Vietnam

SEB MERCHANT BANKING – COUNTRY RISK ANALYSIS **April 22, 2014**

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The race continues between the successful FDI cum export boost on the one hand, which has so far stabilized the exchange rate, and the simmering banking crisis on the other where the authorities may appear foot-dragging on efforts to clean banks of bad loans. As of now, it is too early to declare the winner.

Country Risk analysis[1]

Growth picks up modestly: In 2013, growth picked up slightly to 5,4% from 5,2% the year before, and projections are for this to gradually gather speed in the current year but remain still short of the country's potential. The improvement is spearheaded by exports from the FDI sector with a new large assembly factory for telephones soon to reach full capacity making Vietnam one of the global leaders in mobile phone production. This is past years' foreign capital inflows eventually bearing fruits and turning the trade balance into a surplus that has helped the central bank regain investor confidence with the foreign reserve situation steadily improving.

But domestic demand tempered by shaky banks. Despite good export news, the general public remains well aware that the full truth of the previous boom-years may still have more to disclose. Ten years of torrent credit boom that ended in earnest last year, have likely left banks with bad debts still to be fully recognized. In June last year, the government established Vietnam Assets Management Agency (VAMC) to tackle the problem of NPLs in the banking system. VAMC sought a novel approach different from international practice with the aim to minimize the costs to the government. The scheme forces banks to provision for NPLs sold to the VAMC by 20% per year while being compensated for any loss of liquidity. The central bank issued strict guidelines to banks but subsequently pushed back implementation being alarmed about potential consequences. That could be a bad omen suggesting a NPL problem perhaps many times worse than the 4% officially recognized.

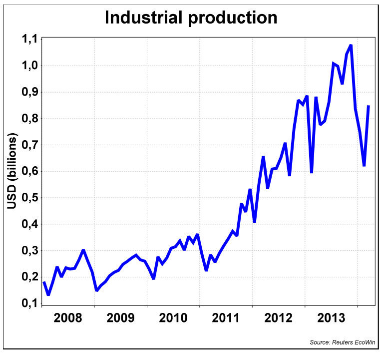
To lift growth, the government has announced some relaxation of financial policies but so far not to any alarming level. Structural rigidities with roots in dominating state-owned banks and enterprises are at the heart of Vietnam's problem together with undisclosed interconnectedness among banks and clients with the potential to foment corruption and intransparency that often fuel the rumor mill and speculation.

The rating agencies have held their line since our last September report, which has our sympathy.

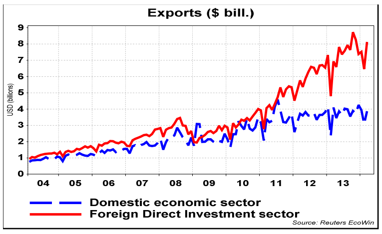
[1] This report is based on publicly available information and information gathered during a recent trip to Hanoi and HCM City that included meeting with officials, academics and representatives of banks and the local business community.

Recent economic developments

Modest pick-up from a modest level. Following a decade of boom years, growth was cooled in 2012 to stem overheating. That slowed the economy to 5,2% expansion and the result for 2013 came in just above that with 5,4% increased activity but with an apparent acceleration through the year as seen in quickening expansion of manufacturing to 7,4%. That should lay the basis for further pick-up in 2014 toward 5.6% overall GDP growth, still some 1-2 pp (percentage points) below estimated potential. Main driving force for growth since late 2011 has been the spectacular export performance of the foreign direct investment sector, while domestic demand has remained sluggish in particular for private investments. The fiscal side has provided some stimulus to the economy, but this has been partly offset by less lax monetary policy and unwillingness of banks to extend new credits. It is noteworthy that the overall cooling of activity has yet to show up in official estimates of unemployment which has remained around 4%.

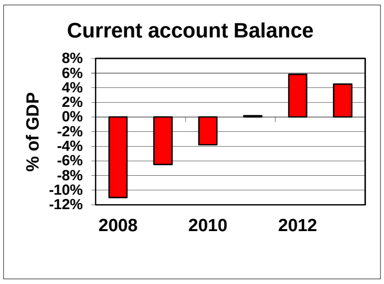


Price pressures abates: Price pressure has continued to ease from 9% pa. in 2012 to 6,6% in 2013 in tact with reduced economic pace and despite hiking of several subsidized consumer products still leaving energy, basic food stuff and medicines underpriced. The stabilization of real estate prices since the 2007-2011 housing boom has also contributed at least indirectly to the trimming consumer price inflation. So far in the current year disinflation has picked up speed to challenge our estimate of 6% annual inflatuon.



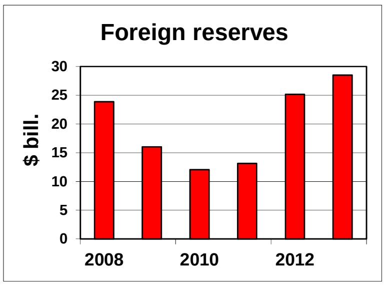
External sector success continues. The export boom that started in late 2011 has continued spearheaded by the foreign investment sector. In 2013, total export growth slowed by 1pp. from the year before but was still strong growing at more than 16%. That was mainly thanks to the foreign investment sector which expanded by 22%, six times faster than domestic exports. Output from the new electronic factory of the Japanese company Samsung once again almost doubled annual production in particular of mobile phones since start-up in 2011. It was accompanied by another telephone maker, Nokia of Finland, which last year opened a new plant and thus made telephones and other high-tech Vietnam's main export products, overtaking textiles.

Also imports quicken but still leave the trade account in surplus. As many of these and other factories opened by foreign investors over the last couple of years are essentially assembly lines, higher exports also drew much new deliveries including from abroad. In the event, at 17%, overall imports in 2013 actually grew slightly faster than exports such that the gap between exports and imports tightened but still left the trade and current account balances in decent surpluses. At a steady $9 bn. equivalent to almost 5%/GDP,



the current account surplus remained strong thanks to the trade balance and healthy remittances from abroad.

A new wave of foreign direct investments. Last year appears to have opened up for a new wave of foreign direct investments (FDI) following the "tsunami" of FDI inflows after Vietnam acceded the WTO in 2007. In 2013, gross FDI inflows rose 24% to $10,4bn. while foreign investment commitments reportedly soared 55% to almost $22bn. That commitment number is still below those recorded in the 2008-2010 period, but this time around observers are less concerned that they include too much "fat" in terms of speculative investments, or in other words, reflecting investor "dreams" rather than hard-nosed decisions. Actually, observers have noted a discernable shift to manufacturing and technology from real estate and land purchases which often dominated the FDI flows in the past. Japanese manufacturing companies have remained the largest investors with 15% of the total, closely followed by Singapore, Korea and Taiwan.



Foreign reserves on the rise. The rumors of an imminent tightening of US monetary policies that caused major capital flows out of emerging markets for several months in the middle of 2013, also hit Vietnam even though it had not been a major recipient of the carry-trade which benefited many regional peers in the 2011-2012 period. In June, 2013, to ease some of the pressure on the exchange rate, the central bank, State bank of Vietnam (SBV), announced a mini-devaluation of 1 percent. But that was reportedly followed by more market pressure forcing the SBV to intervene heavily to maintain the new parity. As a result and despite underlying balance of payment surplus -- the combined surpluses on the current and FDI accounts -- by September central bank reserves were still stagnating at around $25bn.[2] However, that apparently changed in the last few months of the year, as investor pessimism faded. This enabled SBV to build reserves to $29bn. at year-end based on local observers' estimates in lack of official data which are normally much delayed.

Reserve accumulation holds up. According to media reports, the balance of payments remained strong in the first quarter of 2014 to the tune of $7,7bn. As a result, official reserves should now have reached $37bn.[3] That would cover about 2,8 months of estimated merchandise imports for 2014, up from 2,5 months a year ago. This is nonetheless far behind peers and as such represents a continued concern which is only mitigated by the country's low external debt at around 25% of GDP, of which the major part is on concessional terms with low interest rate and long maturity.

Economic policies

Economic policies remained about neutral in 2013 despite a small fiscal stimulus and monetary accommodation. So far in 2014, policy formulation has followed in the same track, although recent announcements indicate that the government is about to loosen the fiscal and monetary stance. At the same time and after a long pause, reform policies are apparently being resuscitated although many observers express skepticism as to the

[2] From International Financial Statistics on-line dataservice, downloaded April 7, 2014.
[3] Viet Nam News, April 2, 2014.

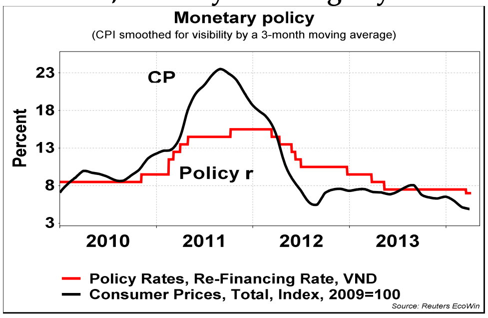
efficacy of implementation, at least as long as the country still battles with a simmering banking crisis.

Fiscal policy loosening: In 2012, the government formulated a fiscal policy aiming at an average annual deficit of 4,5% of GDP for the remaining years up to 2015.[4] That target was breached already in 2013 as the deficit is likely to have increased to 5,3% when, halfway through the year, the government introduced various measures to revive growth, including cutting corporate taxes from 25 to 22% of profits and promising further cuts to 20% by 2016. It also permitted deferment of corporate income and value added taxes for SMEs as well as tax breaks for real estate companies. This slowed tax collection and lowered the government's revenue to GDP ratio to 22%. There is a risk that this may have a carry over effect on the budget performance in 2014.

More expansive policies could be in the pipeline. According to the official budget presentation, the budget deficit for 2014 should remain unchanged from the preceding year at 5,3%. But this presentation does not follow international standards and may not present the real fiscal impact in an efficient manner. In fact adjusting for these deviances one of the rating agencies – FitchRatings -- finds that the extra fiscal stimulus in 2013 may have come to a full percentage point of GDP, and that this will grow by another 0,3pp. in 2014 producing a total fiscal deficit of 6,1%/GDP.

Government debt rising slowly: Fiscal stimulus programs since the outbreak of the Global Financial Crisis (GFC) have contributed to the rise in outstanding government debt from 34% of GDP in 2009 to an estimated 44% in 2013, not yet alarming but ultimately unsustainable if rise is not corrected. The majority of this debt is on concessional terms from multilateral and bilateral creditors, but the share of domestic debt has been growing to an estimated 43% of the total. This is presumably on market terms but in return denominated in local currency. It remains to be confirmed that this includes debt contracted to finance off-budget spending including for infrastructure projects and outstanding arrears to private contractors which the government has promised to settle by the end of 2015.

Monetary policy remains overall accommodative, but may have slightly tightened, perhaps unintendedly: In 2013, SBV continued slashing interest rates in view of easing price pressure. However, since late 2013, the rate of inflation has dropped faster than the SBV's policy rate leaving real rates in positive territory by a small but widening margin (Conf. chart) . In view of still relatively weak growth, one may ask whether this is an unintended effect, or if the central bank is preparing the grounds for a stronger monetary stance for example to strengthen reserve building. It would certainly also be keen to avoid a repeat of the situation in 2011 when it failed to react proactively to sky-rocketing price pressure. Nevertheless, recently the SBV cut its policy rate but once again out of line with recent months' faster disinflation. Lending rates from banks have overall dropped in pace with policy rates to the 9-12% pa. range for non-prioritized sectors. It is still unclear how these policies may affect domestic banks which struggle in the



[4] Decision 958 from the PM office

aftermath of a credit boom. (For a more detailed analysis of Vietnam's banking sector, pls. confer the document "Vietnam, banking sector analysis" dated April 16, 2014, on www.seb.se/mb ("our services > "Research/Country analysis")

Exchange rate policies: Apart from the minor devaluation of 1% in last June, the exchange rate has remained overall stable for more than two years, defeating a tainted history of periodic and turbulent pressure on the dong. Several reasons have been cited for this achievement including the strengthening of the current account balance and new capital inflows, lower inflation and stricter regulation of the volatile domestic gold market.

Competitiveness and business environment: According to the latest "Doing business" survey from the World Bank, Vietnam has lost 9 ranks to the 99th. On the Economic Forums Global competitiveness index Vietnam fell from 59th (2011-12) to 70th ranking in the 2013-14 assessment. The country scores even lower on the corruption prevention index reaching only to the 123rd place among 175 countries. On political stability, by contrast, Vietnam ranks as number 53, better than many peers.

Structural policies poised for a new revival? *Equitization*, that is a process to prepare state-owned companies for greater commercialization and eventual sale to private investors, had since its start in 2001 and until it culminated ten years later affected about 4000 enterprises, some two thirds of the total. Following that, it all but collapsed with only 13 companies equitized last year. In 2014, by contrast, the government has pushed for a new wave with a pledge to bring such companies to the market within 3 months after equitization. Even the national carrier, Vietnam Airlines, is reportedly under the hammer. If all goes to plan this should leave about a thousand enterprises in government hands, including some of the very largest though -- categorized as "strategic", including as policy instruments for the government and representing some 95% of all remaining in terms of value. As normal in privatization deals, the hurdle lies in market conditions and if the government can accept a lower than expected market price. In the case of Vietnam, the law may also prohibit sales that formally represent a loss to the government. In addition, many of these assets include land which foreigners cannot hold. After being listed or otherwise presented to private investors the government plans to retain 65% control in banks and 51% in companies. Observers note that these reform policies are at a critical stage, and that the government itself seems is aware of the risk it could lose oversight of the SOEs. That is with reference to the recent rise of NPLs in its largest commercial bank, Agribank, and the scandals surrounding this institution in recent times.

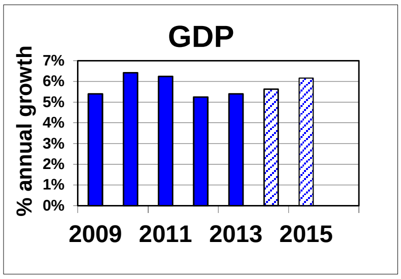
Political

Domestic developments: Judged by the World Bank survey, "Ease of doing business", most investors assess the political situation as reasonably stable, at par with Argentina but better than China and Thailand. Having survived much blame for several recent scandals coming out of the SOE sector including Vinashin and for the mismanagement of the economy up to 2011, the PM is now likely to sit out his term to 2016. However, in the few remaining years, he may shy away from jeopardizing his reputation by taking on risky political projects. Observers are therefore concerned that the government may continue foot-dragging on reforms and thus leave simmering problems to brew for more years.

External security: The situation vis-à-vis China, Vietnam's only external security threat, has changed little over the last year. Should China take lessons from Russia's recent re-annexation of the Crimea, Vietnamese analysts believe she is unlikely to make Vietnam her first target having been beaten back with severe losses when the two countries clashed in a short but intense war in late 1979.

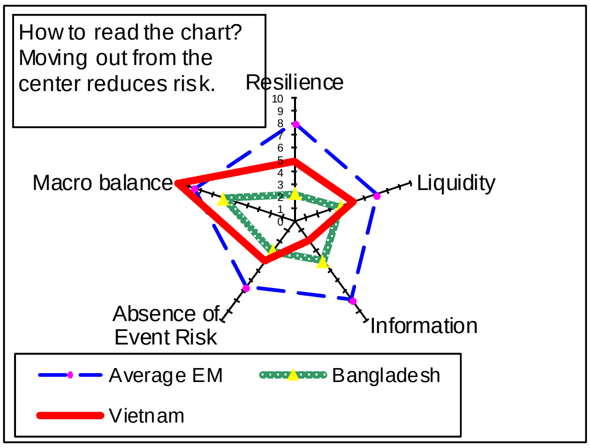
Outlook

In our main scenario and that of most observers, Vietnam will continue slow recovery for the next couple of years achieving about 6% growth in 2015. That will be spearheaded by continued export growth from the foreign invested sector and new capacity expansion in manufacturing supported by a modest pick-up of domestic consumption – private and public. All this is based on continued calm in financial markets and a steady management of the exchange rate. A supportive global environment will also help, but in a short to medium term perspective, exports will advance regardless based on investments already in the pipeline.



Risks to this scenario lie mainly in policy mistakes. Overzealousness in fiscal or monetary policies to jump-start growth could undermine confidence in government policies with potential negative effects for the stability of the banking system. That said, also failure to sequence reforms and fine-tune the speed – not too fast to leave too many broken enterprises and banks along the roadway, but neither too slow to lose the respect of investors, could derail the project of bringing Vietnam back to a reasonably strong growth in line with the country's potential. The hoped for near term conclusion to the US led TPP (Trans Pacific Partnership) negotiations over a comprehensive multilateral free-trade agreement could help spur such a development, but would still present only a temporary reprieve and no substitute for a proper revival of the reform process.

Key ratios	**2014**
Population (mill.)	91.7
GDP/capita ($)	2360
GDP (change)	5.6%
Inflation	6.3%
Curr.Acc. Balance/GDP	2.5%
Reserves/imports (months)	2.2
Budget balance/GDP	-6.1%
Government debt/GDP	44%



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

Peers:
Sri Lanka
Philippines
Portugal

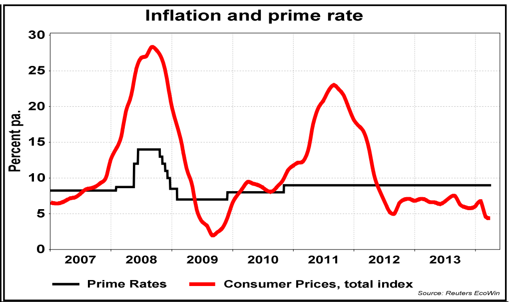
Graph: The pentagon shows Vietnam's credit profile dominated by weak liquidity and a poor information base. This makes for a potentially dangerous combination, particularly against a background of high event risk of domestic and external nature.

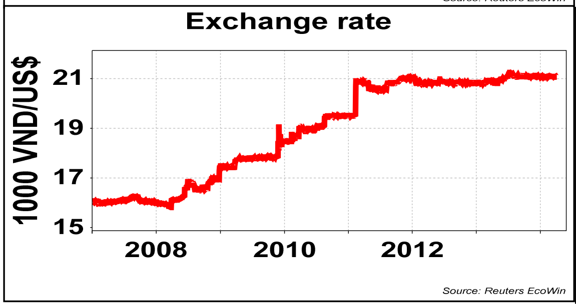
Key data:	2008	2009	2010	2011	2012	2013	2014	2015
GDP (bill.US$)	98.3	101.6	112.8	134.6	155.6	192.6	218.3	239.1
GDP/capita (US$)	1125	1152	1267	1497	1714	2102	2360	2560
GDP (% chng)	5.7%	5.4%	6.4%	6.2%	5.2%	5.4%	5.6%	6.2%
Investments/GDP	30%	31%	33%	28%	27%	27%	28%	29%
Budget balance/GDP	-7.2%	-4.6%	-2.8%	-2.9%	-4.5%	-5.8%	-6.1%	-4.9%
Govt debt/GDP	36%	34%	41%	39%	39%	42%	44%	45%
CPI (% chng)	23.1%	6.7%	9.2%	18.7%	9.1%	6.6%	6.3%	6.0%
Money demand (%)	20.7%	26.2%	29.7%	11.9%	24.5%	2.3%	11.3%	10.9%
Stock prices (eoy)	316	495	485	352	414	505		
Interest rates	13.6%	10.8%	10.8%	12.8%	9.1%	7.1%	7.5%	8.0%
Exch. Rate ($) (avg.)	16440	17800	19131	20649	20859	21017	21150	21885
Trade/GDP (%)	157%	135%	152%	163%	158%	149%	147%	150%
Oil price (Brent)	$62	$80	$111	$112	$109	$104	$103	$106
Billions US $								
Export of goods	70.4	63.6	80.3	106.8	125.4	145.5	161.5	178.8
Imports of goods	84.1	73.3	90.9	112.0	120.2	140.7	160.4	180.9
Other (net):	2.9	3.0	6.4	5.4	3.9	3.9	4.3	5.0
Current account	**-10.8**	**-6.6**	**-4.3**	**0.2**	**9.1**	**8.7**	**5.4**	**2.8**
(% of GDP)	-11.0%	-6.5%	-3.8%	0.2%	5.8%	4.5%	2.5%	1.2%
FDI	9.6	7.6	8.0	7.4	8.4	10.4	11.7	12.9
Loan repayments	-0.8	-1.0	-1.1	-3.1	-4.1	-3.0	-2.4	-2.0
Net other capital flows	2.5	-7.9	-6.6	-3.5	-1.3	-12.7	-10.3	-7.4
Balance of payments	**0.4**	**-7.9**	**-4.0**	**1.1**	**12.0**	**3.3**	**4.4**	**6.2**
Reserves	23.9	16.0	12.1	13.1	25.2	28.5	32.9	39.1
Total debt	26.5	33.1	44.9	53.1	59.1	52.2	47.9	45.7
o/w short term debt	4.3	5.2	6.9	10.0	9.9	8.7	8.0	7.6

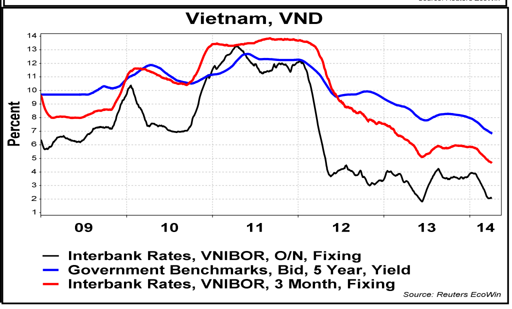
Source: OEF (Oxford Economic Forecasting) and SEB estimates.

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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