Vietnam

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The countervailing forces we have described in previous reports continue to fight for dominance over Vietnam's economy. We would have loved to declare the buoyant foreign owned export sector as winner, but in our ears, the background noise of a rumbling banking sector crisis cannot be ignored as yet.

Country Risk analysis

Growth set to slightly disappoint despite external sector strength: Our report of last April expressed hopes of a slight acceleration of growth in 2014, but weaker than expected domestic demand has led the World Bank to project unchanged growth rate at 5.4% as in 2013. Only, surging exports from the foreign owned manufacturing sector combined with growing tourism and some fiscal easing are now upholding decent growth. Since 2012, the external sector has turned deficits into surpluses on both the current account balance and the total balance of payments. Last April, foreign reserves reached an all-time high of $36bn, although enough to cover only three months of imports. A more stable exchange rate has prompted the return dollars into dong deposits, thus shoring up bank liquidity and staving off the threat of an immediate banking crisis.

But banks are not yet out of the woods: Abundant bank liquidity is also the result of very weak loan growth reflecting low loan demand but also reluctance on the side of banks to lend into what is still a shaky business environment. This is encroaching on bank profitability and eating into already weak capitalization. Since 2013 bad loans (NPL) have declined to 4-5% of total loans -- possibly a clear understatement of the true level, though -- as a result of banks' write-offs and sales to the newly established asset management company. But the process has been slow with sales of bad assets much behind targets and marred by delays in implementation of a new identification code for NPL reportedly due to lobbying from banks including some of the worst hit. Some of the largest state banks were heavily involved in the pre-crisis booming property market. They were also known to be bankrolling state owned enterprises (SOE) when these entered into non-core businesses that later went bust. For that reason observers point out that a revamp of the banking sector must go hand-in-hand with SOE reforms.

Vietnam's challenges are mounting and postponement of their resolution may only raise the final costs. However, there are growing reasons to expect that continued strengthening of external balances can "finance" those costs in the future. Apparently taking solace from that one rating agency recently upgraded the sovereign one notch.

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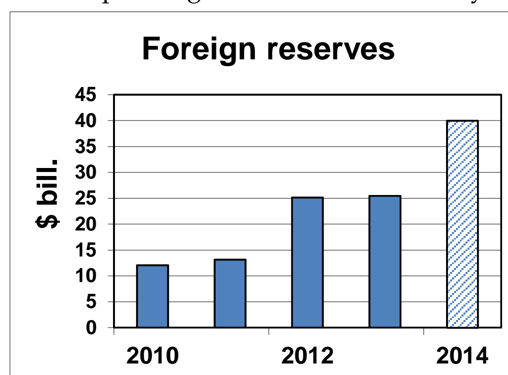
Recent economic developments

Modest near-term growth set to continue: Since 2012, following a decade of boom years, growth has decelerated to clearly below the estimated potential of 6-7% and the result for the current year is now likely to tick in at 5.4%. That is according to estimates by the World Bank and indicates the same rate of expansion as in 2013. Such is short of the authorities' first projection of a 5.8% rise in GDP due to weaker domestic demand in particular for investment goods. Credit expansion has all but collapsed to only 2-3% since the beginning of the year notwithstanding reduced interest rates. A still gloomy housing market after its collapse a couple of years ago is keeping a lid on banks' risk appetite. Only fiscal expansion, resurgent capital inflows and strong exports uphold decent economic activity. Since last year foreign direct investments have been flowing in for the construction of a wide range of production units targeting foreign markets.

Price pressure forced back: In a break with the past and reflecting suppressed real demand, annual consumer price inflation has stabilized around 5-6% pa so far in the current year and the latest reading for August came in at 4.3%. The labor market is still quite tight though, with the official unemployment rate at less than 2%. However, with only one third of the workforce in the formal sector of the economy, the real unemployment rate is hard to judge.

Export surge continues: In the first half of the current year exports were up 20% on the year-earlier period driven by the foreign investment sector which dominates two thirds of total exports. Recent focus includes car parts and high-end electronics and mobile phones. That combines with growing remittances and tourism revenues – arrivals in the first half of 2014 were up 21% year-on-year (yoy), but also slower imports to support a current account surplus equivalent to 2.7% of GDP, down from 5.0% in 2013.

FDI inflows remain strong helping build reserves: T Resurgent capital inflows since 2012 are still going strong, but in the first six months of the year investment commitments fell back by a third, while actual disbursement remained flat at $5.8bn on a year-to-year comparison. Provided these trends continue through year end and are joined by sharply reduced capital flight, reserves could easily reach $40bn before the end of the year. That is 3 months of import cover and enough to pay for scheduled debt repayments more than four times. According to the State Bank of Vietnam (SBV) – the central bank -- reserves were already standing at $36bn in April, up from $26bn at the beginning of the year. Since 2012 Vietnam's external debt has been declining. It stood at $52bn. at the end of last year and is expected to drop to $48bn by the end of this year. Most of it is borrowed from international development banks at favorable terms and long maturities.



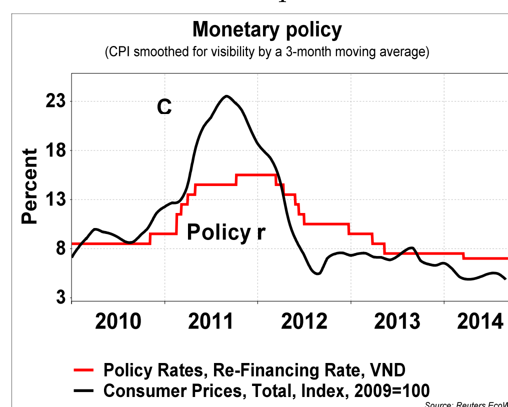
Financial policies:

The fiscal balance weakens: Structural changes in the economy is taking its toll on the budget and combines now with the sluggishness of domestic demand to weaken the tax take and revenue performance in general. The rise of the foreign owned sector means a structural shift with significant consequences for the budget. Many of these new enterprises benefit from tax holidays and lower tariffs and excise taxes within special export zones. At the same time the government has promised cuts in the corporate income tax rate by 3 percentage points (pp) to 22% in the current year, with further reductions to 20% in 2016. As a result budget revenues can drop to 21% of GDP and raise the deficit to 6.4% of GDP, up from 5.6% in 2013 and 4.5% in 2012 following World Bank's calculations according to international standards.[1]

Growing deficits impinge on capital expenditures: As a result of growing fiscal deficits, government debt is now on the rise and will likely end the current year at more than 44% of GDP to which should be added explicit government guarantees mainly for SOEs at 11%/GDP. Almost 90% of the debt is long-term owed multilateral and bilateral financial institutions on preferential terms. That said, as mostly contracted in US dollars they represent a potentially exchange rate risk to the budget. While not yet alarming the government appears cognizant of the implicit danger of such a rising trend of its debt and the possible rise in other contingent liabilities related to struggling SOEs. It has so far reacted mainly by limiting discretionary budget expenditures including for capital investments. That is unfortunate in view of the need to remedy the many bottlenecks in transportation, ports and other infrastructure.

But demand for treasuries is still strong: Despite the fiscal challenges, demand for government debt is still strong including from banks which at the moment see few other attractive investment opportunities. Decline in sovereign CDS spreads is also benefiting the local treasury market.

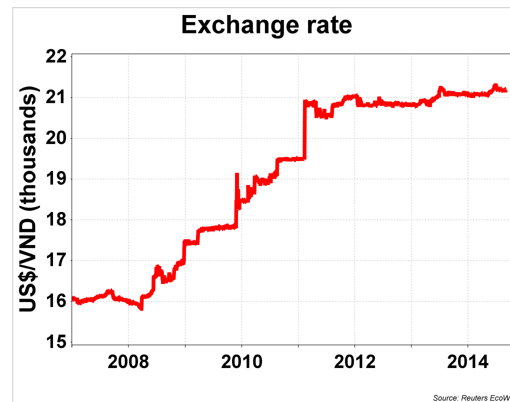
Monetary policy changes tack. Over recent years subsiding inflation pressure has allowed the central bank – State Bank of Vietnam (SBV) – to lower policy rates by 8.5pp. to 6.5% pa for the SBV refinancing rate. It has also reduced the cap on deposit rates to 6% pa and for loan rates to 8%pa for priority sectors. That has now returned real rates to positive territory whereas they used to be sharply negative. As a result of this and regained stability of the dong, confidence in the banks has strengthened and customers have returned their liquid wealth into local currency deposits resulting in improved liquidity for banks. Wary of high levels of bad assets or non-performing loans (NPL), however, many banks have used this to invest in safe assets such as government debt instead of lending to productive activities. As a result banking sector liquidity has swelled and the liquidity crisis that threatened the banking system until



[1] The government's own estimates are somewhat lower at 5.4 and 5.7% respectively for 2013 and 2014 as a result of different accounting methods.

a year ago has been averted. IMF has described recent monetary policies as accommodative but could also be viewed as slightly tightening, albeit probably unintended as such.

Exchange rate stabilization: Viewed against a turbulent history, the recent stabilization of the exchange rate since 2012 is remarkable and the result of a confluence of benign trends. The central bank's success in controlling inflation has strengthened investor confidence in the dong, while the surge in exports from companies planned and built in previous years has helped boost reserves. A small devaluation last June by 1 percent, however, came as a surprise and was probably a compromise between the authorities' desire to maintain market confidence in exchange rate stability while also preparing expectations for the inevitable adjustment to the nominal rate to offset a rising real dong rate. Over the last two years the dong has appreciated by about 10% in real terms, against which 1 percent nominal devaluation seems tepid. Going forward, the danger is that the recent exchange rate stability eventually could be undermined without tougher actions against ongoing albeit diminishing inflation pressure.



Banking sector woes: Improved liquidity has helped to raise confidence in banks although partly due to circumstances beyond the control of the banks themselves, i.e. the rise in central bank forex reserves. How much they have done themselves to shore up confidence is more questionable. The amounts they have sold to the VAMC (Vietnam Asset Management Company) one year after its inception in June 2013, around VND45tr, is far below the targeted amount of VND70-100 trillion. They are also rumored to have lobbied the central bank for a less active approach in resolving their bad-loan books by having the central bank to put off a second time, till 2015, the implementation of Circular 02 of 2013 which stipulates procedures for bad loan identification and resolution.

Weakening profitability: The reason for their caution is also that weak credit markets continue encroaching on profitability. In the first half of the current year banks' loan books rose by an average of only 2,5% short of the 14% official growth target for 2014. That comes on top of already poor capitalization standards and reserve levels and undermines banks' capacity to write off bad loans, including some of the largest state owned banks (SOB). They used to bank-roll many SOEs that ventured into non-core areas such as real estate and finance and other businesses that often went bust.

Tackling the bad loans problem: Banks' apparent reluctance to recognize bad loans in their books combined with almost stagnant credit growth, may suggest that the problem could still be growing. According to the World Bank the system-wide level of NPL stood at 5,7% in late 2013, but at only 4% (reported by Moody's) four months later, a decline that may reflect write-offs and sales to VAMC in the meantime. All of these numbers, however, may greatly underestimate the true bad loans problem probably by a factor of 3-4 times.

VAMC – short term band-aid? It should be borne in mind, though, that banks' sales to the VAMC do not mean they have disposed of their bad-loans problem for ever, but only postponed the realization of it by five years. After that banks' will have to buy back the bad assets that VAMC has not been able to dispose of

itself. It is yet to be resolved how that disposal can take place. Many of the bad-loans origin from SOEs but selling state assets below book value may be interpreted as incurring a loss to the government which apparently is still subject to the criminal code.

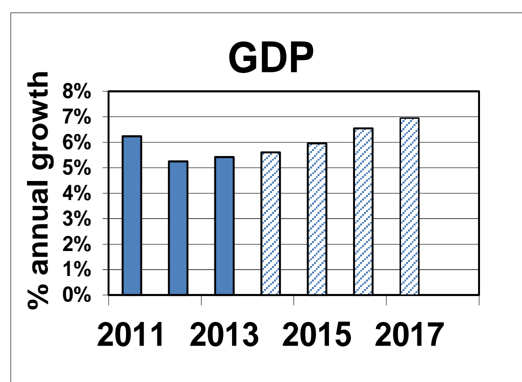
Structural reforms picking up? Long-standing government plans to reform the dominating state owned enterprise sector continue at low speed. Admittedly, last year the number of equitized companies tripled to 74 but that was still far short of the target of 400 equitized SOEs by 2015, Moreover, most of them were rather small and little equitized assets changed into private hands. In contrast, the government has called for all SOEs to get out of non-core activities in finance and real estate by 2015 and last June the national assembly approved a revised law on bankruptcy to facilitate corporate restructuring. Regarding the banking sector, the central bank has encouraged mergers among the 35 joint stock banks (i.e. "private" banks) with the aim to end up with less than half of that number. Moreover, Decree 01/2014 revised the maximum ownership for organizational and strategic investors to 15% and 20% respectively of capital in a domestic credit institution. That should help attract greater private interests. However, it is not for sure this is going fast enough to prevent vested interests from putting spanners in the works. While there are risks from reforming too fast, the IMF warns that risk may also rise if reforms are too slow.

The real estate market: After the boom years up to 2011, the market cooled, but has now probably bottomed out. However, prices have far from recovered sufficiently to resolve banks' bad loans problem and the market remains overall frozen with unfinished projects and an accumulation of unsold units in particular in the luxury segment. The government has set aside a stimulus package of VND 30tr (USD 1.4 bn.) of which only a quarter has been used so far.

Politics:

China factor: Anti-China riots broke out in last May over what most Vietnamese and the government saw as China's intrusion into contested waters with the positioning of a large oil rig. Enterprises believed owned by Chinese businesses but actually belonging to other countries as well were put on fire or otherwise damaged by mobs in several cities. However, China has emerged as Vietnam's greatest trade partner, and the government has proactively reassured investors that political temperatures will not be allowed to spill into violence again. It seems to have received the benefit of the doubt as Samsung, Microsoft, Intel and others have continued to announce major new FDI projects in recent months. In domestic politics calm appears to prevail with the PM Nguyen Tan Dung likely to sit out his term until 12th National Congress of the Communist Party in 2016.

Outlook:



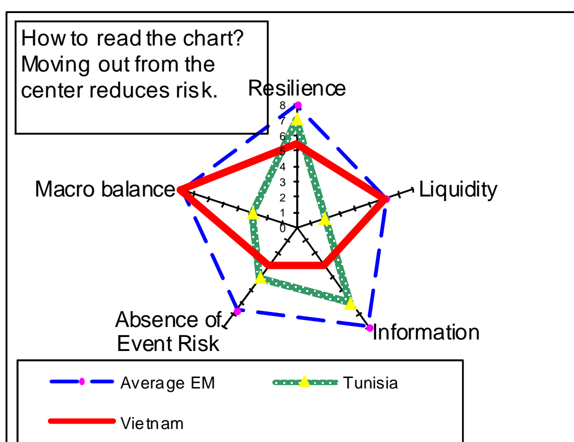
Export success: The great success of the FDI sector and the surging exports of recent years have come as a great relief and to the surprise of most observers. Without this Vietnam could have been in a deep crisis by now. This has supported growth at a decent level above 5% -- still clearly lower than potential tough -- and also helped the central bank build reserves from dangerously low levels. Such trends or better are likely to prevail in the short to medium term as most observers foresee modest uptick in the country's economic performance. In 2015, growth will probably come closer to 6% while reserves could grow by another 5-10bn.

Flying on one engine: However, the country is flying on one engine as long as the rest of it, excluding the export sector, is still in the doldrums. Domestic demand remains weak and banks are unable to perform their social functions of

credit intermediation. In last June, the World Bank office in Hanoi wrote: "With elevated NPL ratios and balance sheets intertwined with SOEs (state owned enterprises), the banking sector remains susceptible to sudden shifts in depositor confidence and unexpected news on SOE profits or real estate price movements." That emphasizes the importance of wide-ranging reforms on many fronts at the same time -- a difficult task in most countries. In a recent report, Moody's, a statistical rating agency, while maintaining negative outlook on Vietnamese banking system, expressed confidence that "..banks' greater resilience is driven by their healthier liquidity profiles and gradual workout of non-performing loans." However, it may also be argued that as long as uncertainty about how to deal with the NPL problem is holding back lending activities a resolution to the underlying banking crisis may last for years.

Rising attractiveness: Overall, however, the apparent attractiveness to foreign investors is a strong story of the country's underlying competitiveness. Although transparency is an issue for most countries with banking systems under distress, and with the caveat that negative surprises may still pop up, it appears right to suggest that positive forces are gradually beginning to take the lead.

Key ratios	2014
Population (mill.)	93
GDP/capita ($)	2094
GDP (change)	5.6%
Inflation	5.9%
Curr.Acc. Balance/GDP	2.7%
Reserves/imports (months)	3.0
Budget balance/GDP	-6.1%
Government debt/GDP	44%



External ratings:
Fitch: B+/pos
Moody's: B1
S&P: BB-

Peers:
Sri Lanka
Tunisia
Romania

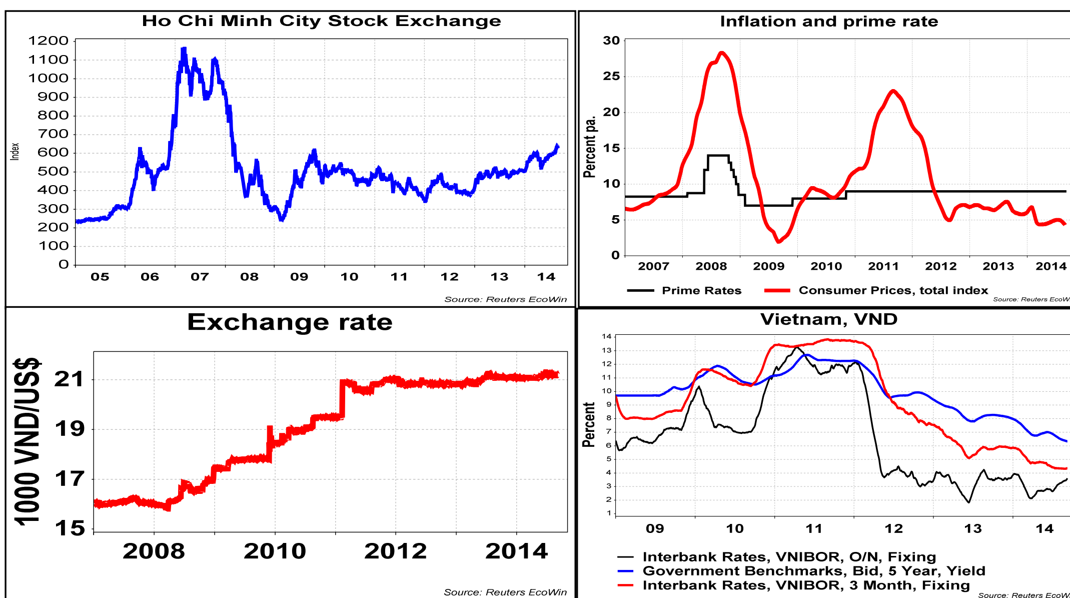
Graph: The pentagon shows Vietnam's credit profile dominated by event risk and poor information. Strengths lie in improved macro balance and liquidity. Note the marked difference from the risk profile of Tunisia despite almost equal risk rating in our country risk model CRIS

Key data:	2010	2011	2012	2013	2014	2015	2016	2017
GDP (bill.US$)	115.9	135.5	155.8	171.2	193.7	211.7	231.6	254.4
GDP/capita (US$)	1302	1507	1716	1868	2094	2267	2461	2682
GDP (% chng)	6.4%	6.2%	5.2%	5.4%	5.6%	6.0%	6.5%	7.0%
Investments/GDP	33%	28%	27%	27%	28%	29%	29%	29%
Budget balance/GDP	-2.8%	-2.9%	-4.5%	-5.8%	-6.1%	-4.5%	-3.7%	-3.5%
Govt debt/GDP	41%	39%	39%	42%	44%	44%	43%	42%
CPI (% chng)	9.2%	18.7%	9.1%	6.6%	5.9%	6.0%	5.5%	5.0%
Money demand (%)	29.7%	11.9%	24.5%	21.4%	-6.2%	10.9%	10.7%	10.6%
Stock prices (eoy)	485	352	414	505				
Interest rates	10.8%	12.8%	9.1%	7.1%	7.5%	7.9%	8.4%	8.8%
Exch. Rate ($) (avg.)	18613	20510	20828	20933	21101	21834	22437	22945
Trade/GDP (%)	152%	163%	157%	166%	165%	169%	172%	172%
Oil price (Brent)	$80	$111	$112	$109	$107	$103	$106	$109
Billions US $								
Export of goods	83.5	107.6	124.7	144.6	160.6	177.8	196.2	216.3
Imports of goods	93.0	113.2	119.2	139.6	159.2	179.5	201.3	222.4
Other (net):	5.2	5.8	3.6	3.6	3.9	4.5	5.1	5.6
Current account	**-4.3**	**0.2**	**9.1**	**8.6**	**5.3**	**2.8**	**0.0**	**-0.6**
(% of GDP)	-3.7%	0.2%	5.8%	5.0%	2.7%	1.3%	0.0%	-0.2%
FDI	8.0	7.4	8.4	9.2	10.4	11.4	12.4	13.7
Loan repayments	-1.1	-3.1	-4.1	-3.0	-2.4	-2.1	-2.1	-2.1
Net other capital flows	-6.6	-3.5	-1.3	-14.5	-8.6	-5.5	-2.2	-2.1
Balance of payments	**-4.0**	**1.1**	**12.0**	**0.3**	**4.7**	**6.5**	**8.2**	**8.8**
Reserves	12.1	13.1	25.2	25.5	30.2	36.7	44.9	53.7
Total debt	44.9	53.1	59.1	52.2	48.0	45.8	45.7	46.2
o/w short term debt	6.9	10.0	9.9	8.7	8.0	7.7	7.6	7.7

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

Rating history				
Fitch (eoy)	BB-	B+	B+	B+
Moodys	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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