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VIETNAM'S FDI INFLOWS TO REMAIN RESILIENT

Foreign direct investment (FDI) is one of Vietnam's most important growth drivers, and Vietnam's FDI inflows have benefitted more than any other country's from the US-China trade war. However, two potential risks to Vietnam's future FDI inflows recently caught the attention of local business leaders and Government policy makers:

1) Vietnam could be *losing its competitiveness* as an FDI destination versus India, Malaysia and/or Indonesia.

2) A new *global corporate minimum tax* scheme would reduce Vietnam's relative attractiveness as an FDI destination by limiting the tax incentives offered to prospective investors.

Tim Cook's visit to India in April spawned a plethora of articles on the intentions of Apple and others to build new factories in the country. But it is important to note that most of the products produced in those factories will be sold into the Indian market. In short, new investments to India are not being motivated by the "China + 1" investment strategy that drove FDI inflows into Vietnam over the last decade, particularly at an accelerated pace since the start of the US-China trade war.

Some observers have also noted that planned FDI into Malaysia and Indonesia surged during the last two years, while Vietnam's registered FDI was essentially flat. However, as we discuss below, investments into Malaysia and Indonesia were largely channeled into the production of goods Vietnam does not make, including electric vehicle (EV) batteries.

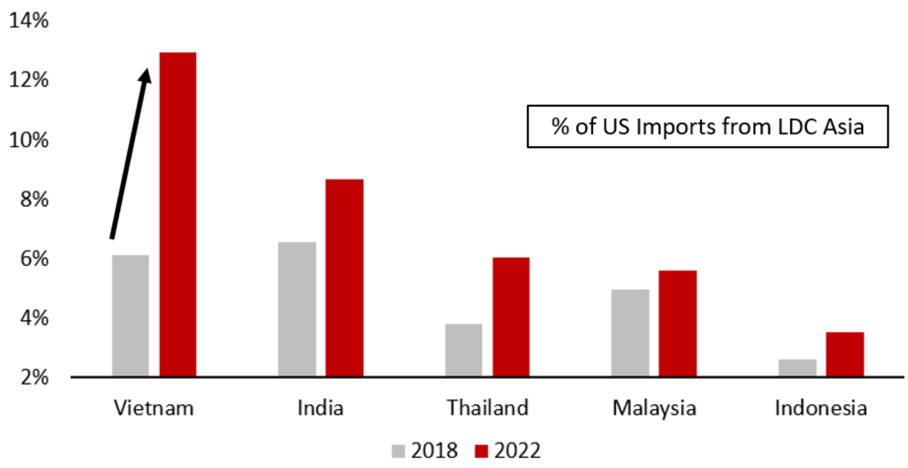
Finally, Vietnam has attracted far more than its "fair" share of FDI since the US-China trade war emerged in 2018, so some of Vietnam's regional competitors for FDI inflows are now experiencing some "catch up" investments after having lagged Vietnam in recent years. But we believe it is likely that Vietnam will continue to be the biggest beneficiary of "China + 1"- motivated investments in the years ahead for reasons discussed in the next section of this report.

Vietnam is the Preferred "China + 1" Destination for Multinationals

The US-China trade war emerged in 2018, and from then until 2022, China's share of exports to the US plunged by about 13%pts, from 69% of total exports from Less Developed Countries (LDC) in Asia (including India) to 56% of LDC Asia exports to the US. Vietnam absorbed about half of

China's drop in export market share, increasing its own share of exports to the US from 6% in 2018 to 13% in 2022.[1]

Vietnam Has Benefited The Most from The China-US Trade War



Vietnam has been the biggest beneficiary of the US-China trade war because the country's three key strengths as an FDI destination propelled investments by multinationals, which in-turn drove the country's surging exports. First-and-foremost, factory wages in Vietnam are less than half those in China, while the quality of the workforce is comparable to China's according to surveys by JETRO and others. Vietnam also has close geographic proximity to the supply chains in Asia, especially for the production of high-tech products.

And finally, Vietnam benefits from the so-called "friendshoring" phenomenon in which multinational firms increasingly invest in countries that are perceived as having minimal risk of having steep tariffs put on their exports to the US[2]. Vietnam's appeal in that regard increased significantly this year in the wake of visits to the country from US Secretary of State Antony Blinken as well as the biggest-ever delegation of leading US firms, both of which followed a call between President Biden and Nguyen Phu Trong, General Secretary of Vietnam's Communist Party.[3]

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[1] Our definition of "Less Developed Countries (LDC)" in Asia includes China, India, Malaysia, Vietnam, etc. but does not include Taiwan and Korea.
[2] https://www.nytimes.com/2022/11/18/business/friendshoring-jargon-business.html
[3] https://tuoitrenews.vn/news/business/20230322/biggestever-us-business-delegation-comes-to-vietnam-to-seek-investment-opportunities/72207.html

India is Not a Threat to Vietnam's FDI Inflows - Yet

Apple's April announcement of ambitious plans to expand its iPhone production in India generated a lot of news, but it is consistent with other multinational firms that are investing in India primarily to manufacture products to be sold to Indian consumers, which is very different than their motivation for investing in Vietnam.

Vietnam is pursuing the so-called "East Asian Development Model," which is the same approach that the "Asian Tiger" economies used to become wealthy. This economic growth strategy is focused on manufacturing products that are exported to the US and other developed countries, and multinational firms that invest in Vietnam are contributing to that endeavor; nearly all of the products they produce in Vietnam are exported, especially to the US, which is Vietnam's largest export market (at over one-quarter of Vietnam's exports).

In contrast, India is pursuing a more domestic-oriented growth strategy, so multinational firms investing in that country are seeking to profit from its rapidly growing middle class rather than as a production base from which to export. For example, Apple iPhone sales in India have exploded in recent years, as can be seen in the table below, so Apple has been pouring money into India to increase its local iPhone production capacity, which has not kept pace with local demand. Of the 7m phones the company sold in India last year, only 6.5m were produced locally, with the balance imported to meet demand, illustrating why Apple's immediate motivation to invest in India is to address surging local demand.

Year	2018	2019	2020	2021	2022
iPhone Sales (m)	1.8	1.9	3.1	6.5	7

Obstacles to Export Production in India

Two key issues are preventing multinational companies from aggressively investing in India to produce goods for export: workforce-related issues (including literacy) and India's strict labor laws. For example, factories in India with more than 100 employees require government approval before laying off any employees, and India's "Make in India" program, which was launched in 2015 to attract manufacturing FDI (partly with tax incentives) is widely recognized as having failed to attract foreign investment, partly for these reasons. These dynamics could change in the future, however, as Apple and others have been pressuring India to improve its attractiveness as an FDI destination because of their desire to diversify production out of China for geopolitical and other reasons.

Last year, Vietnam's "Ease of Doing Business" ranking in the Economist Intelligence Unit (EIU) rating of countries around the world leapt by 12 places, which was the largest improvement in any of the

82 countries the EIU assesses; India's ranking also increased, albeit by six places. In contrast, China's ranking *fell* by 11 places, and the country now ranks below both Vietnam and India.

We do not see India threatening Vietnam's FDI inflows and continue to believe FDI is likely to remain one of Vietnam's key growth drivers for years to come. The current wave of new FDI announcements in India should not be viewed as taking investment away from Vietnam.

Malaysia & Indonesia: Benefiting From EVs & Cloud Computing

Planned foreign investments in Malaysia and Indonesia surged at a near 65% rate and 30 % rate (CAGR), respectively, over the last two years, while Vietnam's registered FDI was essentially flat, and fell in the first four months of this year. Some observers have interpreted this to mean that multinationals maybe setting up factories in Malaysia and Indonesia instead of in Vietnam, but both of those countries are benefitting from a surge of investments into electric vehicle (EV) battery production, and Malaysia is attracting considerable investment into data centers that benefit from cloud computing.

For example, Tesla, BYD, and Hyundai are investing in EV battery production in Indonesia, and Samsung is investing in Malaysia. In Indonesia, such investments are motivated by an abundance of "green metals" in the country as well as the country's strategy to encourage investment in downstream commodities industries (Indonesia banned the export of unprocessed nickel last year, for example). Malaysia is also experiencing a boom in data center and cloud computing-related investments, which grew 4000% last year, driven by investments by Amazon Web Services, Byte Dance systems, and Bridge Data Centres.

Vietnam's high-tech foreign investments are still focused on the assembly of consumer and other electronics as the country's capabilities do not yet extend to higher value-added businesses like data centers and cloud computing. But it is important to keep in mind that Malaysia's climb up the high-tech value chain also started with the assembly of electronic products, so Malaysia's success can be viewed as an indicator of where Vietnam is likely to be in the future.

Global Corporate Minimum Tax Won't Dampen Vietnam's FDI Inflows

FDI companies that invest in Vietnam typically enjoy tax breaks that may include a 0% tax rate during the initial years of their operations in Vietnam, followed by a gradual increase up to Vietnam's full 20% corporate income tax rate over a period as long as ten years.

In 2021, over 100 countries (including Vietnam) agreed to an OECD proposal for a global corporate minimum tax (GMT) that would impose a 15% minimum corporate tax rate on income for companies with consolidated incomes above circa USD850 million, starting from 2023. The implementation of this agreement was subsequently delayed to 2024, and it is not clear yet whether the US, China, and India will participate in the scheme[4].

Vietnam has been preparing for the implementation of the new GMT system next year[5], and it has been reported that around 70 companies in Vietnam could see their tax rates rise if it is imposed. Some of Vietnam's regional EM peers are reportedly investigating alternative schemes in which some of the additional tax revenues would be channeled into a "business support fund" that would effectively offset companies' higher tax burdens by subsidizing some of those firms' production costs (for example, with subsidized electricity prices, spending on the construction of a new factory, worker housing, etc.).

More importantly, low tax rates are far from the most important factor in a company's decision about where to establish a new factory, according to surveys from the World Bank and others. Considerations like political stability, ease-of-doing-business, workforce (quality and wages), and physical infrastructure[6] are all more important factors.

The net conclusion of all of the above is that the new GMT is unlikely to impede Vietnam's FDI inflows given the fact that tax incentives are not the primary attraction for setting up a factory in Vietnam, and it seems likely that workarounds to the GMT are likely to be put in place, if-and-when the scheme is actually implemented.

Conclusion

FDI has been one of Vietnam's most important economic growth drivers over the last decade. Vietnam has significantly outperformed its regional peers in attracting FDI since the US-China trade war emerged, but concerns have been raised about Vietnam's continued competitive advantage amid growing interest in India from firms like Apple and others.
We are not overly concerned that India will affect FDI that would have otherwise poured into Vietnam for any number of reasons, but mainly because this new-found corporate interest in India is to produce for the rapidly growing local market while Vietnam is seen as a base for manufacturing for export. At this point, India is not widely considered an attractive option in the context of a "China + 1" investment strategy while Vietnam is the preferred option for most companies.

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[4] The Biden administration strongly supports US participation in the global corporate minimum tax plan, but the Democratic party does not currently control the Congress, and congressional Republicans have voted unanimously against the US corporate minimum tax in the past.
[5] https://vietnamnet.vn/en/global-minimum-tax-is-a-challenge-but-also-huge-opportunities-for-vietnam-2113400.html
[6] https://openknowledge.worldbank.org/entities/publication/58e3709a-29e0-5c3e-931d-6afad17d20f1

Meanwhile, the new GMT regime should have little-if-any impact on FDI into Vietnam. We believe the Government will, like its peers in some regional markets, find workarounds that will essentially balance out GMT obligations.

For these and other reasons, we fully believe that Vietnam will continue to be a prime destination for FDI, particularly from multinationals looking to produce for export and seeking an alternative and/or additional manufacturing base to China, for the foreseeable future.