registered projects committed US$4.4 billion in the energy sector: Long An LNG Power Plant Project I and II (Singapore investor, total registered capital of over 3.1 billion USD) and O Mon II Thermal Power Plant Project (Japanese investor, total registered capital of over 1.31 billion USD). After a significant drop in 2021, investment committed in real estate bounced back, increasing by 68.8 percent to US$4.5 billion in 2022, the highest level since 2019.

13 UNCTAD, 2022. World Investment Report. https://unctad.org/system/files/official-document/wir2022_en.pdf

Monetary authorities took steps to stave off pressure on the exchange rate

As global financial conditions started to tighten and Vietnam's balance of payments showed signs of weakening, SBV responded with a combination of FX interventions, some depreciation, and monetary tightening. As the nominal dong to the US dollar exchange rate is a central monetary policy anchor, the SBV initially resorted to foreign interventions to stabilize the currency. While this contained dong depreciation at only 3.8 percent y/y until end-September[14], it led to the loss of an estimated US$22 billion in foreign reserves. The official reserves fell from US$110 billion in December 2021 to US$88 billion as of September 2022, equivalent to about three months of import cover (Figure 1.18). Vietnam's 20 percent official reserve loss was one of the largest in East Asia, which reflects the strong commitment of the State Bank of Vietnam (SBV) to maintain the nominal dong/dollar anchor and reduce depreciation pressures (Figure 1.19). Concurrently, Q3-2022 balance of payment reported net errors and omissions term outflow of US$12 billion, compared to an inflow of US$4.1 billion in Q3-2021, likely reflecting some additional unaccounted capital outflows.[15] As pressure on the dong continued into the fall, the SBV introduced measures for greater exchange rate flexibility in mid-October, such as increasing the corridor around the central exchange rate from +/- 3 percent to +/- 5 percent (Figure 1.20). Simultaneously, the SBV tightened monetary policy with two consecutive rate hikes in a month (100 bps each in late September and again in October), increasing the discount and refinancing rates from 2.5 percent to 4.5 percent and from 4.0 percent to 6.0 percent, respectively. By end-December 2022, the dong had depreciated by a mere 3.4 percent y/y, well below many comparator countries and developed economies (Figure 1.21).

Figure 1.18. International reserve accumulation

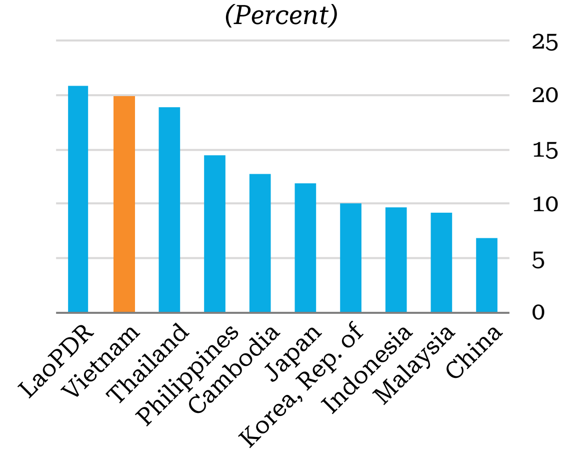


Source: SBV, IMF and World Bank staff calculations

Note: GNFS = goods and non-factor services

Figure 1.19. Loss in official reserves between December 2021 and September 2022

(Percent)

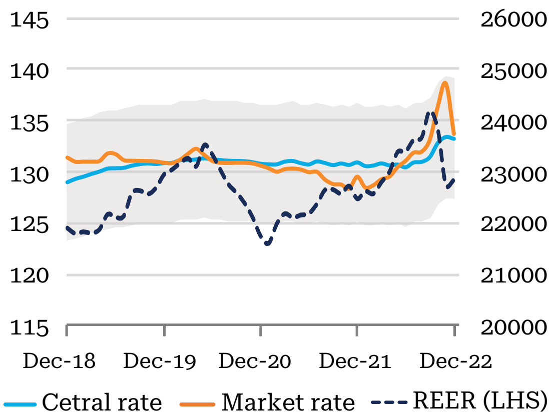


Source: IMF and World Bank staff calculations

14 Haver Analytics, Vietnam Exchange rate middle rate (from Vietcom Bank), monthly.

15 Latest official data available; next data release is March 2023.

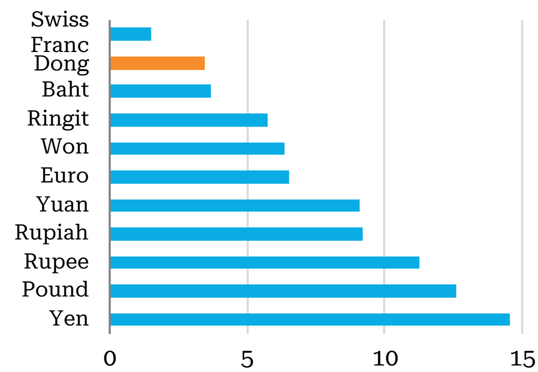
Figure 1.20. Average exchange rate
(VND/US$)



Source: SBV, Vietcombank, Haver Analytics, GEM database and WB staff calculations.

Note: Shaded area represents the two-way 5% band around the central rate set by SBV. Increase in VND rates represent a depreciation of the dong.

Figure 1.21. Rate of currency depreciation against the US$ (select countries)
(Percent)



Source: Financial Times and Haver Analytics.

Note: Comparison between December 31, 2021, and December 30, 2022; positive value indicates a depreciation against the US$

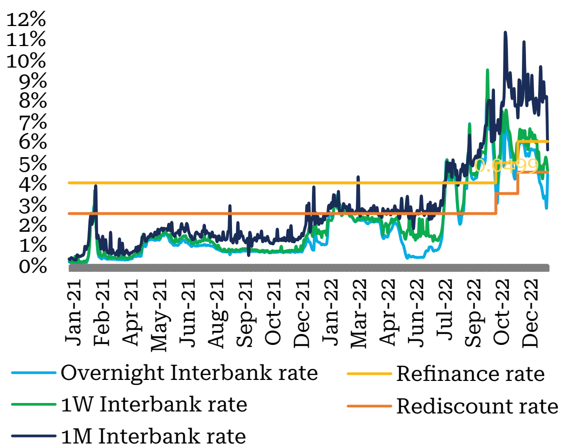
The financial sector experienced a series of shocks, highlighting weaknesses and the need for structural reforms

Vietnam's financial sector experienced increased pressure in 2022 due to external and domestic factors. Global inflation and interest-rate increases in the U.S. and other countries increased domestic interest rates (200 bps increase in policy rates), elevating banks' cost of fund (180-220 bps increase in 12-month deposits) and, in turn, borrowing costs for individuals and the corporate sector (Figure 1.22). The recent brief run on the Saigon Commercial Bank (SCB), triggered by the arrest of several individuals accused of fraud in real-estate and corporate bond deals associated with the bank, shook confidence in the banking sector and capital markets. Risk perception increased, and investors sought higher yields for domestic investment, including equity prices (prices dropped by 32.8 percent in 2022), bonds (government bond yields increased by 324 basis points (bps) on average in 2022), and bank deposits. Small banks appeared to suffer disproportionately from tightening liquidity, as there was a flight-to-quality amidst this heightened risk aversion.

The tightening of financing conditions and resulting lower liquidity in Q4-2022 led to increased interbank and deposit rates. The overnight interbank rate increased from 0.65 percent at the beginning of 2022 to as much as 8.4 percent in October. However, it came down to 4.4 percent by the end of December, more aligned with the prevailing short-term policy rates. Bank deposit interest rates also increased, with the ceiling for those under six months raised from 5.0 to 6.0 percent by the SBV. Interest rates for longer-tenor deposits, as determined by individual commercial banks without a ceiling, increased by 3.5-4.0 percentage points in H2-2022 (compared to the same time in 2021), and in some banks reached as high as 10 percent per year (for terms longer than 12 months) by the end of December 2022, indicating overall tightening market conditions. In some small banks, these deposit rates rose to 11-12 percent, depending on the amount and terms of the deposit.

Figure 1.22. Interbank rates and policy rates

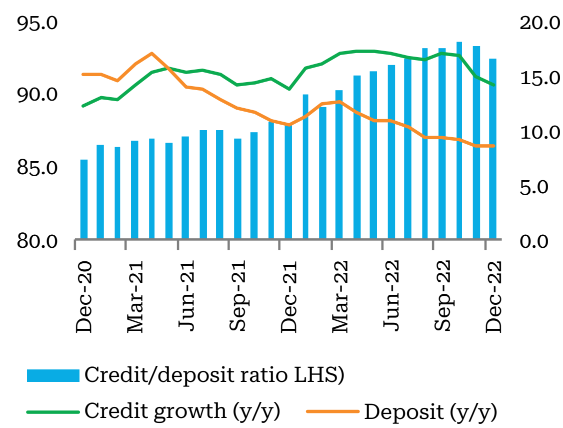
(Percent)



Source: FiinGroup; SBV

Figure 1.23. Loan and deposit

(Share and percent, y/y)



Source: SBV, Haver Analytics, and World Bank staff calculations

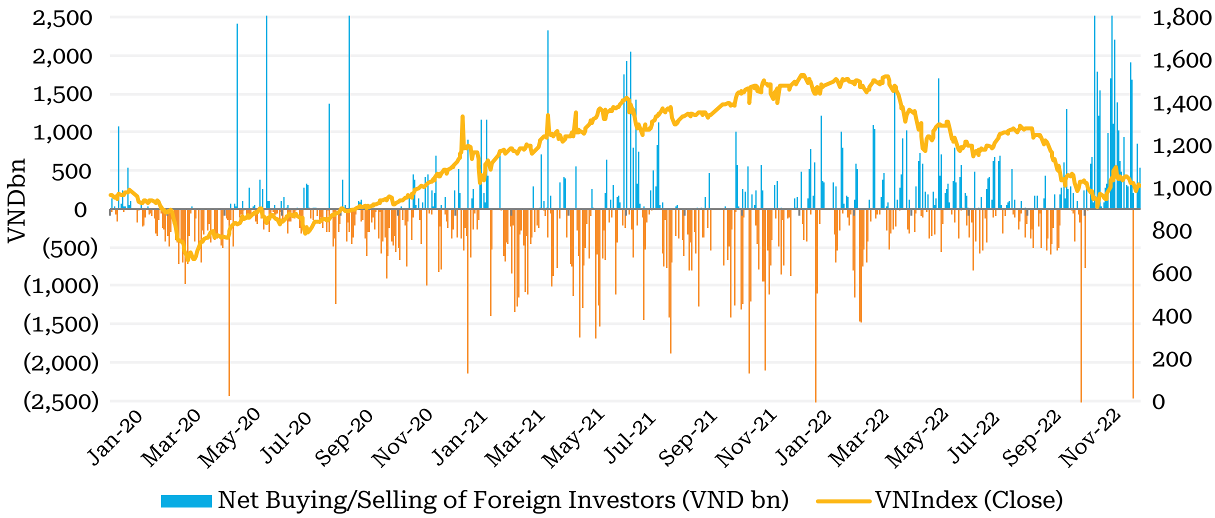
The loan-to-deposit ratio rose sharply during 2022, reflecting falling liquidity, while credit continued to grow

After a short-lived recovery in Q1-2022, deposit growth continued to slow through 2022 (Figure 1.23). The Q1-2022 recovery of credit growth was associated with banks succeeding in bringing back some consumers who had divested of banks' deposits to invest in the markets in search of higher returns. However, a low overall interest environment through September and the scandal around SCB in early fall affected the attractiveness of bank deposits. It is only in late 2022 that higher offered deposit rates incentivized some depositors to return, stabilizing the deposit growth rate at 8.5 percent in November and December. At the same time, credit remained high at 14.5 percent, adding pressure on banking sector liquidity and the interbank market rate, especially during Q4-2022, when the authorities were also intent on tightening conditions in the financial market.

The loss of confidence and tighter liquidity also weighed on corporate bond and stock markets. By the year-end, the main stock market index (VN Index) price fell by 32.8 percent from the beginning of the year (Figure 1.24). The corporate bond market also suffered from a significant drop, recording a total issuance of VND 280.4 trillion (USD 11.8 billion) for 2022, equivalent to only 38.2 percent of the issuance amount in 2021. The decline was due to low market confidence and to tightening issuance rules as stipulated in Decree 65/2022 and amending Decree 153/2020. Amidst investor demand and concern over the potential investigation of misappropriation of bond proceeds, several companies bought back VND 161 trillion in corporate bonds. As investor confidence dropped, corporate borrowers found it challenging to refinance VND 285 trillion (USD 12 billion) of corporate bonds, which matured in H2-2022.

Figure 1.24. VN Index and net buying/selling of foreign investors

(VND billions and index, January 2020 to November 2022)



Source: FiinResearch, Foreign investor inflows data from Hanoi Stock Exchange.

The authorities took swift action to address multi-faceted issues occurring in the financial markets. They made announcements to restore the confidence of depositors and investors, including about the safety of depositors' money in commercial banks and the isolated nature of the alleged fraud. The SBV's Banking Supervisory Agency (BSA) reportedly deployed staff and experts in SCB to bring it back in order and prevent it from deteriorating further. Also, Decree 65 added safety measures to the private placement bond issuance process, including a credit rating, guarantees, and collateral requirements for bonds offered to individual investors. In late November 2022, the SBV decided to increase credit growth limits in select banks, relieving some pressure around liquidity issues affecting corporate borrowers.

High energy prices led to inflation

Indicative results from a recent analysis of the effects of supply and demand shocks on inflation suggest that the effects of the oil price shock on inflation could fade after one year. The analysis is based on inflation response to shocks during the last 20 years (Box 1.1). A negative oil price shock (oil price increase) could induce a 0.73 percent rise in inflation in the first quarter, reaching 1.86 percent in the fourth quarter (Figure B1.a). Higher domestic demand could also contribute to inflationary pressure, but to a lesser extent. A positive demand shock could induce a 0.39 percent rise in inflation in the first quarter, with the increase reaching 0.58 percent in the second quarter (Figure B.1.b). These indicative results appear to be generally consistent with the inflation developments in Vietnam during 2022.

Following the commodity-price shock of March 2022, both headline and core inflation increased, breaching the 4 percent target in October 2022. [16] The Consumer Price Index

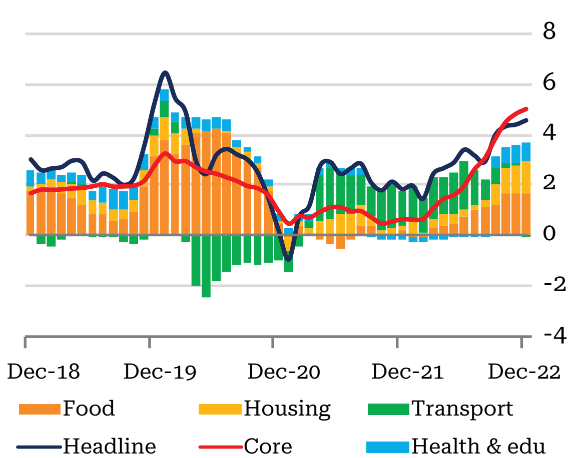
16 Core inflation excludes food, energy, and items whose prices are administered by the government.

(CPI) inflation increased from 1.8 percent in December 2021 to 4.5 percent in December 2022, while core inflation rose from 0.7 percent in December 2021 to 5 percent in December 2022 (Figure 1.25). The inflation was driven by supply and demand side factors. Rising energy prices were the main cause of inflation up to June, with gasoline and diesel prices 61.2 percent higher in June 2022 compared to a year earlier. As a result, transport costs rose by 21.4 percent and contributed 60 percent of the CPI in the same month. In the second half of the year, the second-round transmission of transport cost increases passed through to the economy while domestic private demand continued to firm post-COVID-19 reopening (from 6.5 percent y/y in H1-2022 to 9.5 percent y/y in H2, or two percent (y/y) above trend), leading to rising prices of food, housing, education, and health services in H2-2022. Increases in housing costs are due to higher construction costs and increased demand for housing associated with the reopening of schools and universities. Increases in the cost of health and education services followed two years of price freezes—decreed by the authorities at the beginning of the COVID-19 crisis. These price freezes, together with a freeze on electricity tariffs and price fuel subsidies (through cuts to the environmental protection tax) helped keep inflation lower in Vietnam than in most East Asian neighbors and advanced economies (Figure 1.26).

The manufacturing producer price index increases slowed in Q4-2022. The manufacturing producer price index (PPI) rose by an average 4.1 percent (y/y) in the first three quarters of 2022 (Figure 1.27), driven by a 5.8 percent increase in input prices in the same period. While the 2021 rise in import and input prices was related to the disruptions caused by COVID-19 shocks, increases seen in 2022 are related to the impacts of the war in Ukraine (Figure 1.28). Although price of inputs used in agricultural production also rose by 10 percent, the agriculture PPI only rose by 6.5 percent in the third and fourth quarters of 2022. This disconnect could be due to the longer agricultural production cycle compared to the manufacturing production cycle, leading to a lag in observed inputs versus output prices.

Figure 1.25. Contribution to CPI inflation

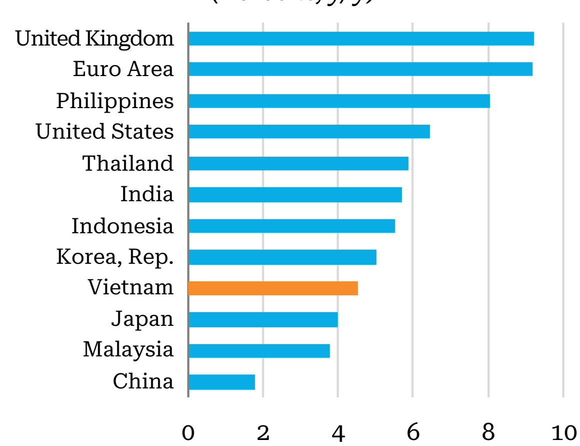
(Percentage points, y/y)



Source: GSO.

Figure 1.26. Inflation in December 2022 in select countries

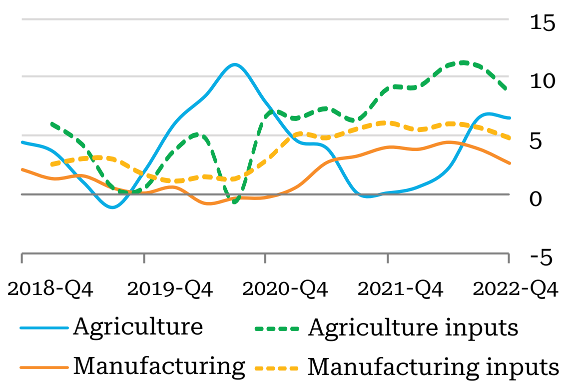
(Percent, y/y)



Source: Haver and GSO, WB staff calculations

Figure 1.27. Producer price indexes

(Percent, y/y, NSA)

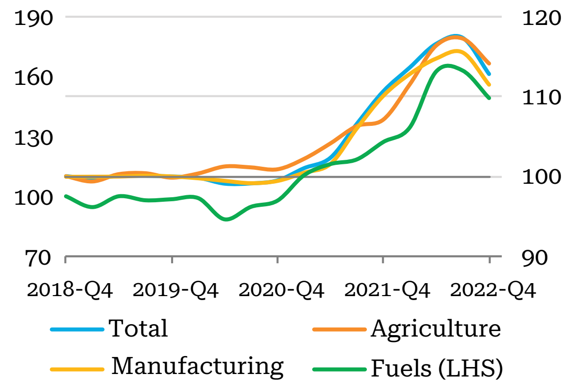


Source: GSO.

Note: Data on price of raw materials and fuels in Q4-2018 are not available; NSA = not seasonally adjusted.

Figure 1.28. Merchandise import price indexes

(Q4-2018 = 100)



Source: GSO.

Box 1.1. Impact of select macroeconomic shocks on inflation in Vietnam

An analysis of pass-through from various macroeconomic shocks to inflation in Vietnam sheds light on questions such as: what shocks affect the pass-through to domestic inflation? Is inflation supply-driven or demand-driven? How will money supply influence inflation?[17] We find that:

Inflation rises in response to a negative oil price shock (oil price increase): One standard deviation (SD) oil price shock leads to a significant impulse response in the first four quarters following the shock. A negative oil price shock induces a 0.73 percent rise in inflation in the first quarter, reaching 1.86 percent in the fourth quarter (Figure B.1.a). The increases in fuel prices subsequently pass-through on to production costs in broader consumer items, resulting in higher inflation.

Higher domestic demand contributes to inflationary pressure: One SD demand increase leads to a significant inflation response in the first two quarters post-shock. A positive demand shock induces a 0.39 percent rise in inflation in the first quarter, with the increase reaching 0.58 percent in the second quarter (Figure B.1.b).

Positive money-supply growth contributes to inflation with lags: One SD M2 growth rate increase leads to a significant inflation response in the fifth to sixth quarter. A positive shock induces a 1.56 percent rise in inflation in the fifth quarter, with the increase reaching 1.65 percent in the sixth quarter (Figure B.1.c).

17 Usually, three broad sets of factors help define the impact of macroeconomic shocks on domestic inflation: (i) the structure of the economy (its production, consumption, and trade); (ii) policies adopted by the government, such as subsidies, export bans, and price controls can also dull some of the pass-through from a macroeconomic shock to domestic prices; and (iii) the measurement methodology, including data collection.

Depreciation contributes to higher domestic inflation: One SD shock to nominal effective exchange rate (NEER) increase has a significant negative impact on domestic inflation in the second to fifth quarters after the shock. A depreciation shock induces a 0.65 percent increase in inflation in the second quarter, with the increase reaching 1.78 percent in the fifth quarter (Figure B.1.d). Exchange rate depreciation contributes to inflation rate through the rising cost of imports in domestic currency. The prices of foreign goods, including imported petroleum and petroleum products increase, putting upward pressure on domestic inflation. Importers of foreign raw materials and intermediate components then face higher relative prices.

Figure B.1. The impulse responses of inflation to macroeconomic shocks

Figure B.1.a. Accumulated response of inflation to one SD crude oil shock

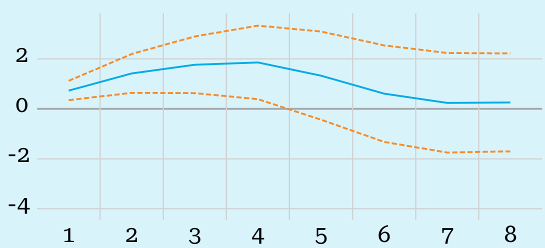


Figure B.1.b. Accumulated response of inflation to one SD GDP shock

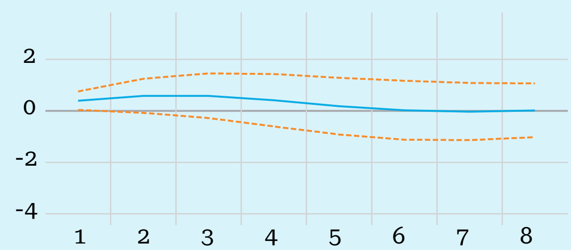


Figure B.1.c. Accumulated response of inflation to one money supply shock

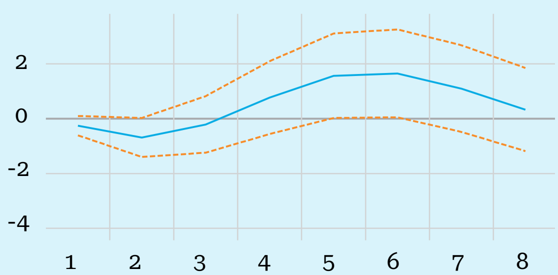
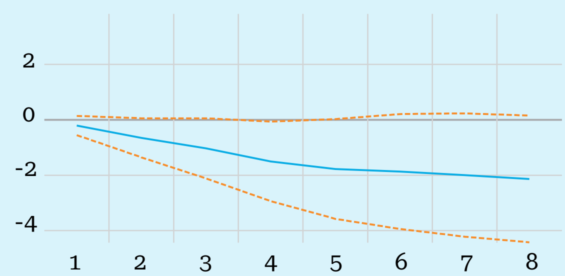


Figure B.1.d. Accumulated response of inflation to one SD shock to nominal effective exchange rate



Source: IMF data, Bruegel data, Haver, FAO data, CEIC data.

Note 1: The impulse responses (the mid-solid line) are presented over an 8-quarter period along the horizontal axis. All shocks are standardized to one Standard Deviation (SD) shock and, hence, the vertical axis shows the approximate percent change in macroeconomic variables with one SD shock. The two upper and lower dotted lines represent two standard confidence bands around the estimation.

Note 2: This analysis uses Vector Auto-Regression (VAR) approach, which is a multivariate time series model that relates current observations of a variable with past observations of itself and past observations of other variables in the system. More importantly, impulse responses in VAR enables the reaction of inflation in response to macroeconomic shocks. The analysis uses quarterly data that covers from Q1 2004 to Q2 2022. To ensure the stationarity of the variables, the unit root test has been applied. *** and ** represent a unit root is rejected by 1 percent and 5 percent significance, that is, the variable is stationary for the VAR analysis. First differences are taken for the variables to ensure the stationarity. The unit root tests are reported in Table 2. This VAR is with ordering of d(3-spot oil price index), d(Nominal GDP_SA), d(M2_yoy), d(NEER), d(inflation). A lag length of three is chosen based on the lag order selection criteria.

Budget implementation challenges thwarted intended fiscal policy support

The government planned a fiscal deficit of 4.2 percent of GDP, but the budget registered monthly surpluses during most of 2022, culminating in an estimated overall fiscal surplus of 1.4 percent of GDP (Figure 1.29).[18] The surplus was driven by higher-than-planned revenue collection (18.9 percent of GDP) and lower-than-planned expenditures (17.5 percent of GDP), while the interest payment on the debt constituted another 1.1 percent of GDP. The primary fiscal surplus is estimated at 2.5 percent of GDP.

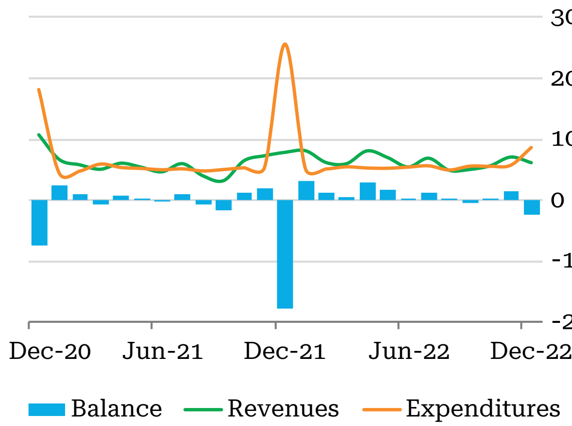
The surplus was partly driven by the higher-than-planned collection of revenues (+26.4%). The 2022 planned revenues were set at a conservative 14.5 percent of GDP, well below recorded revenue collection rates of 18.4 percent of GDP during the 2020-21 (COVID-19 period) budget years and average collection rates of 19.4 percent of GDP during 2016-19. Also, in 2022, collected revenues were 13.8 percent higher than in 2021, due to economic recovery, higher tax collections (including oil taxes), and higher non-tax capital revenues (Figure 1.30).[19] Figure 1.32 highlights that the collection of most taxes (excluding environmental protection tax [EPT] and corporate income tax [CIT]) in the first 3 quarters of 2022 had surpassed collections in the same period of 2021.[20] EPT fell as government cut the tax to provide broad-based subsidies in response to the oil-price increases following the war in Ukraine. The CIT registered lower y/y collection as the government continued to provide tax relief to corporations as part of the 2022-23 Economic Recovery Program. The bulk of the CIT is due by the end of 2022. At the end of Q3-2022, the authorities announced strong collection ratios for five major taxes, ranging from 80 percent of planned CIT to 108.8 percent of planned personal income tax.

18 World Bank staff estimate.

19 Q3-2022 is latest available data. This increase was mostly driven three revenue categories. Sharply higher revenues from oil taxes (+133 percent y/y as of Q3-2022, or +213 percent of planned revenue for this tax category) contributed 2.9 percentage points to total revenue growth as of Q3-2022. Non-tax capital revenues such as long-term land leases (+ 94 percent y/y as of Q3-2022, or +120.6 percent of plan) contributed 5.2 percentage point to total revenue growth. Also, strong economic recovery contributed to non-oil tax revenues, which increased by 19.6 percent (y/y) as of Q3-2022, in turn contributing 12.8 percentage points (y/y) to total revenue growth.

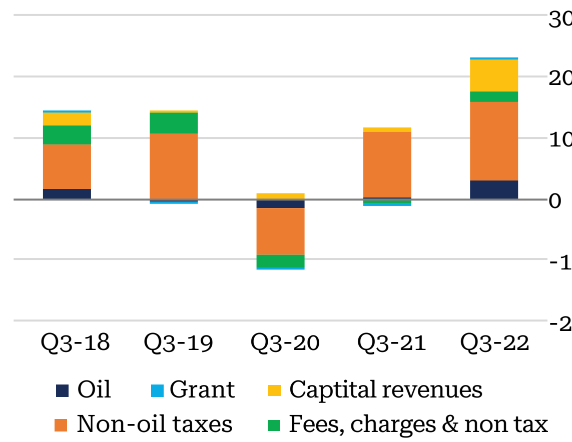
20 Q3-2022 data is latest available.

Figure 1.29. Aggregate fiscal execution
(VND trillions)



Source: MOF and World Bank staff calculations

Figure 1.30. Contribution to total revenue growth by main sources
(Percentage point, YTD, y/y)



Source: MOF and World Bank staff calculations

Budget policies and procedures led to the under-execution of the budget, which also contributed to the fiscal surplus. While planned expenditure was set at 18.8 percent of GDP for the year, the government reported a 12-month executed budget of 16.4 percent of GDP (VND 1,562.3 trillion)[21], an execution rate of 87.5 percent by the end of 2022 (Figure 1.31).[22] Given the practice of a 13-month budget cycle, the authorities had an opportunity to improve this execution rate in January 2023. However, given past budget execution trends, the World Bank estimates that the executed 2022 budget will reach 17.5 percent of GDP, below the planned expenditure for the year. The lower-than-expected execution is partly due to the government's ongoing policy to reduce recurrent expenditure in various areas, saving resources as cash stock to be redeployed for specific policy objectives.[23] For instance, some saved resources from previous years are slated to pay for half of the 2023 civil-service salary increases. As a result, during 2022, current spending reached 10.8 percent of GDP (VND 1,026.2 trillion), equal to 92.4 percent of the annual plans. Meanwhile, capital investments were affected by rigidities in the budgetary process that did not permit swift reallocation of funds and execution. These procedures include lengthy timelines for preparation of new projects; a slow procurement process; and bottlenecks in land acquisition and contract management (including revisions in design and cost of ongoing projects). As a results, capital investments were slow to disburse in the first half of the year, picking up more momentum in Q4-2022.[24] By the end of 2022, investment expenditure reached 4.6 percent of GDP (VND 435.7 trillion), equal to 82.8 percent of annual plans. Interest payments on debt were an estimated 1.1 of GDP in 2022.

21 Ministry of Planning and Investment. "Government Releases Resolution on Annual Socio-Economic Development Plan for 2023." January 6, 2023. https://www.mpi.gov.vn/en/Pages/tinbai.aspx?idTin=53946&idcm=146. MoF reports that the total state budget expenditure accumulated by end December 2022 was VND 1562.3 trillion, while the estimated 2022 expenditure was VND 2033.0 trillion. This means that the authorities estimate that another VND 471 trillion would be executed in January 2023, as per the budgetary practice to allow a 13-month budgetary year.

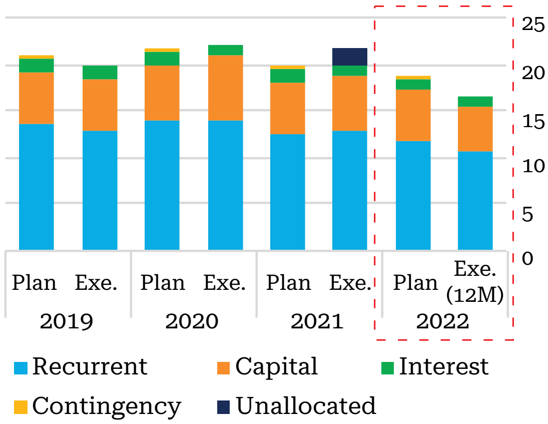
22 During the 12 months of 2022, the executed budget stood at VND 1562.3. About 65.7 percent is current and 27.9 percent is investment expenditures, and 6.5 percent interest payments. Current spending reached VND 1,026.2 trillion, equal to 92.4% of the annual plan. Investment expenditure reached VND 435.7 trillion, equal to 82.8 percent of the annual plan, and interest payments were VND 97.5 trillion.

23 Current expenditure in 2022 are based on the MOF's Press Release No. 1 (January 3, 2023).

24 Capital expenditures are based on the 13-month public investment report No. 845/BCT-ĐT published by the MOF on January 31, 2023.

Figure 1.31. Planned and executed public spending 2019-22

(Percent of GDP)

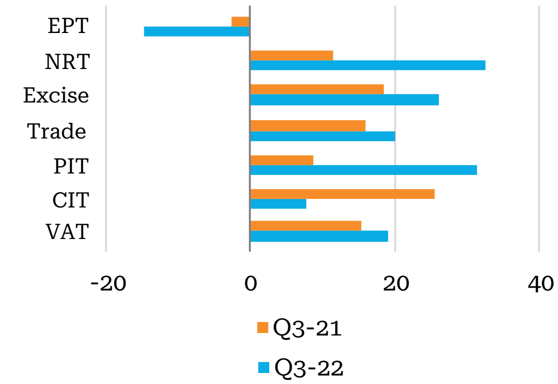


Source: World Bank staff calculation from MOF and GSO data.

Note: Disbursed public spending in 2022 info is from the December Socio-Economic Report, GSO, 29 December 2022.

Figure 1.32. Major non-oil taxes collection

(Percent, y/y, NSA)



Source: MOF and World Bank staff calculations

Note: CIT = corporate income tax; EPT = environmental protection tax; NRT = natural resources tax; PIT = personal income tax; VAT = value added tax

The government has ample fiscal space and debt remains sustainable. The existing fiscal space is partly due to several years' underspending of the investment budget, which helped reduce public and publicly-guaranteed (PPG) debt from a high of 50.9 percent of GDP (GFS) in 2016 to an estimated 39.3 percent of GDP (GFS) in 2021—significantly below the 60 percent debt-to-GDP threshold set by the National Assembly. The authorities also implemented measures to lengthen the maturity and reduce dependence on external debt (which decreased from 14.7% of GDP in 2021 to 12.3% of GDP in 2022). For 2022, given the excess revenues collected and budget implementation issues, we estimate the budget balances to register an overall fiscal surplus of 1.4 percent of GDP. This surplus- together with the fast-growing economy, reduced publicly guaranteed debts, and external debt repayment - will contribute to reducing PPG debt to 35.7 percent of GDP.

II. ECONOMIC OUTLOOK, RISKS, AND POLICY IMPLICATIONS

A positive outlook for the economy, but heightened domestic and external headwinds warrant coordinated and data-driven policy responses from the authorities

The baseline outlook for Vietnam's economy remains favorable. Reflecting domestic and external headwinds, GDP is expected to grow by 6.3 percent in 2023. While the tourism sector continues to recover (thanks to the gradual return of Chinese tourists, who accounted for about

30 percent of total tourists to Vietnam before the pandemic) the services-sector growth will moderate as the post-COVID-19 low base-effects fade. Domestic demand is expected to be affected by higher estimated inflation (4.5 percent average) in 2023. In H1-2023, manufacturing exports will moderate as demand from the U.S. and eurozone weakens, while the path to China's economic recovery is uncertain. However, the expected recovery of Vietnam's major export markets during the second half of the year will positively impact exports. Growth is expected to reach 6.5 percent in 2024 onward as exports strengthen further in response to recovery in all three of Vietnam's primary markets (the U.S., eurozone and China).

Table 1.1. Selected economic indicators, Vietnam, 2020-25

Indicator	**2020**	**2021e**	**2022e**	**2023f**	**2024f**	**2025f**
GDP growth (%)	2.9	2.6	8.0	6.3	6.5	6.5
Growth of expenditure components:						
Consumption: Public	1.2	4.7	3.6	6.3	5.2	5.1
Consumption: Private	0.4	2.0	7.8	6.5	6.8	6.8
Investment	4.1	3.7	6.0	7.2	4.9	5.9
Exports	4.1	13.9	4.9	4.5	6.6	7.0
Imports	3.3	15.8	2.2	5.0	6.2	6.9
Consumer Price Index (average, %)	3.2	1.8	3.1	4.5	3.5	3.0
Current account balance (% of GDP)	4.3	-1.0	-1.7	-0.3	0.1	0.1
Fiscal balance (% of GDP)	-2.9	-3.4	1.4	-0.3	0.8	1.4
Public debt (% of GDP): MOF a/	43.7	42.7	38.0	39.0	---	---
Public debt (% of GDP): GFS b/	41.3	39.3	35.7	35.0	33.2	31.0

Sources: GSO; MOF; SBV; IMF; and World Bank staff calculations

Note: The revised GDP is used in all calculations unless otherwise stated. e = estimate; f = forecast.

a/ As reported by the MOF

b/ Following GFS – World Bank staff calculations 2022-2025

In the baseline, the fiscal balance is expected to register a small deficit while monetary policy will remain prudent. Fiscal balances will continue to be determined by the higher-than-planned revenue collection and implementation challenges affecting the capital budget. The authorities plan to roll out the investment component of the Economic Support Program

—amounting to about 1.6 percent of GDP— with projects that were prepared during 2022. Given the persistent under-execution of capital spending in the past, this program is expected to be partially rolled out from 2023 onwards. The SBV will calibrate short-term policy responses in coordination with fiscal authorities. Its medium-term its mandate of exchange rate management and inflation risk containment is unchanged.

The current account is expected to register a small surplus in the medium term, thanks to the recovery of goods-export performance, foreign tourism, and resilient remittances. Currently, 2023-24 global prospects are facing headwinds with growth projected around 1.7 percent and 2.7 percent, respectively.[25] Continued elevated inflation and monetary tightening in advanced countries to fight inflation are expected to persist into mid-2023. But as the commodity price shock dissipates and global inflation-risks recede, and as China's economic recovery gathers speed, global demand is expected to recover and exports from Vietnam will regain momentum. In the meantime, remittances are expected to contribute substantially to the current account.

CPI Inflation is estimated to average about 4.5 percent in 2023. This estimation assumes that inflation in H1 will be affected by the still-dissipating effects of the March 2022 fuel price shock and the withdrawal of the 2 percent VAT tax break provided as part of the economic support package in 2021. In H2-2023, higher electricity prices and a salary increase for civil service workers will affect inflation. CPI is expected to moderate to 3.5 in 2024 and 3.0 in 2025, returning to pre-pandemic levels.

Risks are broadly balanced. In the near term, Vietnam faces heightened risks associated with external headwinds and domestic vulnerabilities. Persistent inflationary pressures and the prospects of more aggressive monetary tightening, especially in the U.S. and other advanced economies could induce volatility in global financial markets and hamper economic growth even further at a time when a slowdown is already underway. Uneven or incomplete recovery in China could further affect its growth and trade dynamics with Vietnam. Additionally, the risk of de-globalization looms, with heightened geopolitical tensions and conflicts raising uncertainty about the future path of global trade and growth and would substantially affect small open economies such as Vietnam. Domestically, higher inflation and heightened financial risks could affect growth prospects. Persistent price-increases could cause inflation expectations to rise, feeding into destabilizing pressures on nominal wages and production costs. Higher and more persistent inflation tends to discourage domestic consumption due to the higher prices of products and discourage domestic investment due to higher uncertainty about economic conditions. Weaknesses in the policy and supervisory framework of the financial sector and the balance sheet in the corporate, banking, and household sectors could amply risks, affecting domestic investor and consumer sentiments. On the upside, improved growth prospects in China, the US, or EU and stronger than expected global demand could lift exports and hence growth above the baseline projection.

25 World Bank, 'Global Economic Prospects', January 2023.

High uncertainty means that policies should remain responsive to the pace of the recovery in Vietnam and the rest of the world and vigilant to inflation and financial risks

Given the domestic and global outlooks, a supportive fiscal policy stance could hedge against downside risks to growth. Vietnam has fiscal space to act. In the short run, the focus is appropriately on the implementation of the capital budget, including the projects identified in the Economic Recovery Program that include digital and physical infrastructure. These projects would help bolster domestic demand in the near-term and contribute to Vietnam's long-term potential growth. In the medium term, addressing institutional bottlenecks that have led to the chronic under-execution of the public investment program would make fiscal policies more effective. In addition, continued expansion of the targeted social safety-nets would help buffer the effects of elevated inflation on poor and vulnerable households and cushion impacts on private consumption.

Following last year's tightening measures, monetary policy will need to continue balancing inflation, financial stability, and growth objectives. Since domestic headline and core inflation have risen above the policy target set by the government, the current prudent and vigilant monetary policy stance appears appropriate for the time being. However, if headline and core inflation continue to accelerate, coordination of monetary and fiscal policies will be essential. In this circumstance, SBV may wish to consider further monetary tightening to quell inflationary pressures through interest rate hikes, but such hikes could exacerbate existing financial sector vulnerabilities. Maintaining sufficient liquidity support to key funding markets will therefore be crucial to avoid overshooting. Externally, the prospects of further monetary tightening—especially in the U.S. and other advanced economies—could exacerbate the global economic downturn and induce further capital outflows from emerging markets, including Vietnam. Authorities would need to calibrate the use of FX interventions which could lead to FX losses, with the options of increasing the flexibility around the exchange rate and further tightening of the domestic liquidity. Of the three, consideration should be given to increasing the pace of depreciation of the central rate to accommodate pressures on the nominal anchor. Accompanying these steps with clear and forward-looking communication of monetary policy decisions would help guide market participants, quell financial market uncertainties and disruptions, and help anchor inflation expectations. Over the medium term, more fundamental reforms to enhance the SBVs monetary policy framework and a move towards inflation-targeting would enhance monetary policy transmission and effectiveness. This could include steps to expand the tools available to manage liquidity and enhanced macroprudential measures.

Emerging financial risks highlight the need to strengthen policy, supervisory and corporate governance frameworks for the financial sector. Among key measures, consideration should be to the following 6 areas of reform. First, enhance the framework for risk-based supervision by the SBV, including early intervention to prevent significant weakening of balance sheets and contain insolvency risks. Second, strengthen the framework for resolving weak or insolvent banks. A strong framework will have a clear timeline and subsequent actions, including recapitalization, merger, asset separation, revocation of licenses, liquidation, etc. The role of deposit insurance should also be strengthened. Third, establish robust frameworks and policies for supervising consolidated banking groups, including setting a clear separation between banks and company groups. Fourth, amend the Law on Credit Institutions and the State Bank Law to ensure that supervisors have a strong legal mandate and are legally protected from actions they take in good faith within their supervisory responsibilities. This is particularly relevant in early intervention and group supervision, among others. Fifth, enhance corporate bond market standards, including promoting a more-transparent public offer market (vis-à-vis, private placement) and using credit rating to strengthen investor protection and prevent market abuse. Sixth, increase overall transparency of the financial sector. The lack of transparency of the banking sector data and information might have contributed to market uncertainties and volatility. The authorities should regularly publish banking sector and financial market indicators in a timely manner with sufficient granularity. Many of these long standing reforms would benefit from a proactive government approach as they take time to complete and may require changes in legal foundation and culture within and among regulatory/supervisory authorities.

In addition, enhancing the sustainability of growth in the medium to long term will depend on deep structural reforms. Regulatory reforms would improve the business environment and spur business formalization and competition, which would lift productivity growth and help further develop the domestic private sector to respond to demand from a growing middle class. These reforms could ensure resources go to the most productive firms by reforming the insolvency framework. They can also include measures to improve productivity of firms through more and more inclusive access to finance (digital banking, development of capital markets). While efforts to develop manufacturing and the industrial sector are central to the development vision of Vietnam, reforming the regulatory and business environment affecting the various services subsectors would boost sub-sectoral productivity and lead to positive spillover effects within the services sector and across sectors to manufacturing and agriculture, enhancing overall national productivity gains (the focus of the second chapter of this report). This could include reforming regulations around FDI investment in backbone industries such as logistics, banking and telecommunications. Vietnam is a member of 15 active Free Trade Agreements (FTAs) and could explore undertaking services reforms as part of its commitments.

CHAPTER 2. HARNESSING THE POTENTIAL OF THE SERVICES SECTOR FOR GROWTH

I. INTRODUCTION

The services sector has been a critical—though underappreciated—contributor to economic growth in Vietnam. Over the past 20 years, policymakers in Vietnam have prioritized industrialization and manufacturing exports to transform the economy and achieve economic growth. Their decision has helped to ensure a fast-growing and prosperous country, and continued industrialization is considered the backbone of sustained economic growth. Concurrently, the services sector has not only remained the largest sector of the economy but has increased in importance—growing from 40.7 percent of GDP in 2010 to 44.6 percent of GDP in 2019. Moreover, the services sector has often edged out industry as the most significant contributor to growth in Vietnam, as services contributed an average of 3 percentage points to economic growth in 2010-19 compared to 2.8 percentage points from industry.

Looking ahead, services—if properly leveraged—can play a crucial role in supporting Vietnam's ambition to become a high-income economy. All high-income economies boast a large services sector as a dominant employer and source of value addition. For example, in 2019, services (by value-added) constituted 70-80 percent of GDP in the euro area; 70.8 percent in Singapore; and 57.2 percent in the Republic of Korea. Employment in services also constituted 84 percent and 70 percent of total employment in Singapore and Korea, respectively.[26] Further, services have the potential to play an essential role in upgrading Vietnam's development model—a primary objective of the authorities as noted in the Socio-Economic Development Strategy (SEDS), 2021-2030. Upgrading Vietnam's development model— especially its industrial process—entails a greater degree of "servicification" of manufacturing to increase value addition to the production process and further development of enabling services sub-sectors.

This chapter examines the contributions of the services sector to Vietnam's economy and its future potential by exploring drivers for services sector growth and its contribution to the overall economy; intrinsic characteristics of the subsectors of the services sector; and mechanisms by which the services sector may be better leveraged to contribute to Vietnam's economic transformation and goal of reaching high-income economy status by 2045.

26 World Bank data.

II. THE SERVICES SECTOR PERFORMANCE IN VIETNAM

The services sector has contributed substantially to Vietnam's economic transformation, growth, and employment

Vietnam's success in pursuing an export-led manufacturing model has been widely acclaimed, but the role of services in driving growth and economic transformation should not be underestimated. Over the past decade, the services sector has contributed between 40-50 percent of the GDP growth (Figure 2.1). It has also absorbed a substantial number of workers leaving the agricultural sector as Vietnam underwent a structural transformation process (Figure 2.2). The share of workers employed in services increased from 19 percent in 1991 to 35.3 percent in 2019, similar to the increase in the employment share in industrial sectors, which rose from 10 percent in 1991 to 27.4 percent in 2019. This growth has also benefited sectors outside of services, as the service sector provides critical inputs into industrial production and exports, including through banking, logistics services, and transport services.

Box 2.1. Vietnam's export-led growth model: in need of upgrading

Vietnam's successful export-led development model was built chiefly on the low-value-added manufacturing sector. This strategy led to steady FDI inflows that rose from US$2.4 billion in 2000 to US$20 billion disbursed investment by 2020,27 mostly in manufacturing exports. As a result, the share of the manufacturing sector in GDP (as measured by value addition) rose from 17 percent in 2010 to 24 percent in 2020.[28] The share of employment in the industrial sector grew from 21.7 percent in 2010 to 32.6 percent in 2020.29 Reflecting this economic transformation, the share of manufacturing exports rose from 82 percent in 2010 to 96 percent in 2020,30 fueled by both a population dividend and Vietnam's integration into the global economy, including its membership in 15 active FTAs and various global value chains for garments, shoes, and electronics.

However, after a solid run, the traditional drivers of growth—accumulation of physical capital, demographic dividend, and manufacturing expansion (mostly in labor-intensive low-valued added sectors)—are gradually running out of steam. The Government has charted a new development paradigm (SEDS, 2021-2030), where growth would be driven by increased value addition from productivity gains powered by the digital revolution, more efficient and greener technology, and the use of new and existing assets and resources (including human resources). Increasing value addition in the industrialization process would entail more "servicification" of manufacturing, as well as further development of enabling services sectors, including logistics, transport, financial sector services (banking and insurance), and strengthening education services to build the necessary skills in future workers.

Source: World Bank, staff, and ILO data.

27 Vietnam General Statistics Office (GSO) "Foreign direct investment projects licensed in period 1988 – 2021."

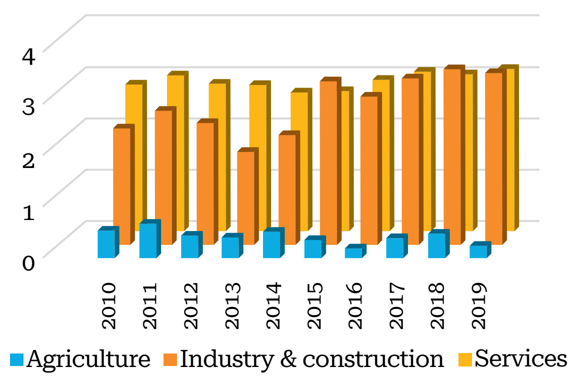
28 Share of industrial sector in GDP (value added) grew by from 33 percent 2010 to 36.7 in 2020. World Bank data.

29 ILO. Data for 2020 from ILO database: share of agriculture in total employment: 32.6%; industry: 31.1%; services: 36.3%. Total employment was 53,326 million.

30 GSO. "Exports of goods by kinds of economic activity."

Figure 2.1. Vietnam: Contribution to GDP growth from the production side, 2010-19

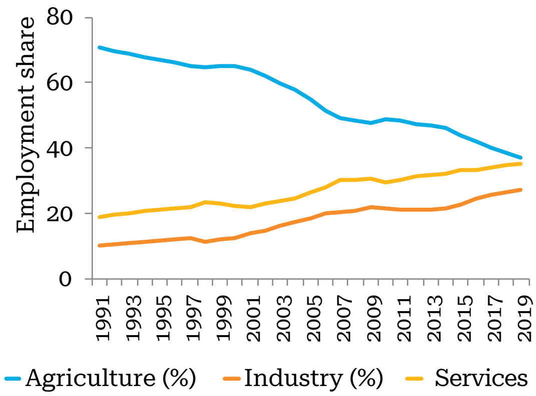
(Percentage points)



Source: GSO and World Bank, staff calculation.

Figure 2.2. Vietnam: Share of employment, 1995–2019

(share of total employment)



Source: World Bank and ILO.

The movement of employment out of agriculture into services and manufacturing has been enhancing aggregate productivity. This movement coincided with increased labor productivity in the latter sectors, contributing to overall economic growth. Labor productivity (measured as value added per worker) rose in manufacturing and some services subsectors such as transport and "other services" (which includes personal services) over time (Figures 2.3 and Figure 2.4). However, productivity improvements were uneven across sectors and subsectors. The 2009-10 global financial crisis severely affected manufacturing and some services sectors—especially commerce and hospitality—and these sectors experienced a sharp decline in productivity. On the other hand, business services (including ICT, professional services, and administrative services) have seen steady employment growth; in 2018 the sector employed 4.8 times as many workers as in 2000. This expansion was initially characterized by declining productivity, but in recent years both productivity and employment have increased in this sector (Figure 2.4).

Figure 2.3. Labor productivity in non-service sectors

(Vietnamese dong, value added per worker)

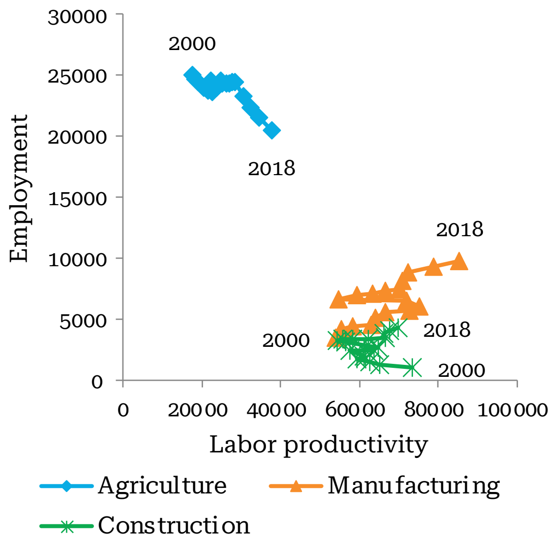
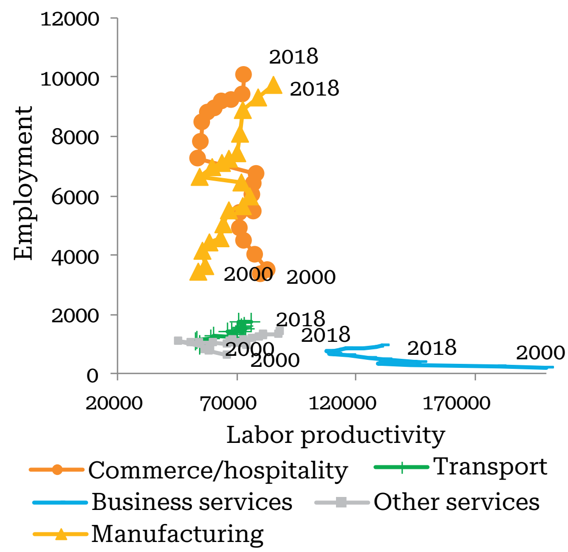


Figure 2.4. Labor productivity in service sectors and manufacturing (for comparison)

(Vietnamese dong, value added per worker)



Source: UNU-WIDER/GGDC Economic Transformation Dataset.

Note: Omitted services sectors include financial services and social services (public administration, health, and education), which are often publicly provided. The significant drop in value added per worker—which hit the commerce and manufacturing sector especially hard—corresponds to the period 2009-10 of the global financial crisis.

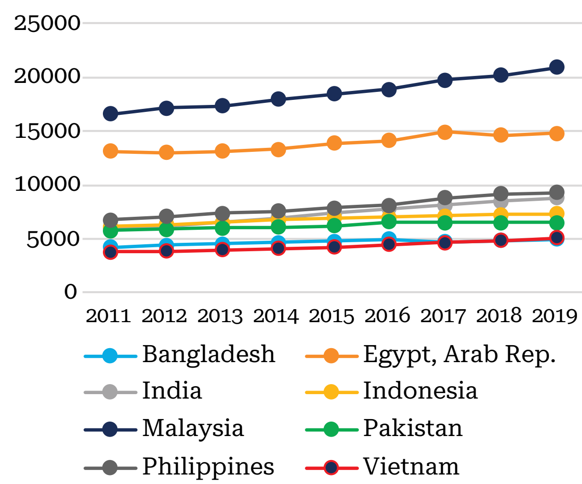
Vietnam's services sector performance continues to lag its peers

Despite its contributions, the performance of Vietnam's services sector lags peer countries. Productivity and employment in the services sector in Vietnam remain lower than many regional, structural, and aspirational peers.[31] Figure 2.5 shows that Vietnam's services sector labor productivity (measured by value added per worker) has increased by 34.3 percent between 2011-19; however, it matches that of only Bangladesh and is well below other comparators. As of 2019, the services' share of employment in Vietnam is only higher than that of India and Laos (Figure 2.6).

31 The analysis includes many comparator peers to provide more perspective. Turkiye and India are included because of the large role of services in their economies and because SCD identifies them as structural comparators along with Bangladesh, China, Egypt, Mexico, Pakistan, Philippines, and Thailand. We have also included regional

Figure 2.5. Services, value added per worker

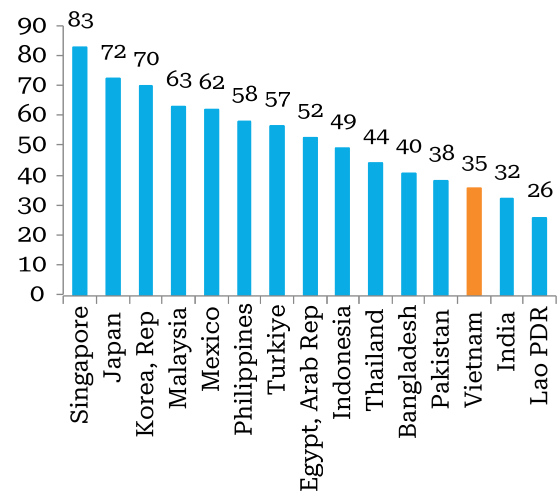
(Constant 2015, in US$, select countries)



Source: World Bank, staff calculations.

Figure 2.6. The employment share in services

(2019, in %, select countries)



Source: World Bank and ILO, staff calculations.

III. A DIVERSIFIED SERVICES SECTOR WITH UNTAPPED POTENTIAL

Distinguishing between different types of services is key to understanding how they contribute to growth, employment, and exports

The services sector covers a wide range of economic activities. Services differ in the extent to which they are traded, their labor intensity, their skills, and whether they are linked to other sectors (Figure 2.7). These characteristics also help define how pro-development the services subsectors are.[32] For example:

- Global innovator services (including ICT, finance, and professional services) are, in relative terms, highly offshorable and traded internationally, require intensive R&D, and share linkages with other sectors, but typically require intensive high-skilled labor. Global innovator services in Vietnam tend to be among the most productive in the economy.
- Low-skill domestic services (such as arts, entertainment, and recreation; administration and support; retail trade; and personal services) employ a large share of low-skilled workers but provide little by way of productivity-enhancing potential through international trade and

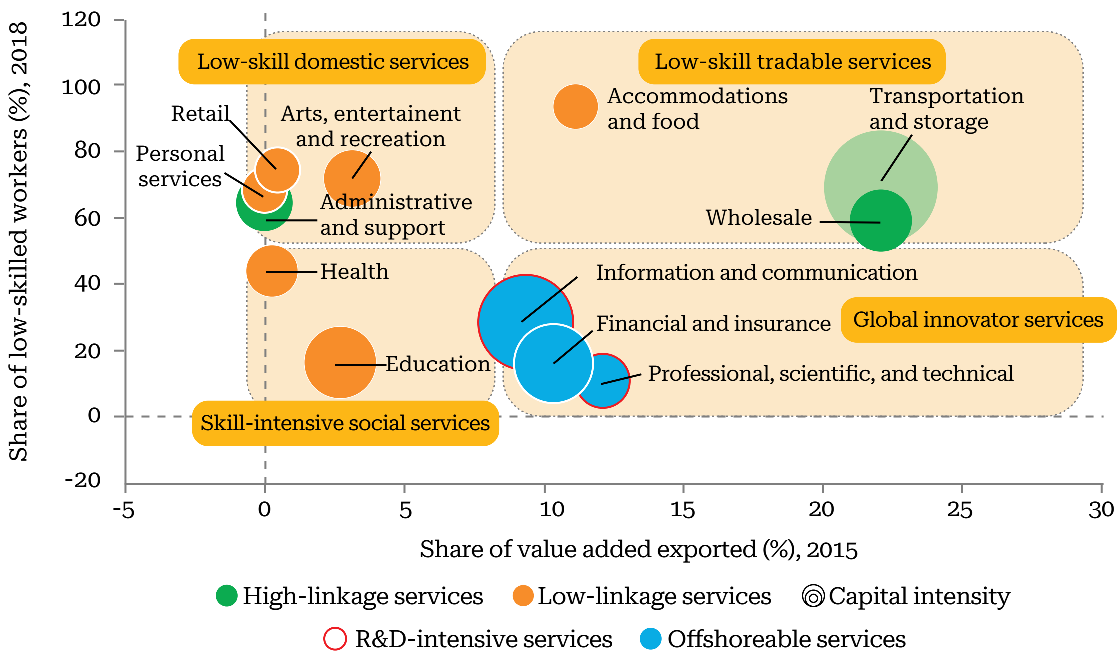
comparators such as Indonesia, Malaysia, Lao PDR. Some aspirational peers were also included in the analysis, including Singapore, Japan, Republic of Korea, France, Chile, Great Britain, and like show how far Vietnam services needed still to improve.

32 Classification of services by pro-development characteristics is based on data from high-income countries.

linkages. On average, low-skill domestic services are less productive than manufacturing across countries.

- Low-skill tradable services (including accommodation, transportation, and wholesale trade) are, in relative terms, highly traded internationally and share linkages with other sectors while also employing a large share of low-skilled workers. On average, the productivity of low-skill tradable services is almost on par with manufacturing across countries.
- Skill-intensive social services (including health and education) are, in relative terms, less traded internationally and share few linkages with other sectors but employ a large share of skilled workers.

Figure 2.7. Example of how services differ in their tradability, labor intensity, skill utilization, and linkage to other sectors



Source: Nayyar, Hallward-Driemeier, and Davies (2021), based on OECD data.

Note: This classification is based on broad sectoral characteristics from high-income countries (the United States and 15 European countries).

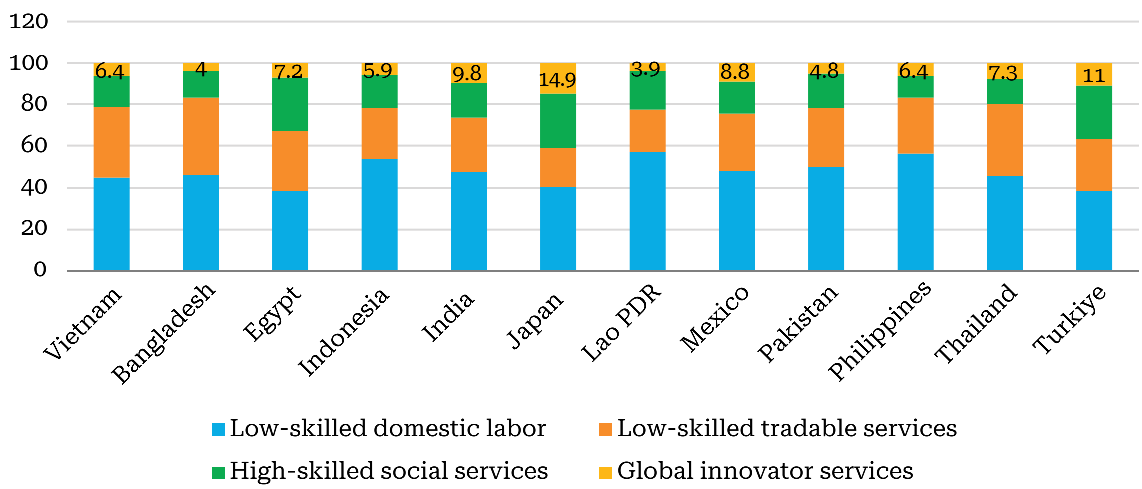
In Vietnam, the share of "global innovator services" employment in overall services employment is low[33]

Only 6.4 percent of Vietnam's overall employment in the services sector is in the critical high-skilled services category of global innovator services. This share is comparable to

33 79.2 percent of services employment is in low skilled jobs, which is relatively comparable to its peers. Only Egypt, Turkiyee, and Japan had smaller shares mostly due to larger social services employment, which represent about a quarter of their services jobs.

the Philippines but less than Egypt, which has a similar income level to Vietnam (Figure 2.8). However, higher-income economies such as Japan, Turkiye, India, Mexico, and Thailand have higher shares of employment in the global innovator category.[34] These jobs contribute most to labor productivity and add more value to the economy compared to other services jobs. Vietnam's share of employment in global innovator services is even lower (about 5 percent) when measured against GDP per capita, ranking well behind most comparator countries (Figure 2.9A). Further, of Vietnam's total services employment, only 1.8 percent relates to professional services, placing it low as compared to aspirational and higher-income peers (Figure 2.9.B).

Figure 2.8. Share of employment in the services sector by skills and tradability

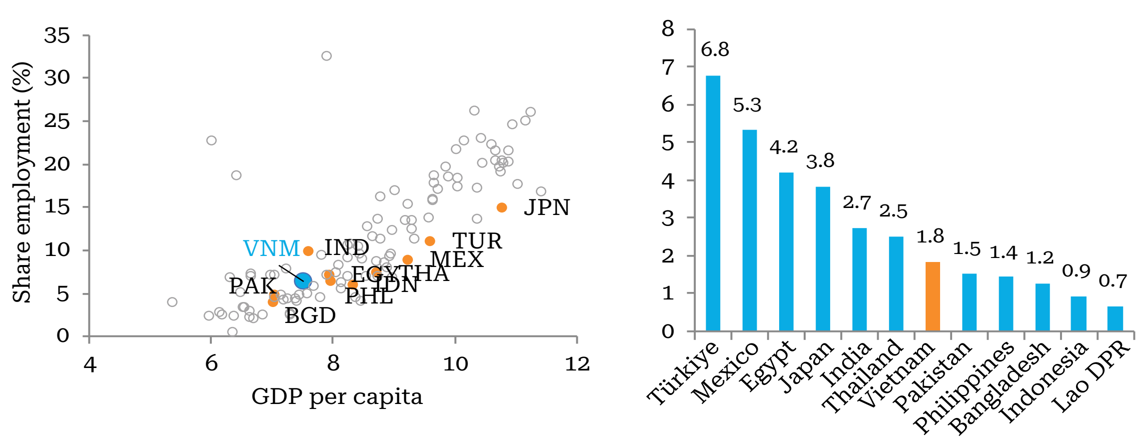


Source: Elaboration based on Nayyar, Hallward-Driemeier, and Davies (2021) and ILO employment data.

Figure 2.9. Employment share in global innovator services

(a) Employment in global innovator services *(as % of services employment)*

(b) Employment in professional services *(as % of services employment)*



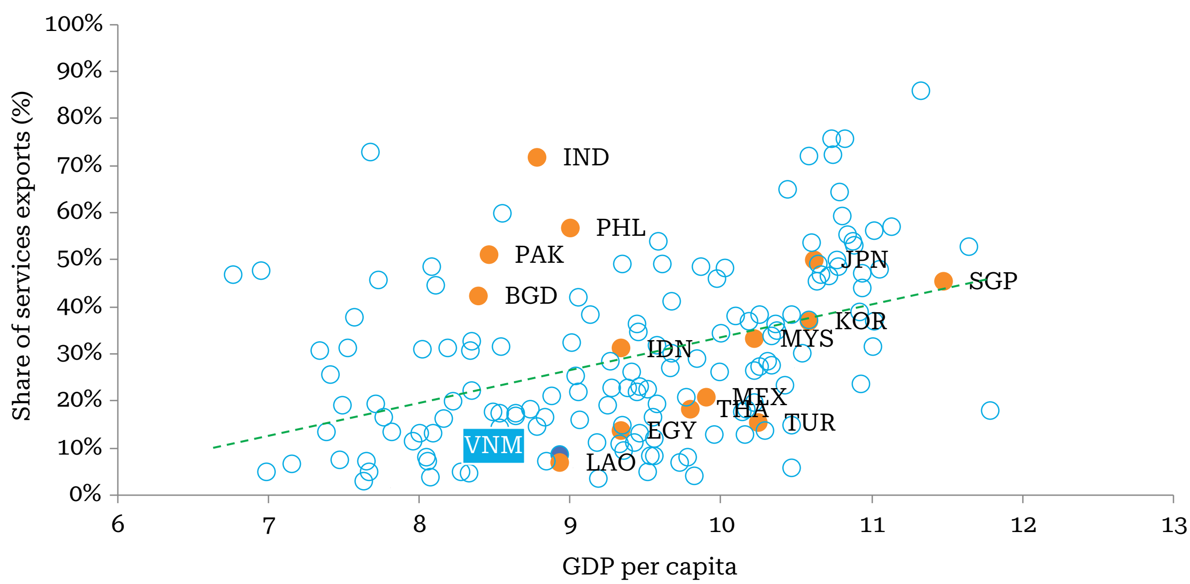
Source: Elaboration based on Nayyar, Hallward-Driemeier, and Davies (2021), and ILO employment data.

34 Income comparison used GDP (constant 2015 US$) for 2019.

Given its small share in employment, global innovator services also make up a low share of services exports

In Vietnam, global innovator services constitute only 9 percent of total services exports, significantly lower than in most other countries (Figure 2.10). Although the general share of global innovators in total services exports is lower for countries with lower income levels, many LMICs have successfully diversified their export baskets by specializing in offshore business services: computer programming, software development, business process outsourcing (BPO), accounting, and architectural and engineering services. For instance, in 2017, global innovator services accounted for more than half of all services exports in Costa Rica, Ghana, India, Pakistan, and the Philippines—a share considerably higher than the average for their per capita income levels (Figure 2.10).

Figure 2.10. Share of global innovator services in total services exports, 2017



Source: Nayyar, Hallward-Driemeier, and Davies (2021), based on WTO Trade in Service by Mode of Supply (TiSMoS) data.

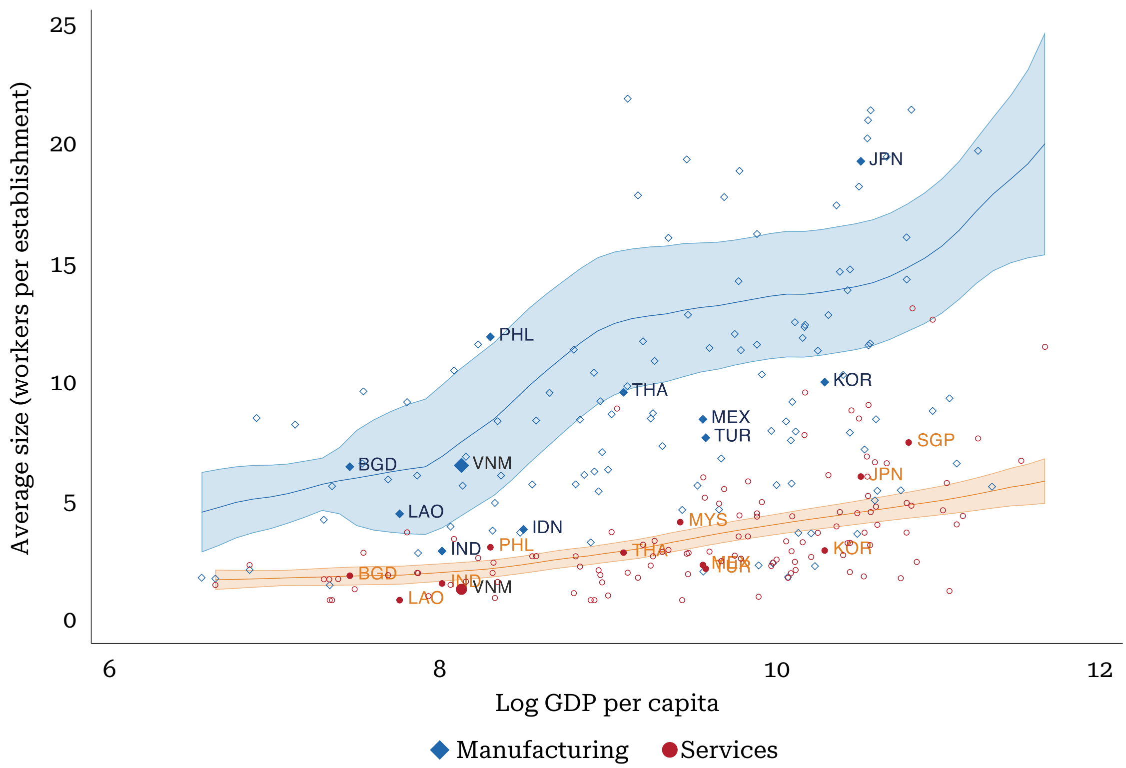
Achieving greater scale, innovation, and cross-sectoral spillovers will boost the services sector productivity and that of connected sectors

The success of manufacturing in creating jobs in Vietnam—and other countries—has been due to its ability to achieve scale, foster innovation and achieve spillovers. Broadly speaking, the manufacturing sector has been able to employ workers productively at scale due to its ability to: (a) achieve economies of scale by increasing the division of labor; (b) augment labor contribution (and productivity) with the adoption of more efficient technologies; and (c) achieve further spillovers between different manufacturing firms through linkages between suppliers and clients. These factors have traditionally played a small role in Vietnam's services sectors, which—just like other emerging economies—have been characterized by small firms with little capital use and few linkages to other parts of the economy. This has been limiting the progress of the services sector.

Services firms in Vietnam operate at a smaller scale compared to countries at similar income levels. Although services firms around the world tend to be smaller than manufacturing firms, the difference is more pronounced in Vietnam. While a manufacturing establishment employs an average of 6.7 workers, a services firm in Vietnam employs on average of only 1.5. This about half the size of what is expected based on its level of GDP, and 3.4 times lower than the average of high-income countries (Figure 2.11), suggesting that services firms in Vietnam are not achieving full economies of scale.

Figure 2.11. Average size of services and manufacturing establishments

(Most recent year, selected countries)



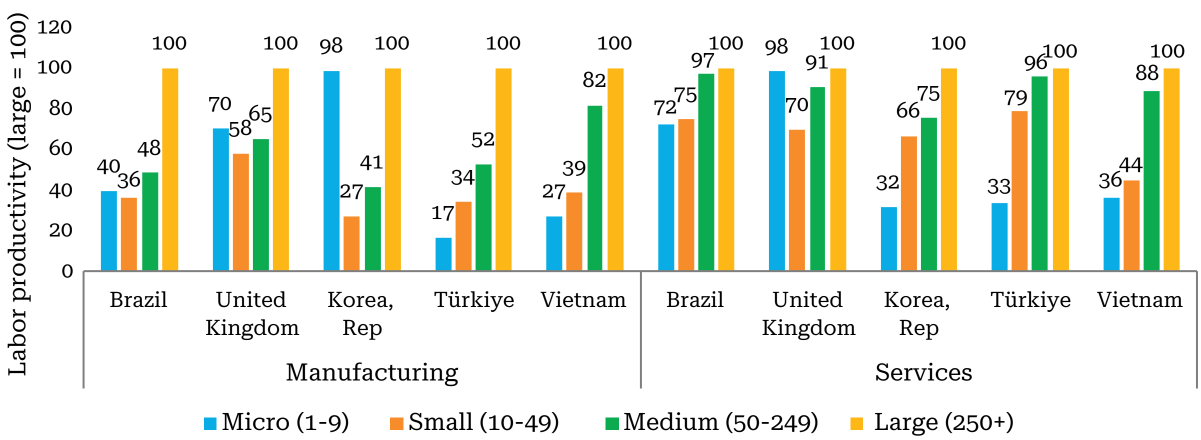
Source: Calculations using data collected by Bento and Restuccia (2021), covering data for 2000-12.

The small scale of services firms has implications for the productivity of the firms and the overall economy (Figure 2.12). In Vietnam, a micro-sized services firm (with less than ten employees) is three times less productive than a large services firm (with more than 250 employees), and about 2.5 times less productive than a medium-sized firm (with between 50 and 249 employees). This means that the growth in the size of services firms is likely to be productivity-enhancing for those firms themselves and, given the large number of small services firms and their growth potential, for the Vietnamese economy. However, scale is not the only determinant: experiences among other higher-income countries—such as Germany and Brazil—show that even small services firms can match the productivity of large services firms. Moreover, the number of services firms with fewer than ten employees in Vietnam are larger than aspirational peers such as Brazil and the United Kingdom, signaling the need for productivity gains among the Vietnamese small services firms.

Enhancing innovation through adopting technology is another way to increase the productivity of the services sector. According to the Firm-level Adoption of Technology (FAT) survey, in Vietnam, average services firms rank 2 and frontier firms rank 2.5 on a scale of 1-5, far from the frontier for global technological adoption for the provision of services (Figure 2.13).[35] Unlike in manufacturing, physical capital plays a minor role for many services sectors (apart from some, such as telecommunications, warehousing, and transportation). Rather, more intangible forms of capital prove more critical such as software, digital assets, intellectual property, brand value, and organizational know-how.

Figure 2.12. Manufacturing and services firms' productivity (value added per worker) relative to large firms in select countries

(latest available years, 2010-17)

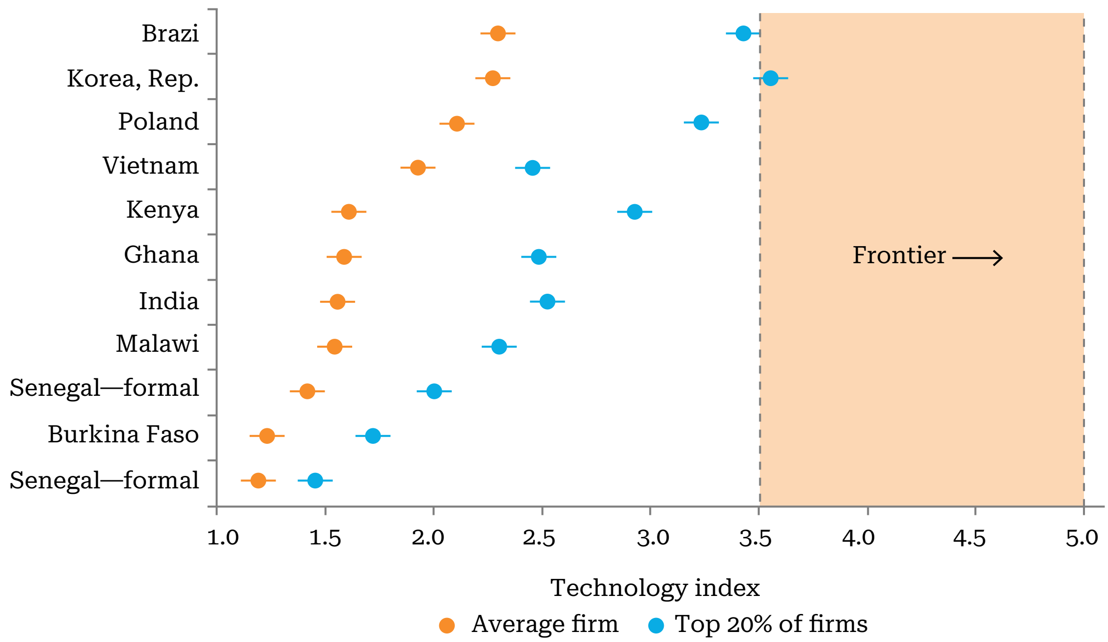


Source: Calculations based on firm-level data from Vietnam and OECD-Eurostat Structural Business Statistics, using data from the latest available period between 2010 and 2017. Vietnam data relates to 2014, the latest firm-level dataset available. The productivity of large firms has been normalized at 100. Productivity comparison is not a cross-country comparison but relative to large firms in a specific country.

35 The frontier is defined by using the top (20 percent) manufacturing firms in the Republic of Korea and Poland as a benchmark. For average firms, the figure plots for each country the average business function, which reflects the average level of technology sophistication of the firm across all business functions, including general business functions (GBFs) and sector-specific business functions (SBFs). Results are based on ordinary least squares (OLS) estimation using sampling weights and controlling for sector, country, formality, firm size group, and age group. Most firms in developing countries, including their best firms (brown dot in Figure 2.13), are far from the frontier. The country rankings based on average technology sophistication tend to coincide with country income levels.

Figure 2.13. The degree of adoption of sophisticated technologies by services firms

(technology index of services firms)

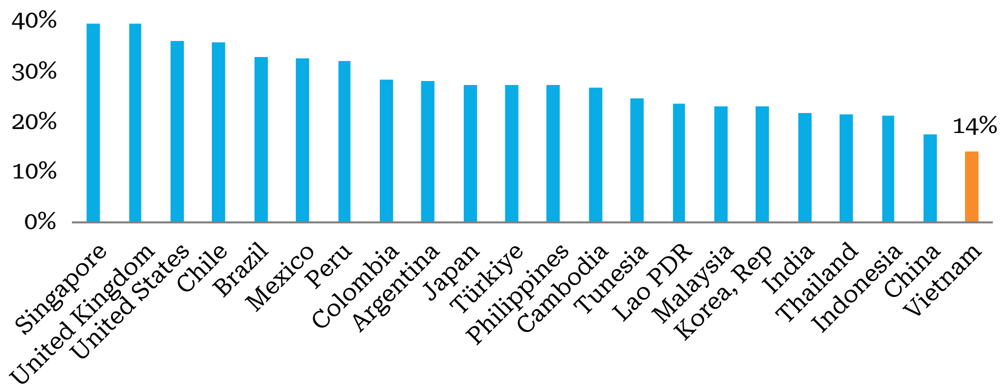


Source: Cirera, Comin & Cruz (2022), based on data from the firm-level adoption of technology (FAT) survey.

Note: The frontier is defined by using the top (20 percent) manufacturing firms in the Republic of Korea and Poland as a benchmark. The figure plots for each country the average business function, which reflects the average level of technology sophistication of the firm across all business functions, including general business functions (GBFs) and sector-specific business functions (SBFs). Results are based on ordinary least squares (OLS) estimation using sampling weights and controlling for sector, country, formality, firm size group, and age group.

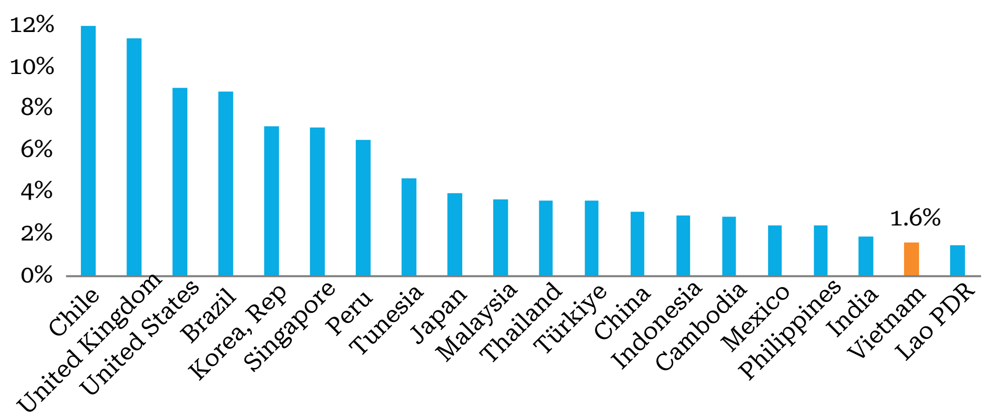
Few linkages exist between services and manufacturing in Vietnam, which limits spillovers between the two sectors. In higher-income economies such as the United States, the United Kingdom, and Singapore, services constitute more than one-third of inputs into manufacturing compared to 14 percent in Vietnam (Figure 2.14). This share is even lower when looking at the use of global innovator services (ICT, professional, and financial services) in manufacturing, where only 1.6 percent of the value of domestic inputs consists of such services in Vietnam (Figure 2.15) compared to roughly 9 percent in the United States and 7 percent in Singapore.

Figure 2.14. Share of services used as domestic inputs for manufacturing, 2018



Source: OECD Input-Output Database.

Figure 2.15. Share of global innovator services used as domestic inputs for manufacturing, 2018

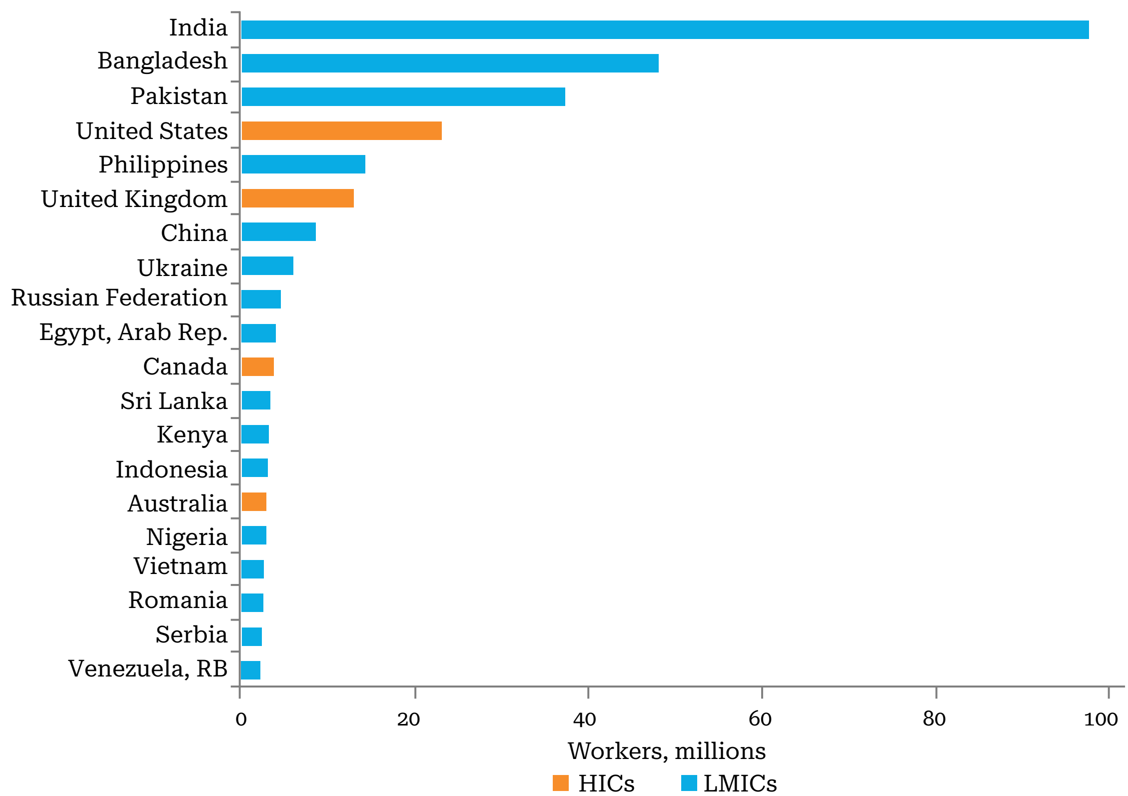


Source: OECD Input-Output Database.

Digital technology will generate opportunities for more scale and innovation in the services sector, enhance linkages with other sectors, and increase the contribution of the services sector to growth in Vietnam

Technology adoption surveys indicate that there is scope for further adoption of scale and innovation processes in Vietnam (Cirera et al. 2021). Figure 2.16 highlights that some Vietnamese workers are already active on large digital platforms, such as Upwork, Fiverr, Freelancer, and MTurk (Kässi & Lehdonvirta 2018). This participation can be encouraged to catch up to regional aspirational comparators such as the Philippines and China. Further use of digital technologies will allow services firms to scale up by transacting with more customers unconstrained by geographical limits. The adoption of digital technology could also bring new forms of innovation and facilitate services delivery efficiency. For example, retail firms can use digital systems to manage inventory, monitor purchases, and automate bookkeeping, while the adoption of digital services in industrial sectors further increases services inputs into the manufacturing process, especially within IT services.

Figure 2.16. Number of workers on five of the largest English-language online freelance platforms



Source: University of Oxford iLabour project.

Box 2.2. Barriers to services trade

Innovation and technology adoption rely on access to knowledge and to the networks, people, goods, and services that store knowledge worldwide. In this context, Vietnam could benefit from more open markets for services trade and competition-enhancing reforms in key services sectors that overarch the economy.

Vietnam's services sector still faces numerous restrictions to trade compared to structural, regional, and aspirational peers (Figure B.2.a). Findings show that the 2021 OECD's Services Trade Restrictiveness Index (STRI) for Vietnam is above the OECD average and is relatively high compared to most countries in the STRI sample.[36]

The index focuses on five forms of services trade restrictions: (a) foreign entry; (b) movement of people; (c) regulatory transparency; (d) barriers to competition; and (e) other discriminatory measures. As a result, the STRI outcomes are primarily driven by economy-wide regulations that affect services across all sectors.

36 OECD-STRI country note on Vietnam, 2021. OECD, Services Trade Restrictiveness Index (STRI).

Figure B.2.a. Services trade restrictiveness Index (STRI) by country and policy, 2021

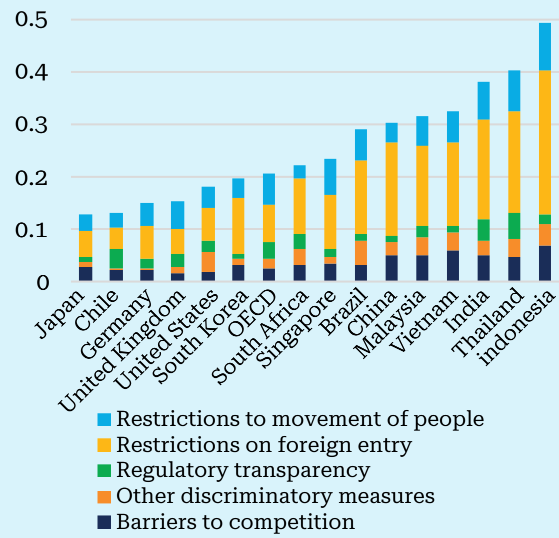


Figure B.2.b. Vietnam's evolution of services trade restrictiveness, 2014-21

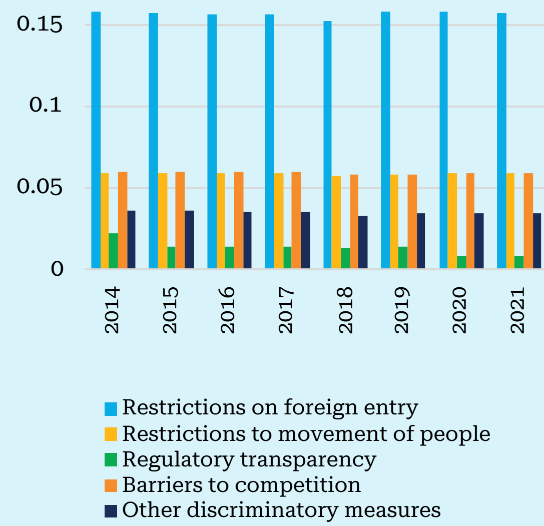


Figure B.2.b highlights that a large part of regulatory restrictiveness is derived from restrictions on foreign entry for service delivery. There have been minor improvements in reducing restrictions between 2014-21, indicating a slow drive to reform and liberalize the services sector. For instance, the country liberalized its computer services and maritime transports to some degree in 2020. Despite its membership in the WTO and an increasing number of active FTAs in the past decade, regulatory transparency has been the sole dimension that has improved noticeably. While some conditions related to foreign investment were eased with the new Investment Law in 2020, some requirements associated with establishing and operating a company remain cumbersome for foreign firms: for instance, a foreigner can only own property for up to 50 years, and that owner must appoint at least one manager or legal representative resident in Vietnam. Certain types of data (such as accounting and some user-generated data) must also be stored in the country. Foreign contractual and independent services providers are subject to labor market tests and their initial entry permits are valid for two years. Participation of foreigners in public procurement has been only possible when provided for in international agreements and is conditional on having a partnership with a domestic contractor or using local sub-contractors.

At the sectoral level, legal services, commercial banking, insurance, and telecommunications are the sectors with the highest score relative to the average STRI across all countries.[37] The highest restrictions are on telecommunications, transport, and distribution services (Figure B.2.c). Telecommunications, with an index of about 0.716, is the most restrictive STRI for Vietnam. Restrictions on air transport services rank high (STRI of 0.493). Logistics services—especially cargo handling (Figure B.2.d), also face trade restrictions (STRI of 0.40). Among services associated with trade in high skills, legal services (STRI of 0.60) and insurance (STRI of 0.435) also face high restrictions.

37 OECD-STRI country note on Vietnam, 2021. OECD, Services Trade Restrictiveness Index (STRI).

Figure B.2.c. Services STRI, 2014-21

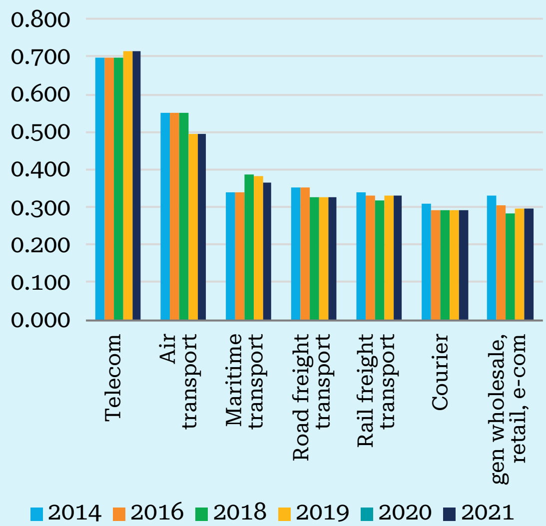
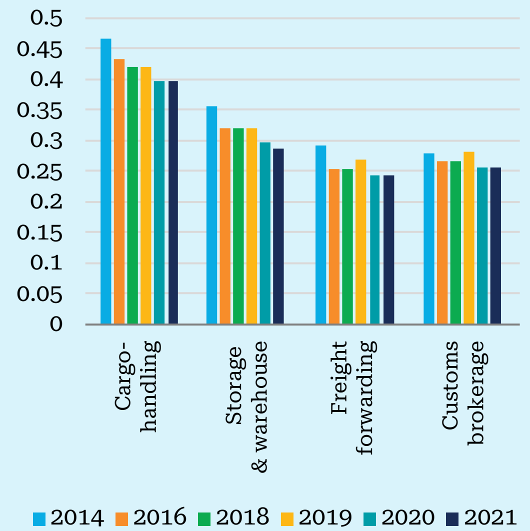


Figure B.2.d. Logistics services STRI, 2014-21



Source: OECD, Services Trade Restrictiveness Index (STRI).

Note: Index is 0-1, with zero indicating full openness. (https://stats.oecd.org/Index.aspx?DataSetCode=STRI). The STRI differentiates between the nature of policy changes by modes of services supply, including cross-border trade (Mode 1), commercial establishment (Mode 3), temporary movement of natural persons (Mode 4), and changes that affect services irrespective of the mode through which they are supplied (all modes).

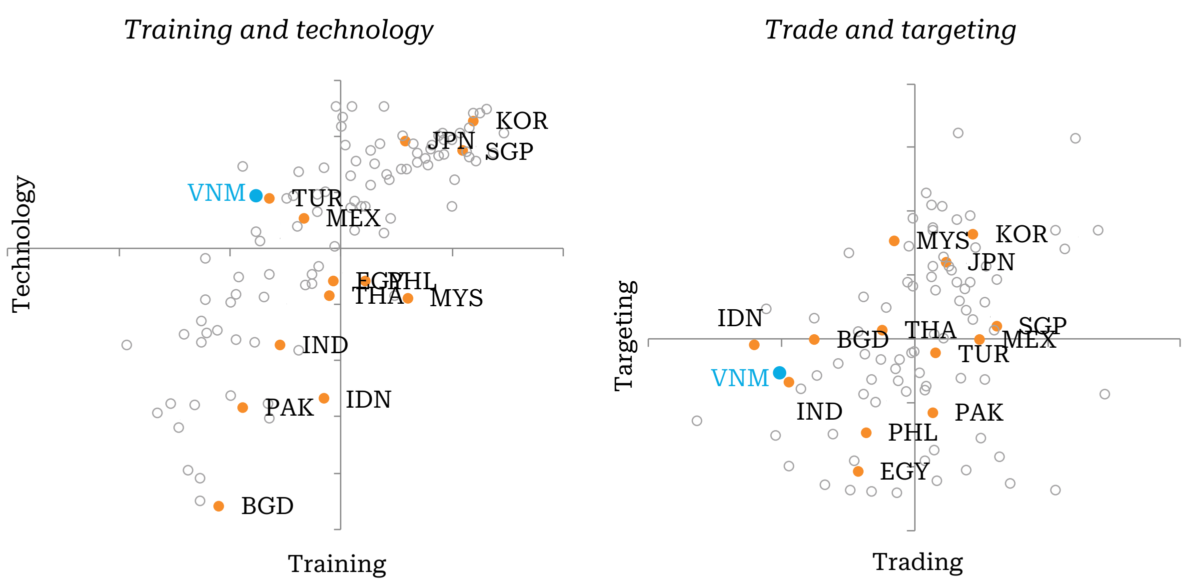
IV. BENCHMARKING THE SERVICES SECTOR ALONG FOUR POLICY AREAS

Four policy areas can play an essential role in fostering the development of services. The World Bank report on services (Nayyar et al. 2021) identifies these policy areas as: (a) trade and investment; (b) training; (c) technology; and (d) the targeting of spillovers. With technology reducing the need for physical proximity between producers and consumers, lowering services trade and investment barriers to enhance service tradability may enable Vietnamese services firms to achieve scalability gains. Expanded access to digital technologies, training, and skills development for workers and managers is necessary to realize the innovation potential that ICTs and associated intangible capital can bring. Recognizing the potential for their linkages with other sectors and targeting the growth of enabling services can maximize spillover effects.

Benchmarking countries along these four policy areas helps identifies the constraints they face in developing their services sector. In this benchmarking approach, trade and investment indicators capture services restrictions and measure the domestic business environment and restrictions on cross-border data flows. The technology indicator is based on the use of the internet and email by firms and the population. The training indicator combines measures of worker and firm competencies—including educational attainment, digital skills, and management practices—across firms. The targeting indicator captures the degree of linkages between services sectors and other sectors.

Vietnam performs above average when compared to peers in technology dimension, but scores below the average for the other three policy dimensions - training, trade, and targeting (Figure 2.17). This underscores that policy priorities should likely focus first on improving firm and worker competencies (the training dimension), strengthening of linkages between services and other sectors (the targeting dimension) and reducing regulatory barriers to cross-border commerce (the trading dimension). On the trading dimension, there is a need to review and reform restrictions on services (see Box 2.2). Even on the technology dimension, the more granular measures of technology adoption presented above (Figure 2.13) indicate that Vietnam services sector remains far from the frontier and ripe for innovation and improvement.

Figure 2.17. Benchmarking Vietnam along the 4T dimensions



Note: Policy dimensions are z-scores of composite indices. The training index combines measures of worker and firm competencies, including tertiary education enrollment, digital skills, and management practices in firms. The technology indicator includes the extent of internet use among the wider population and email use in firms. The trade and investment indicator combines measures of the services trade restrictiveness index (STRI), the ease of doing business, and restrictions on cross-border data flows. The targeting indicator combines the share of forward linkages in the output of ICT/professional/financial services, multiplied by the share of these services in total employment, and the share of forward linkages in the output of wholesale/retail and transportation services, multiplied by the share of manufacturing in GDP. See also Nayyar et al. (2021) for a further description of the construction of indices and underlying sources.

V. POLICIES TO LEVERAGE THE POTENTIAL OF THE SERVICES SECTOR

To enhance the economic contributions of the services sector, policymakers could focus on increasing trade and investment, fostering technology adoption, training workers and firms, and targeting spillovers between services and other sectors

The services sector has played a vital role in creating jobs, driving structural transformation, and contributing nearly half of Vietnam's economic growth. Nevertheless, there is an untapped potential: much of the sectors' growth has been in lower-skilled sub-sectors and not in more productive "global innovator" sub-sectors. Services firms remain relatively small compared to countries with similar income levels. Despite making progress in adopting digital technologies, there is scope for improvement for services firms to innovate by adopting more productive technologies.

A focus on the services sector is crucial for the sector itself and is also needed for higher value-added manufacturing activities. Compared to higher-income countries, manufacturing activities rely little on services inputs. Technological upgrading of the manufacturing process will require a more prominent role of higher-skilled services sectors—such as IT, engineering, and other technical and professional services—but also of lower-skilled services sectors that facilitate trade, such as transportation and logistical services. In addition, the lines between manufacturing and services are increasingly blurring, with manufacturing firms increasingly bundling goods with services.

Reforms and other policies can create a more amenable climate for services growth[38]

On trade and investment, Vietnam could explore opportunities to further reduce restrictions to services trade and entry for foreign investment. OECD Services Trade Restrictiveness Indices (STRIs) indicate that specific "backbone" services sectors—including telecommunications, logistics, aviation, legal services, banking, and insurance—still face high restrictions and little progress has been made in removing or mitigating them (see Box 2). For instance, foreign investment freight transport is restricted in various ways, including in internal waterways freight and road freight (FDI up to 49 percent and 51 percent ownership, respectively).[39] Within banking,

38 The role of these policy dimensions will likely differ across sectors. For example, for global innovator services, all four dimensions are important, as is catching up on the training dimension. For skill-intensive social services (health and education), worker and firm competencies are likely an important driver. For low-skilled tradable services (transportation, wholesale, and tourism services), technology, trade, and targeting are the most important policy dimensions. For low-skilled domestic services (including retail and personal services), technology adoption is the key policy dimension.

39 Per WTO commitments from Acclime, 2021. "Conditional & restricted business sectors for foreign investors in Vietnam 2023."

the total aggregate shareholding of foreign investors in a Vietnamese commercial bank may not exceed 30% of its 'charter capital'.[40] The authorities may wish to consider that

a) reducing restrictions associated with entry of FDI as innovation and technology adoption relies on access to knowledge and networks, people, and goods and services that host that knowledge. The Vietnamese partners and firms could harness this technological knowledge and innovation.

b) undertaking business environment reforms to enhance competition and domestic firms' access to finance

On technology, Vietnam should encourage the further adoption of digital technologies by firms to spur innovation. A recent assessment of Vietnam's science, technology and innovation (STI) policies by the World Bank indicates that great focus has been put on promoting foreign R&D-based innovation and the Government has tried to 'push the technological frontier' by supporting university and research institutions over domestic firms. However, these policies have a limited focus on non-R&D-based forms of innovation, such as technology adoption (Akhlaque, Cirera & Frias 2020). Going forward, it would be useful to further investigate questions such as:

a) how should the STI policies and funding bias towards R&D be rebalanced to focus more on upgrading firm capabilities through business technology adoption and diffusion? If so, what policies and institutional framework can help achieve this goal?

b) which policy instruments could support further knowledge and technology transfers to small and medium enterprises (SME)? How can Vietnam establish lasting and replicable SME/multinational enterprises (MNE) linkages, collaborative R&D programs with MNEs, and entry of technology firms?

c) what are the policy and funding instruments that could support a larger number of firms engaging in incremental innovation of products and processes and adoption of existing technologies? Could use of grants for process innovation and loans for innovation (equipment) work in Vietnam?

On the training dimension, renewed focus should be on both strengthening working skills (fundamental digital skills) and the capabilities of firms and managers. Going forward, it would be useful to further investigate questions such as:

a) how can policy makers support an upgrade of managerial skills and practices? Who will drive this reform agenda and who will provide resources for such training? What is the feasibility and sustainability of relying on skilled diaspora to fill the managerial skills gap?

b) how to incentivize partnership between universities and private sector firms to enhance training? What would incentivize firms to engage into these arrangements, and in investing into more systemic continuous training of their workers?

40 Baker McKenzie (2020) "Global Financial Services Regulatory Guide: What are the requirements to obtain authorization in your jurisdiction?"

On targeting linkages, policies should focus on those services sectors that can contribute to the growth of other sectors, particularly manufacturing. Digital services play a significant role in bringing new technologies and innovations to manufacturing, where currently only a negligible number of firms use “Industry 4.0” digital technologies (Cirera et al. 2020). This also implies addressing constraints to the domestic business environment, including access to finance.

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