Vietnam

SEB MERCHANT BANKING – COUNTRY RISK ANALYSIS April 12, 2013

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Indications are growing that the economy bottomed out in late 2012 and that moderate recovery can be expected over coming quarters as buoyant exports continue and domestic demand gradually picks up. That should bolster confidence in the authorities' ability to revive the ailing banking sector.

Country Risk analysis

Bottoming out. Last year growth fell to only 5% the lowest in a decade as the authorities slammed the breaks to cool the economy following overheating in 2011. In the event, monetary tightening succeeded in taming inflation to below 7%. That growth did not suffer more was mainly thanks to buoyant exports as signs were growing that Vietnam had begun to harvest the fruits of the large FDI inflows that followed WTO accession in 2007. The result has been a turn-around in external balances from huge annual deficits to a small trade surplus in 2012. Combined with continued inflows of foreign capital this has allowed rebuilding of foreign reserves to 12 weeks of import cover. While still low, that is a significant improvement from a dangerously low level in early 2012.

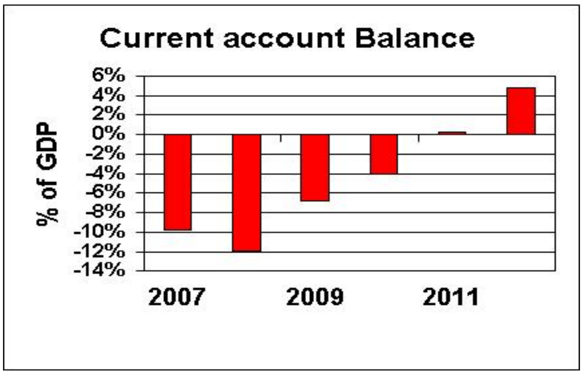
Measures aimed at averting a banking crisis. However, the successful cooling -- mainly by means of tighter monetary policies -- caused banks' balances to weaken as their clients struggled to cope with higher than expected interest rates. As a result, bad loans rose sharply to 10% in late 2012. This prompted the central bank to recommend the establishment of an asset management company (AMC) to help banks clean their loan books, a measure that was accepted by the government in last March. Although this may not be the last word in averting a looming banking crisis, it is notable that the problem has been officially admitted, an obvious prerequisite for its resolution. That may be supported by a new constitution before year-end aiming at creating a more level playing field for private and state owned enterprises. The latter have been accused of having used their cherished position under the present law to venture into new business that have proved unprofitable and eventually added to the bad loan of the banks which had financed it.

Improving outlook: While Vietnam is still not out of the woods, important parameters are about to improve. That is now allowing the authorities to scale back previous austerity measures, including high interest rates, to the benefit of overall financial stability. Two of the three main agencies have kept their ratings unchanged in recent years (S&P: BB-; Fitch: B+) while Moody's, last September, downgraded Vietnam to B2 mainly based on its assessments of the banks. However, that took place before recent efforts to tackle the looming crisis which should offset much of the risk pointed out by Moody's.

Recent developments

Soft landing: Signs are strengthening that Vietnam has managed a soft landing following overheating in the years 2008-2011. GDP growth has moderated, but only by a sliver more than one percentage point, from an average of 6,1% in the overheating period to 5% in 2012. Inflation, by contrast has come down much sharper, from almost 19% in 2011, after a peak of 23% yoy (year-on-year) in August of that year, to 9% in 2012 in response to tighter monetary policies and promises of less activist fiscal policies. The effect has been to damp domestic demand, in particular for investment goods including construction of residential real estate, while continued interest from foreign investors has helped cushion the drop in corporate investments. But last year's the decline in growth would have been sharper without continued high export growth, along the trend that started in late 2011 and also supported quicker growth of industrial production.

External sector balances improve: With whole year trade statistics now available, the acceleration of exports in 2012 has become evident. Moreover, the compression of imports due to slower domestic demand produced a significant strengthening of the trade balance. Exports rose by 18% buoyed by electronics from new factories, while imports rose only 7%. Combined with continued strong inflows of remittances mainly from expatriates in the US and disbursements of foreign aid the current account balance recorded a surplus of $6,6 bn. equivalent to 4,7% of GDP. That bucked the trend of of large and often unsustainable annual current account deficits in the preceding years overheating.



Foreign reserves rise fast. The current account surplus of 2012 combined with continued strong inflows of foreign capital to the tune of $8-9bn or about 6% of GDP mostly in the form of FDI. These were also increasingly dominated by brand name companies from South Korea and Japan. As a result, the balance of payment ended in a surplus estimated at $12bn. which would have been stronger still but for unexplained outflows of some $5bn. They probably reflected unregistered payments for imports of gold which is a common hedging and savings instrument for households and domestic companies. In the absence of updated official reserve data from the State Bank of Vietnam (SBV) -- the country's central bank -- it has been calculated that the net of all these external transactions should have doubled the official reserve to $26bn. through 2012. That raised the import-coverage to 12 weeks -- considered a minimum safety level and is still low compared to peers. As the SBV remains prohibited from publishing a comprehensive financial statement, little is known about how these reserves are held. However, market seems to have accepted that they represent reasonable liquid holdings of securities and safe deposits with foreign banks.

Economic policies:

The fortunes of last year's economic adjustment process can be traced back to early 2011 when the government declared a change to its" growth above all"-policies implying greater focus on balance and sustainability. Following the last major devaluation in the summer of that year, the SBV began decisive tightening of monetary policies, employing both market conform and administrative measures.

Fiscal policies: In 2012, the fiscal deficit is estimated to have widened to 4,8% of GDP from 4,3% one year earlier according to headline numbers in the official presentation.[1] That was largely due to pressure on revenues reflecting the slowing economy and therefore reduced tax take including from customs as import growth slipped. However, in last May, the government also announced a fiscal stimulus to help the struggling economy. That included tax cuts for companies and a doubling of the tax threshold for households to VND9mill./month ($4400). This suggests the fiscal deficit might have been higher but was saved by a stronger than expected oil price affecting about a quarter of total budget revenues.

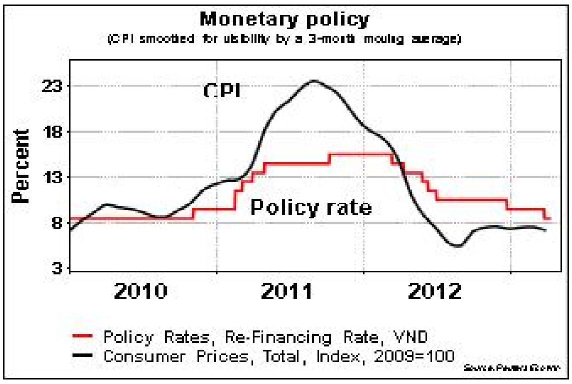
Yet, the government debt ratio stayed put but for contingent liabilities. Despite the higher than expected budget deficit the government debt ratio rose only by one percentage point of GDP to an estimated 45%.[2] That is not low compared to regional peers but neither is it any cause for immediate alarm. About half of it is in local currency and the remainder is dominated by concessional lending including from multilateral creditors (i.e. the World Bank and the Asian Development Bank). Of more concern is the potential for contingent liabilities related to the many overleveraged state owned companies and the country's banks. Should the government be forced to bail them out this could add more than 10% GDP to the debt ratio according to some observers. However, while letting one of its largest companies, the shipbuilder Vinashin, default on a US-dollar loan two yeas ago, the government proved that it will not take responsibility for any activity not directly under its responsibility. One rating agency noted this as a positive for the sovereign creditworthiness, but in our view that does not necessarily have a positive impact on country risk. As regards external debt distress, by contrast, Vietnam is at low risk according to the IMF/World Bank Debt Sustainability Analysis.

Monetary policies tighten and ease. Late 2011 the SBV launched a significant monetary policy turn-about as it hiked interest rates sharply and put restrictions on banks credit growth. This was in response to surging consumer price pressure reflecting the effects of previous devaluations and high global commodity prices. In the event this tightening had a greater effect than expected. In 2012, credit growth fell to 9%, i.e. markedly less than nominal GDP growth of 13% and only half of the 15-17% ceiling on credit expansion set by the SBV at the beginning of

[1] Taking into account various off-balance sheet transactions one of the rating agencies, Fitch, has estimated the fiscal deficit to be around one percentage point higher relative to GDP. These estimates are reflected in attached tables to this report.

[2] Some reports put this at 53% (World Bank December 2012).

the year. It appears that this was in response not only to high lending rates, but also growing unwillingness from the banks to extend new credits as many of them were increasingly worried about the weakening quality of their loan books. In the event the SBV turned around again as it began to reduce policy rates which now appeared to be biting too hard. Receding price pressure meant that expected real interest rates were at risk becoming too high with the danger they could trigger unnecessary defaults among bank clients.



Bad loans rising: For many borrowers the monetary easing that began in early 2012 has come too late. As a result, they have not been able to service their debt in a timely manner. In June, as the problem came to the fore, SBV conducted a survey with on-site inspections and found that the average level of bad loans -- so-called "non-performing loans" (NPL) -- had reached more than 8% of total credits. That number rose to 10% in September but fell to 6% three months later, as many banks used reserves to write down a part of their bad loans. Were that to be the end of the story, the torrid credit boom from 2007 to 2011 which quadrupled the size of the banking system and doubled it to 120% of GDP, would still have been granted a rather happy ending.

Could grow worse: Almost two thirds of the bad loans are linked to the real estate sector, including developments under construction. Many of them were launched by state-owned enterprises which have ventured into non-core activities with little prior experience of which Vinashin is a telling example. However, it is unclear how many bad loans of state owned enterprises that have been recognized as NPLs as the law is unclear whether a state dominated company can go bankrupt. Indeed, the law apparently stipulates severe punishment for anybody who incurs a loss on the state. Again Vinashin is an interesting case. The loans it no longer can service as scheduled have been "frozen", apparently meaning that banks are not required to report them as NPL. The bad loan situation is therefore quite uncertain at the moment and could deteriorate further even if the economy slowly recovers and interest rates remain at current low levels. According to Colliers International, the residential real estate markets of Hanoi and HCMC were still "difficult" at the end of 2012 with prices discounted by 35% and a significant overhang of unsold units.

Vietnam Asset Management Company: Late 2012, SBV began to prepare for the establishment of a so-called asset management company (AMC) with the purpose of buying bad debt from banks at a discount with the aim of eventually selling it. Such have been standard procedures in many countries for solving banking sector problems. However, with this pre-emptive move Vietnam may have an advantage. Most countries are too late in recognizing banking sector problems. When the crisis hits with full force moral hazard often proliferates among debtors causing the bad loans problem to grow larger than might otherwise have been the case. As such, the government's support of last March to SBV's AMC plans deserves credit for having nipped the problem in the bud, and may save Vietnam from the fate of peers in the past -- the Nordic countries in the early 1990s, several Asian countries later in the same decade or the Baltic countries in 2008-9.

Structural policies on hold. Over recent years Vietnam's so-called "equitization" program has come to all but a full stop. In the first stages of Vietnam's reform policies "equitization" allowed the government to divest holdings in thousands of commercial companies thus reducing their numbers to less than 4000. However, as Vinashin and other state owned companies have proved over recent years, including also the national carrier Vietnam Airlines and the electricity provider EVN, commercial activities can become a burden on the state. Besides trampling on political prestige, divestment may in many cases also be hindered by legal limbo in the absence of proper bankruptcy laws and a constitution that still cherishes state owned enterprises at the cost of private sector companies.

A new constitution should bring a more level playing field: However, the latter hindrance noted above could soon disappear. A new constitution is under preparation for the National Assembly before year-end. According to observers who appear to have seen early drafts, a reference to "a socialist-oriented market economy" remains in place but it is now envisaged that such an economy be populated by "various forms of ownership" enjoying "equality and cooperation" whether they be state-owned, private, foreign or domestic. Such revised phrasing should remove justifications for the many privileges that state owned enterprises still enjoy in terms of access to land, finance and other inputs.[3]

Political developments

As a one-party state political developments in Vietnam are often kept behind closed doors. Reports have nevertheless emerged about controversies between opposing factions within the ruling communist party centered around the offices of the President and the Prime Minister. In the event, it appears that the President drew the longest straw, and that the prime minister was forced to endure all but direct censure because of his handling of the economy. In national security policies the conflict with China over maritime borders has not improved but has been overshadowed by the intensification of China's stand-off with Japan.

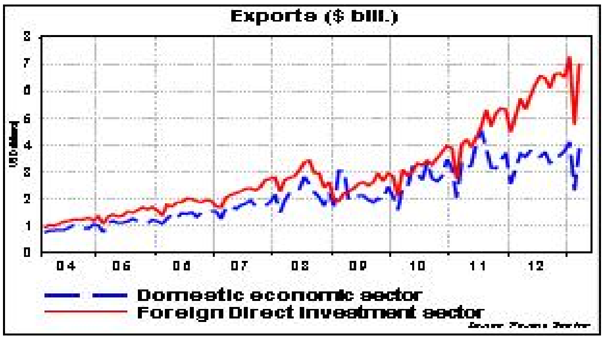
Outlook:

Gradual recovery underway. The first few months of 2013 present a mixed picture of the economic situation. On the bright side, industrial production continued at a decent clip rising 7% yoy in February and the stock market remained upbeat while price pressure eased as the CPI slowed to 6,5% on the same month a year ago. On the flip side, tourist arrivals fell almost 10% in the first two months of the current year, probably due to fewer Chinese arrivals in the wake of the more hostile relationship between the two neighbors. Late rains may also have caused coffee production to contract by 10% this season. Nevertheless, observers appear convinced that a recovery is under way and that activity should rise by at least 5,5% in 2013 based on growing exports and revival of domestic demand as credit conditions ease and unemployment below 3%.(official data).

Exports drive: Of particular interest in this scenario are rapid exports since late 2011. This has come along with a rising share of the FDI sector in total exports to

[3] Excerpts from Oxford Analytica briefing of February 14, 2013.

more than 50% in 2012, up 10 percentage points from one year earlier. The driving force is clearly the massive FDI inflow since 2008. That is now coming to fruition as production units come on-stream including for export products. A case in point is Samsung, the Korean electronics producer. Its factory was set up a few years earlier and started production in 2011. This contributed significantly to the doubling of Vietnam's electronics exports in 2012. As FDI inflows continue apace, this development is poised for an improved trade balance in coming years provided ability to contain ongoing cost pressures as Vietnam's real effective exchange rate have continued to rises faster than those of foreign competitors.



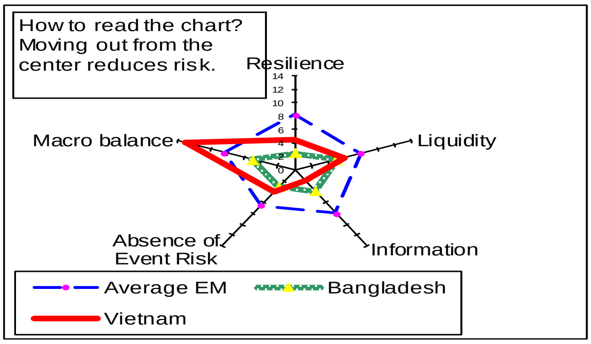
A looming banking crisis? A risk not yet averted is a possible banking crisis within one or two years. While the government is about to take contingency measures and is setting the framework for the resolution of problem banks, the situation could prove worse than expected. In a reasonable worst case scenario, Moody's believes that the level of NPL could triple to 30%, which would be exasperated by a new and deep devaluation of the dong.[4] In that case the state could be forced to bail out banks at an estimated $20bn. which would raise the government debt level to almost 60% of GDP and likely reduce foreign reserves significantly. That would still present a relatively benign result compared with most banking crises in other countries and should be manageable provided timely financial assistance from the IMF. Such assistance has so far not been possible due to legal hurdles, a situation that the new constitution hopefully will remedy.

Overall we still believe there are reasons to take solace from signs that

- ***the government is preparing for a possible worsening of the situation in the banks***
- ***the FDI sector continues to support the economy and thus facilitate the rebuilding a buffer of foreign reserves which in turn would support any bank rescue operation.***

That should mean improved medium term prospects provided the government does not fall back to bad old habits of reactivating the economy at the first signs of any slowdown.

Key ratios	**2013**
Population (mill.)	89.7
GDP/capita ($)	1702
GDP (change)	5.5%
Inflation	7.0%
Curr.Acc. Balance/GDP	2.7%
Reserves/imports (months)	1.7
Budget balance/GDP	-3.7%
Government debt/GDP	43%



External ratings:
Fitch: B+
Moody's: B2
S&P: BB-

Peers:
Sri Lanka
Philippines

Graph: The pentagon shows Vietnam's credit profile dominated by weak liquidity and a poor information base. This makes for a potentially dangerous combination, particularly against a background of high event risk of domestic and external nature.

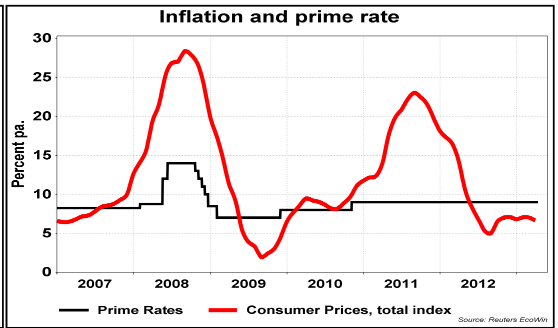
[4] Compared to the level of 10% in September 2012 before year end write-offs.

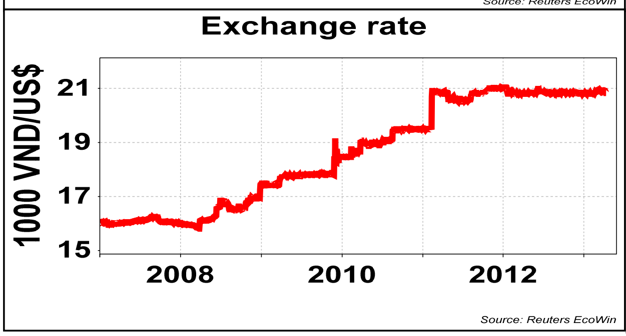
Key data:	2007	2008	2009	2010	2011	2012	2013	2014
GDP (bill.US$)	71.0	91.1	97.2	106.4	123.6	139.2	154.2	170.7
GDP/capita (US$)	835	1060	1118	1211	1392	1553	1702	1865
GDP (% chng)	8.5%	6.3%	5.3%	6.8%	6.0%	5.0%	5.5%	6.0%
Investments/GDP	39%	38%	40%	41%	35%	35%	36%	37%
Budget balance/GDP	-1.5%	0.0%	-4.4%	-4.8%	-2.8%	-3.5%	-3.7%	-3.7%
Govt debt/GDP	36%	34%	43%	44%	44%	45%	43%	0%
CPI (% chng)	8.3%	23.1%	7.1%	8.9%	18.7%	9.1%	7.0%	6.4%
Money demand (%)	49.1%	20.7%	26.2%	29.7%	11.5%	14.1%	12.1%	11.3%
Stock prices (eoy)	921	316	495	485	352	414		
Interest rates	8.7%	8.2%	9.0%	10.8%	13.5%	6.8%	9.0%	8.4%
Exch. Rate ($) (avg.)	16105	16302	17065	18613	20510	20859	21402	21995
Trade/GDP (%)	170%	171%	147%	165%	180%	179%	181%	182%
Oil price (Brent)	$97	$62	$79	$111	$112	$106	$108	$113
Billions US $								
Export of goods	54.6	71.0	66.4	82.5	109.5	128.4	142.9	157.9
Imports of goods	65.9	84.8	76.4	93.4	112.8	120.8	135.6	152.9
Other (net):	4.3	3.0	3.5	6.7	3.5	-1.1	-3.1	-3.6
Current account	**-7.0**	**-10.8**	**-6.6**	**-4.3**	**0.2**	**6.6**	**4.2**	**1.3**
(% of GDP)	-9.8%	-11.9%	-6.8%	-4.0%	0.2%	4.7%	2.7%	0.8%
FDI	6.7	9.6	7.6	8.0	7.4	8.4	9.3	10.3
Loan repayments	-0.6	-0.8	-1.0	-2.0	-2.4	-1.6	-1.1	-0.9
Net other capital flows	11.0	2.5	-7.9	-5.7	-3.8	-0.9	-8.3	-6.7
Balance of payments	**10.1**	**0.4**	**-7.9**	**-4.0**	**1.5**	**12.5**	**4.0**	**3.9**
Reserves	23.5	23.9	16.0	12.1	13.5	26.0	30.0	33.9
Total debt	22.0	27.0	38.0	45.0	51.0	46.4	43.4	42.5
o/w short term debt	0.2	0.8	4.5	7.7	7.8	7.1	6.6	6.5

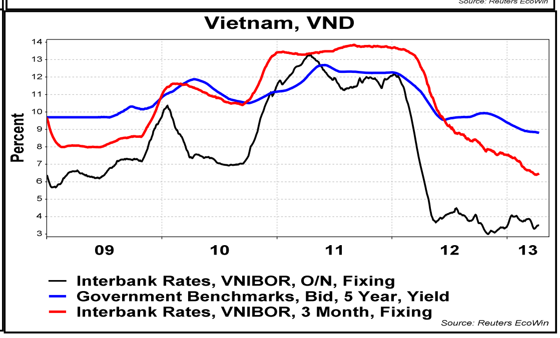
Source: OEF (Oxford Economic Forecasting) and SEB estimates.

Rating history						
Fitch (eoy)	BB-	BB-	BB-	B+	B+	B+
Moodys	Ba3	Ba3	Ba3	B1	B1	B2

Type of government: Communist party
Next elections Partyconference in 2016
Other:
Latest PC deal 1993
Recent IMF programs PRGF (Poverty Reduction and Growth Prog. interrupted before expiry in 2004.







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