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Chinese FDI in Vietnam: Trends, Status and Challenges

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EXECUTIVE SUMMARY

- Chinese FDI in Vietnam since 2011 has witnessed an improvement in source nation rankings, and increase in geographical spread and fields of investment.
- While Chinese investments in Vietnam have brought benefits, there have been complaints that such investments are low in technological content, use outdated technology, engaged in price transfer, and beset with numerous delays.
- There is room for Vietnam to improve the overall environment for foreign investors including those from China.
- On its part, the Chinese government could do more to address the negative perception and the lack of confidence in Chinese investments in the eyes of the Vietnamese public.

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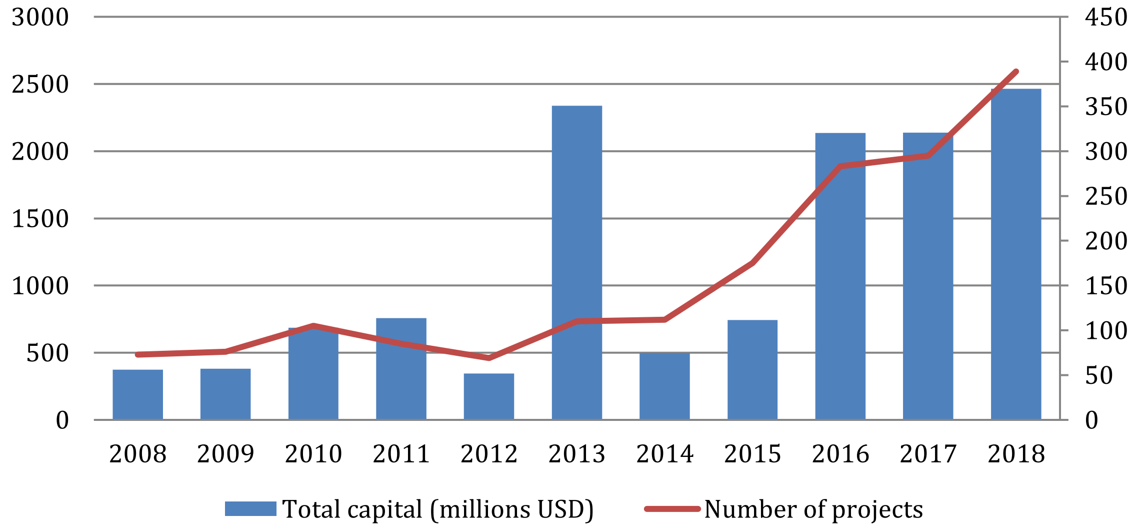
OVERVIEW OF CHINA'S FDI IN VIETNAM

Since 2011, China's foreign direct investment (FDI) in Vietnam has changed dramatically in many ways. The key trends have been a general rise in the rankings, an increase in scale and a change in form and field. From 2015 to the present, and particularly since Vietnam signed on to the Trans-Pacific Partnership (TPP) which later morphed into the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), China is usually among the top ten sources of foreign investment in Vietnam as it seeks to gain a foothold in the lucrative CPTPP market via Vietnam.

According to the General Statistics Office of Vietnam, the total registered capital from China (excluding Taiwan) in Vietnam amounted to US$700 million in 2011. By 2018, the registered capital of China had reached over US$2.4 billion, a three-fold increase sustained by an average annual growth rate of about 18%. Accounting for 6.8% of the total registered FDI in 2018, China ranked as the fifth top investor in Vietnam, behind Japan (ranked 1st at 24.5%), South Korea (ranked 2nd at 20%) and Singapore (ranked 3rd at 14%).[1] This leap of Chinese FDI into Vietnam is impressive, as in 2011, China ranked only 14th out of 94 countries investing in Vietnam.

Number of projects and total new registered capital from China to Vietnam (2008-2018 period)



Source: General Department of Statistics

During the period from 1991 to 2000, China's investments in Vietnam were mainly concentrated in the light industry and consumer sectors. In recent years, China's FDI in Vietnam has shifted strongly towards construction, manufacturing, processing and large construction projects and projects in the energy sector. Processing and manufacturing industry now account for 61.4% of total investment capital, followed by production and distribution of electricity, gas, and water, and air conditioning at 18.2% and real estate at 5.6%.[2] As of 2018, the average investment capital of a Chinese project is about US$6.3 million, with many projects valued in the range of US$1 million to US$10 million.

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The Chinese projects are spread all over Vietnam. In the north, some large-scale Chinese projects include:

- a Vietnam-China Mining and Metallurgy project in Lao Cai province (US$337.5 million);
- a fabric plant in Quang Ninh province (US$300 million) belonging to Texhong Group;[3]
- the Tan Cao Tham rubber processing plant in Lao Cai province (US$337.5 million);
- an iron and steel plant extension (US$340 million) in Thai Nguyen province;
- the Cat Linh-Ha Dong urban railway (with an initial Chinese investment of US$419 million);[4]
- a steel refining and rolling factory (US$33 million) in Thai Binh province;
- a real estate project (US$100 million) in Tien Giang province;
- a footwear project in Dong Nai province (with US$60 million from Phuong Dong – China).

In the central part of Vietnam, the major investments are:

- the Nam Thanh Dong I urban area project, which includes a halal food production plant (US$20 million) in Hai Hung province;
- plastic injection molding and plastic product manufacturing (US$420 million);
- electronic component manufacturing (US$18 million) in Da Nang.

In the south, key Chinese projects include:

- a MDF plywood project (with US$10 million from Glory Wing, China) in Long An province;
- project services related to inkjet printing, graphics, advertising products, advertising services of spray printing Hai Thai Co., advertising Shandong (US$10 million) in Ho Chi Minh City;
- a Vinh Tan 1 power plant (US$1.76 billion) in Binh Thuan province,
- a Viet Lan Tire Plant (US$400 million) in Tay Ninh province;
- the Hung Nghiep Formosa Dong Nai Textile Limited Company project (nearly US$1 billion) in Nhon Trach Industrial Park.

These projects reflect how widely spread the Chinese investments have become in Vietnam in recent years.[5]

Although China’s direct investments can generally be found in many provinces and localities across Vietnam, they are mainly concentrated in densely populated cities with good infrastructure connectivity facilitating ease of travel between China and Vietnam, a strong focus on import and export of goods, and availability of labour. According to Vietnam’s Foreign Investment Department, as of April 2017, Chinese investments are present in 54 localities among Vietnam’s 63 provinces and cities. Binh Thuan province attracts the most Chinese investment capital, at US$2.03 billion (accounting for 18.1% of China's total registered investment capital in Vietnam) for seven projects. Tay Ninh province ranked second with 46 projects at US$1.65 billion (accounting for 14.8% of China’s total registered investment in Vietnam). Bac Giang province ranked third with 61 projects at US$957.56 million (accounting for more than 8.5% of China's total registered investment capital in Vietnam).[6]

REASONS FOR CHINESE FDI INCREASE IN VIETNAM

The Vietnamese government has traditionally touted the country's relatively cheap labour as a competitive advantage in attracting foreign investment, including those from China. This is especially relevant at a time when labour costs in China are increasing. At the moment, the average monthly cost of a labourer in Vietnam range from US$300 to US$350, which is half the cost of labour in China.

Vietnam has also encouraged the entry of foreign firms into the country in order to bring in new and more advanced technologies as well the latest management models. This provides a good opportunity for local businesses to learn and improve their management and productivity. Chinese enterprises in Vietnam make a general contribution in this aspect.[7]

Foreign enterprises also help to promote Vietnamese exports. Currently, foreign enterprises account for 70% of Vietnam's total export value. At the same time, these also generate positive pressure on various Vietnamese government ministries and agencies to improve the legal and operating environment to become more business friendly and be in line with international practices.

Moreover, with a potential market of more than 100 million people with high consumer demand, the field of e-commerce in Vietnam is an industry attracting many FDI investments. Between 2016 and 2018, the two most developed e-commerce sites in Vietnam, Lazada and Tiki, all received large investments from Chinese businesses. In 2016 and 2017, China's Alibaba Group invested US$2 billion in Lazada. By early 2018, Alibaba Group said that it would double its investment in Lazada to fund its regional expansion in Southeast Asia. In January 2018, the second largest e-commerce group in China, JD.com, confirmed an investment of US$44 million in Vietnam's online retailer Tiki.vn in order to compete with Lazada. These investment activities are partly driven by the prospect of capturing Vietnam's growing and relatively young market population and its relatively untapped potential for online retail sales.

Chinese enterprises have been choosing Vietnam as their investment destination as part of the Chinese government's long-term strategy of pursuing economic integration with the world and neighbouring countries. In fact, China has actively pursued international economic integration for many years, especially after China's accession to the WTO in 2001. So far, the Chinese government has concluded more than 100 bilateral or multilateral trade and investment agreements with other countries. In earlier years, such agreements formed the basis for China to attract incoming FDI. Today, these agreements provide avenues for China's investments to go overseas in search of new sources of growth.

In this regard, Vietnam is a viable destination for Chinese enterprises due to the following inherent advantages. Firstly, China is one of the top ten largest investors in the world today. Secondly, in recent years, the capacity and capability of Chinese enterprises have increased significantly. Thirdly, Chinese enterprises that venture overseas fulfill multiple objectives of expanding external markets, promoting export of goods, and exploiting external

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resources. Moreover, the overall slowdown in China's domestic growth is driving its manufacturing industries to look for opportunities abroad.

The investments of Chinese enterprises in Vietnam is also in line with China's ambitious Belt and Road Initiative (BRI). Projects in Vietnam that come under BRI include the construction of a highway linking the southern provinces of China with Hanoi and the northern ports, and the upgrading or building of new ports in the area. Furthermore, Vietnam has made notable progress in the process of trade liberalisation and integration with the global economy. In this context, choosing to invest in Vietnam can help Chinese companies not only take advantage of Vietnam's membership in various FTAs but also avoid tariff barriers imposed by the United States as a result of the ongoing US-China trade war.

EFFECTS OF CHINA'S FDI

Positive Impact

Foreign direct investment has made a huge contribution to job creation, labour restructuring and in improving the quality of human resources. Figures from Vietnam's Ministry of Planning and Investment indicate that direct employment in the foreign investment sector has increased from 330,000 in 1995 to about 3.6 million in 2017, while also creating indirect employment for about 5 to 6 million workers. Although there are no detailed figures of the number of jobs specifically created by Chinese investment, the major role played by Chinese FDI in Vietnam suggests that it has significantly boosted employment opportunities.

Furthermore, China's increasing role as a key source of FDI into Vietnam has particularly helped the latter to upgrade and industrialise its economy. Especially in the post-2008 global financial crisis, Vietnam had a pressing need for capital so as to recover from the crisis and pursue sustainable development. In the long term, while domestic capital will play a decisive role, foreign capital (including ODA capital, FDI capital and indirect investment capital) remains a very important source for Vietnam's industrialisation and modernisation. Moreover, when Chinese enterprises invest in Vietnam, it plays a catalytic role in attracting investments from other countries into Vietnam as well.

In recent years, China's investment in Vietnam has shifted from the light industry and consumer goods industry to the construction and manufacturing sectors. Apart from the key Vietnamese cities and localities mentioned above, China's FDI also targets some of Vietnam's border provinces which have generally been overlooked by investment capital due to poor infrastructure and low levels of economic development. These provinces include Lao Cai (27 projects), Lang Son (20 projects), Cao Bang (7 projects) and Lai Chau (2 projects). Capital inflows into these regions have helped to speed up the urbanisation and modernisation of remote areas, narrowing the development gap between the underdeveloped provinces in the north and other parts of Vietnam.[8]

The export-oriented nature of Chinese FDI in Vietnam has also boosted Vietnam's export industry by providing a convenient route for Made-in-Vietnam products to reach foreign markets. In general, Vietnamese goods are not well known in Asia and in the world, while Vietnamese enterprises lack competitiveness relative to their more established foreign counterparts in countries with strong economic fundamentals. Hence, Chinese investments in Vietnam's export sectors help to facilitate the reach of Vietnamese goods to various markets including China and other Asian countries. This also creates avenues for domestic enterprises to gain access to international markets. At the same time, the export activities of the FDI sector have also helped to promote the growth of other related sectors in Vietnam such as the hotel, and tourism services, currency exchanges, and consultancy services.

Negative Impact

One major drawback for Vietnam is that the heavy reliance on foreign enterprises for its exports (over 70%) exposes the country to unnecessary risks. As production is generally dependent on transnational supply chains, foreign enterprises in Vietnam are often deeply engaged in both import and export processes, leaving the Vietnamese economy vulnerable to global economic conditions. Vietnam's Minister of Industry and Trade Tran Tuan Anh has commented how "[t]his over-reliance is a disadvantage and poses an unstable element because the production and export of FDI enterprises depends a lot on regional and global supply chains, hence it is quite sensitive to trade fluctuations on the world market".[9]

Another drawback has to do with the type and quality of the industry and technology brought into Vietnam. China's FDI inflows often fall into areas such as textiles, footwear, fiber, thermal power and mining sectors, which are potentially polluting industries. The serious incident of pollution involving Hung Nghiep Formosa Ha Tinh Pte Ltd raised concerns about the environmental consequences of Chinese FDI projects.[10] Moreover, many Chinese FDI projects have either low technology content or use outdated technology. Vietnam thus runs the risk of becoming China's "technology landfill" due to the careless selection of China's FDI projects. In addition, in some instances, the machinery and equipment that Chinese companies bring into Vietnam are the types that Vietnam can produce domestically. The massive import of cheap consumer goods from China has also made it difficult for some Vietnamese domestic industries to survive.

The third drawback is transfer pricing. For the FDI projects that use Chinese technology, their investment costs are often double or three times higher than similar domestic projects that rely on Japanese and European technology. This difference leads to misleading assessments of FDI effectiveness, thereby distorting the indicators of economic efficiency in general.[11] Research has shown that loss reporting[12] is not unique to any industry but is especially common in industries such as garment and footwear manufacturing and the retail and beverages sector. For example, the Department of Taxation in Ho Chi Minh City reported that foreign enterprises in the supermarket, retail and beverage sectors regularly feature among the list of businesses that has consistently reported losses. Other reports have revealed that up to 90% of foreign enterprises operating in the garment sector in Ho Chi Minh City reported losses, although most domestic firms operating in the same industry are profitable. Such a phenomenon appears inexplicable as domestic enterprises are often regarded as having a lower capacity and competitive advantage vis-à-vis their foreign counterparts.[13] According to the Department of Corporate Finance (under Vietnam's Ministry of Finance), around 44% to 51% of foreign enterprises report annual business losses each year. In 2015, 51% of foreign enterprises reported losses while 50% did so in 2016. Notably, there are foreign enterprises that have reported losses over a long time frame such as 10 or even 20 years, but still continue to increase capital and expand investments in Vietnam. This shows that the state of transfer pricing of the foreign investment sector is increasing and complicated. The Vietnam Chamber of Commerce and Industry (VCCI) and

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the United States Agency for International Development (USAID) conducted a survey in 2014 examining transfer pricing behaviour among foreign enterprises in Vietnam which revealed that 20% of such enterprises have admitted to the practice of transfer pricing.[14]

According to experts, the process of transfer pricing involves foreign enterprises overstating the value of their investment at the outset that negatively impacts the host country as a result of tax losses, reduced profit, and unfair competition. The foreign enterprises are usually regarded as large corporations with modern technology and equipment, and thus expected to contribute investment capital based on this definition. As the Vietnamese partner is often unable to assess the price of the modern technology and equipment, the foreign partners tend to place a high valuation to their contribution that will in turn inflate the amount of capital contributed in any joint venture. Next, in the process of production and business, the foreign enterprises will often declare high input prices, and find ways to increase other costs such as advertising and promotional activities in order to reduce or eliminate profits. These firms will also use the loan interest payments to undertake transfer pricing. Hence, even when a firm's subsidiary in Vietnam yields a nominal profit, those proceeds will be channeled towards paying the loan interest and included as a cost, thus eliminating the profit. This has resulted in the phenomenon where some foreign enterprises in Vietnam are expanding their production activities and increasing their revenue stream despite recording consecutive annual losses. Currently, most of the Vietnamese transfer pricing cases have not been brought to court due to the weakness of Vietnam's legal framework on transfer pricing and the sophistication of FDI enterprises in hiding such practices.

In addition to the above negative impacts, some Chinese projects in Vietnam are beset with many outstanding issues, thus affecting their progress as well as the image of Chinese enterprises involved. The Cat Linh-Ha Dong elevated urban railway project in Hanoi is a prime example.[15] After numerous delays, latest indications are that the project was supposed to be completed by the end of 2018, but it remains in the trial phase and is not yet placed into commercial use. This project was officially approved by Vietnam's Ministry of Transport in 2008 with a total initial investment of US$552.86 million. China was to provide US$419 million, with the remaining US$133.86 million coming from Vietnam. However, by 2016, cost overruns saw the project balloon to US$868.04 million (costing an additional US$315.18 million). The change in the total investment amount and the delay in the provision of additional capital adversely affected the progress of the project due to the need for re-appraisal, consultations with relevant agencies, and re-submission to the relevant authorities for approval. For any changes in capital outlays, relevant ministries such as the Ministry of Transport and the Ministry of Finance have to step in to reevaluate from the very beginning the rationale and fairness of the capital adjustment. At the final stage, the project has to be endorsed by the National Assembly before it can commence operation. From its commencement date of from October 2011 until now,[16] the railway project has undergone almost eight years of construction, and is five years behind the original start date of November 2013. According to the experts' calculations, each day of delay costs the project around 1.2 billion Vietnamese dong (US$52,000) in terms of interest payments. Even after it commences commercial operation, it is unclear how seamless the management of the project will be, as the project will be handed over to the Hanoi municipal government although the Chinese side will still be responsible for maintaining the railway until 2021.

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THE WAY FORWARD

In order for Vietnam to benefit fully from Chinese FDI and to limit the negative impacts of such investments, Vietnam will need to continue improving its regulations and procedures to create a conducive environment for foreign investment to thrive in Vietnam. In this regard, the country as a whole could glean useful lessons from the experiences of Ho Chi Minh City since it is the most favoured destination for FDI in Vietnam. In the two years of 2016 and 2017, Ho Chi Minh City's total incoming direct and indirect investment amounted to a staggering US$10.06 billion. This is in contrast to the preceding five years (from 2011 to 2015) when the city only attracted a total of US$10.36 billion.

Part of Ho Chi Minh City's success is due to its good geographical position, a positive track record of being the economically most vibrant city in Vietnam, and a stable socio-economic environment. At the same time, the city has the necessary infrastructure to facilitate foreign investment, especially in terms of port and air connectivity and logistical capacity. More significantly, Ho Chi Minh City has favourable policies and procedures for investors. The city is able to expedite approval for foreign investors as such decisions have been decentralised to the local authorities and departments. Previously, foreign investment projects had to be licensed by the Ministry of Planning and Investment in Hanoi. Since 2015, this role has been handed over to the respective Departments of Planning and Investment of provinces and cities. In addition, the city has stepped up its investment promotion activities and streamlined its administrative procedures. It further aims to develop a one-stop shop service in order to provide investors with information about import and export activities in the processing and industrial zones, as well as support businesses in addressing difficulties they may encounter during the implementation of the project.

In parallel with efforts to improve the overall environment for attracting FDI, it is necessary to take appropriate measures to address the existing outstanding problems related to FDI projects from China. In the short term, Vietnam needs to promulgate a law against transfer pricing and improve its legal framework to counter the practice of transfer pricing among firms. To some extent, it is also necessary to narrow the gap in tax incentives between foreign and domestic enterprises in order to create an overall fairer competitive environment for both of these groups. Vietnam should work towards delegating the right of investigation from the General Department level in Hanoi to the local tax authorities at the provincial and municipal tax level for them to better monitor the activities of FDI enterprises and prevent illegal acts in a timely manner. There is also a need to build up a database on individuals and businesses paying taxes to closely monitor changes in their income and revenue flows.[17] For foreign enterprises that flout Vietnam's business regulations, appropriate sanctions should be meted out, such as reducing the duration of their preferential tax rates or even increasing the tax imposed. Last but not least, the legal framework in Vietnam should be brought more in line with international practices as part of the overall improvement in the operating environment for businesses.

As part of its industrial upgrading, Vietnam will need to find ways to attract foreign investors to invest in high-tech, advanced technologies, environmentally-friendly practices, clean and renewable energy, advanced medical equipment, health care services, and especially new industries based on Industry Revolution 4.0. More training of human resources in the country and the improvement of domestic labour force quality are also necessary.

In addition, the nature of China's FDI inflows to Vietnam in recent years has largely been concentrated in high-risk industries such as thermal power, steel, chemicals, and cement. Such investments need to be screened because it requires huge investment outlays, consumes large amounts of energy, and runs the risk of causing environmental pollution. More stringent screening can also help to keep out old, backward, energy-intensive equipments and technologies from being transferred into Vietnam.

As neighbouring countries, promoting balanced and sustainable economic relations between China and Vietnam is important. Vietnam highly values the role of China’s FDI in contributing to its socio-economic development. However, Chinese FDI activities in Vietnam generally tends to take advantage of the cheap Vietnamese labour, exploit mineral resources, pollute the environment, consume much energy, and increase the trade deficit. The two countries can do more together to improve the quality of China’s investments in Vietnam. This will help to promote a more mutually beneficial economic relationship that will in turn generate positive political mileage for the two countries.

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[1] This data does not include capital inflows via other channels. See General Statistic of Vietnam, https://www.gso.gov.vn/Default_en.aspx?tabid=491

[2] Koushan, D. (2017), *Chinese FDI in Vietnam: Growing Economic Ties, Despite Strains*, Vietnam Briefing, https://www.vietnam-briefing.com/news/vietnam-and-china-growing-economic-ties-despite-strains.html/

[3] In 2014, this group started to build the Texhong Hai Ha Industrial Zone with a total investment of US$215 million and injected another US$300 million for a few more textile plants in the same zone.

[4] This project is funded by Chinese loan and is not a Chinese FDI project. It is included in this paper to provide a sense of the spread of Chinese-related projects in Vietnam.

[5] Foreign Investment Agency (2018) *Tình hình thu hút Đầu tư nước ngoài 10 tháng năm 2018* (The situation of attracting foreign investment in the first 10 months of 2018), http://fia.mpi.gov.vn/tinbai/6073/Tinh-hinh-thu-hut-Dau-tu-nuoc-ngoai-10-thang-nam-2018.

[6] Foreign Investment Agency (2017), *Trung Quốc đạt hơn 11 tỷ USD vốn đầu tư đăng ký còn hiệu lực tại Việt Nam* (*China reached over USD 11 billion registered investment in Vietnam),* http://fia.mpi.gov.vn/tinbai/5328/Trung-Quoc-dat-hon-11-ty-USD-von-dau-tu-dang-ky-con-hieu-luc-tai-Viet-Nam

[7] B News (2018), *Vốn Trung Quốc Tăng Tốc vào thị trường Việt Nam* (*China foreign direct investment accelerates into Vietnam market*), https://bnews.vn/30-nam-thu-hut-fdi-bai-1-vi-sao-tp-ho-chi-minh-luon-hut-von-ngoai-/95667.html

[8] T. H. Nguyen. China's foreign direct investment in Vietnam: Impacts and some issues. Ha Noi, Vietnam, 2012.

[9] In Vietnamese, the Vietnam Minister of Industry and Trade said: “Đây là một điểm bất lợi và thiếu bền vững đối với nền xuất khẩu nước ta, vì sản xuất, xuất khẩu của DN FDI phụ thuộc rất nhiều vào chuỗi cung ứng khu vực và toàn cầu, nên khá nhạy cảm với các biến động thương mại trên thị trường thế giới”. See Vietnam Financial Times, (2018) Xuất khẩu của Việt Nam vẫn 'dựa hơi' doanh nghiệp FDI *(Vietnam exports are still “heavily relying” on FDI enterprises), http://thoibaotaichinhvietnam.vn/pages/kinh-doanh/2018-04-23/xuat-khau-cua-viet-nam-van-dua-hoi-doanh-nghiep-fdi-56593.aspx*

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[10] Hung Nghiep Formosa Ha Tinh Lit, a Chinese foreign enterprise, had discharged toxic industrial waste into the sea through underwater drainage pipes in 2016. This led to massive fish deaths in four provinces in central Vietnam, i.e. Ha Tinh, Quang Binh, Quang Tri and Thua Thien-Hue. The toxic discharged also caused a few Vietnamese deaths due to poisoning and health complications.
[11] BVSC (2011), Nhận diện lại doanh nghiệp FDI, http://www.bvsc.com.vn/News/201178/166028/nhan-dien-lai-doanh-nghiep-fdi.aspx
[12] Loss reporting combined with continuous business expansion is considered as one of the first tell-tale signs that enterprises are conducting price transfers, because theoretically, an enterprise that declares continuous losses will not have the resources to continue expanding its business or continue to do business in a market that does not generate profits.
[13] Please note that currently the detailed information of foreign invested enterprises transfer pricing in Vietnam is not publicised as claimed by Vietnam's Ministry of Finance.
[14] Vietnamnet (2018), *Doanh nghiệp FDI gia tăng chuyển giá, hậu quả khó lường* (*FDI enterprises increase transfer pricing, unpredictable consequences)*, https://vietnamnet.vn/vn/kinh-doanh/dau-tu/dn-fdi-gia-tang-chuyen-gia-hau-qua-kho-luong-477500.html
[15] This urban railway project is 13km long and will comprise 13 trains to be built by Beijing Subway Equipment Co., Ltd. (China).
[16] In fact, construction of the project was meant to start in 2008 but was delayed till October 2011.
[17] V.C. Hoang (2014), Direct investments in Vietnam – patterns and development solutions.

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