Vietnam

SEB MERCHANT BANKING – COUNTRY RISK ANALYSIS May 8, 2015

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Four years after the economic and financial crisis erupted in Vietnam in 2011 following a period of accelerating overheating, observers are commenting the country for having stabilized the situation with lower inflation, external balances and strengthening growth.

Country Risk analysis

Growth picks up: A surge in bank lending and rising consumer sentiment toward the end of 2014 raised economic growth to more than 6% and projections for the current year is a further uptick to 6.2%. Despite that, disinflation will continue under the influence of falling import prices but stay clearly away from outright deflation while wage growth also remains under control.

As in 2014, the current account balance will continue to post a decent surplus of 4%-5%/GDP supported by exports from the country's booming foreign invested sectors which are increasingly dominated by high tech products. Last year that helped the central bank build reserves to the equivalent of 2.4 months of imports, not impressive compared with peers but a far cry from the situation during the crisis in 2011. However, the build-up stopped in mid-year. That is a puzzle and may undermine consensus view of solid market confidence in the authorities' exchange rate management.

In 2015, the state budget will act as a drag on the economy. The government will hopefully pay heed to warnings against a repeat of last year's high budget deficit at 6% of GDP which ratcheted up the debt ratio to more than 55%/GDP. That is not yet an alarming level but one that is about to undermine the capacity of the government to clean-up in the country's state owned enterprise (SOE) sector and many banks – an operation that could cost another 30% of GDP in terms of recapitalization and other rescue operations. Progress is being hampered by a serious lack of transparency due to cross holdings and interconnectedness among banks themselves and with their clients mainly among public sector entities but also in the private sector.

Our ongoing "race" as we have described it before on these pages between bank and SOE sector clean-up on the one hand and building of reserves to instill market confidence on the other remains inconclusive. We believe new impetus is needed to maintain momentum. A reform process has been likened to riding a bike: Keep moving lest you fall over.

Two rating agencies, Fitch and Moody's, recently upgraded the sovereign to BB- and Ba3. That was justified by the improved current account balance turning into a surplus and reduced external net debt despite a growing government debt ratio. As regards overall country risk we find that progress partly offset by the government's apparent procrastination on SOE and bank reforms.

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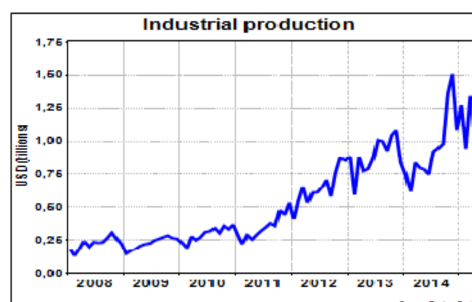
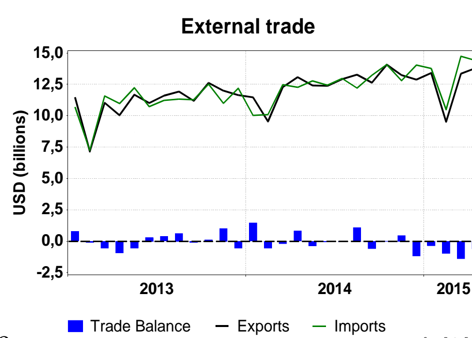
Recent economic developments

Growth accelerates: last year started on a modest note but picked up speed towards the end of the year. As late as in October , World Bank and the IMF estimated whole year growth at around 5,5%, undershooting the final outcome at more than 6%. The year–end uptick seems to have been driven by fiscal expansion and a surge in new credits to support a recovery in construction. In the current year, momentum is keeping up with prices signaling an end to the housing market rout after five years of steep decline by a total of 50%. Stock market strengths are boosting household sentiment reflected in soaring car sales. After a weak start to 2014, industrial production came roaring back in the fourth quarter and has so far remained strong into the current year. Real net external trade, by contrast, shows a more complex story. Last year it provided a small pull but so far into the current year that has turned into a drag with imports outpacing exports.



Disinflation and wages. Despite quickening activity, disinflation has continued into 2015 bringing the consumer price development to the brink of deflation. That reflects lower global energy prices and soft import prices in line with the effective appreciation of the dong. The annual consumer price index touched nil in February before turning slightly up in March. Our whole year estimate is a 2-3% growth in CPI. Continued low unemployment has not triggered threatening wage inflation.

Export growth is outpaced by imports: Last year exports continued to exceed imports by a relatively wide margin resulting in a trade surplus of $7bn. The first four months of the current year, by contrast, has seen a string of monthly trade deficits as imports have surged ahead. While that could be a coincidence and because the Vietnamese new-year's holiday in January-February often cause statistical problems, we still project a reduced surplus on the trade balance for the current year. Seen in a longer perspective the trade surplus is in decline and could disappear beginning next year. To the extent that this trend reflects the ongoing boom in investment inflows, there may not be too much to worry about, however. In terms of destinations, exports continue fairly diversified. The US and EU dominate with 19% each ahead of China and Japan with about 10% each.

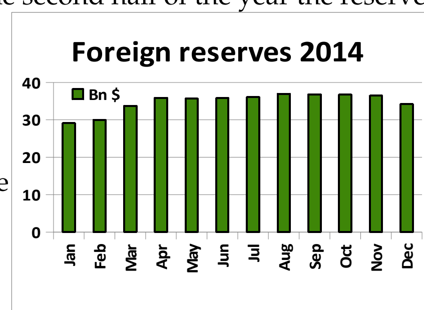


Current account balance still healthy: Last year the current account surplus reached an all-time high of $10bn – 5.2% of GDP – in stark contrast to sky-rocketing deficits in the past. That reflected not only the noted trade surplus but also $11bn of remittances from Vietnamese living abroad. A rising flow of foreign tourists, in particular from regional countries, made a significant contribution as well. In 2015, most observers agree that the current account will remain in a significant, albeit slightly reduced surplus, of some $9bn.

Box 1: The export story: Since 2012 rapidly growing exports have played a key role in Vietnam's recovery. Still dominated by traditional labor intensive manufacturing including garments, footwear and furniture, high-technology items, in particular mobile telephones, are about to emerge as the largest export category. They already make up almost a quarter of Vietnam's total merchandise exports , just behind "low-value manufacturing". Crude oil, in contrast, has fallen back to only 5% of the total. Another salient feature is the steady rise of the foreign invested sector (FDI) which last year hiked its share of total merchandise exports to 67%.

FDI going strong: Vietnam's second FDI boom (Foreign Direct Investments) over the past decade started in 2011 and is still going strong. In 2014, they grew 9% to almost $10bn. at a rate of almost two times greater than those into China taking into account the relative size of the two economies. EuroChams Vietnamese sentiment indicator is at a three year's high and shows that a rising number of international investors find the country attractive in terms of competitive wages, disciplined work force, and a welcoming attitude by the country's authorities – just as many still remember China one or two decades back. Even though the total of Chinese investments remain far below Korean or Japanese, proximity to Chinese supply chains is another important pull factor. In 2015, estimates show continued growth at a slightly reduced speed and last year's drop in commitments signals a deceleration in terms of actual disbursements. Then again, plans to lift the 49% limit on foreign ownership in domestic companies to at least 60% should attract new interest among foreign investors.

Has reserve growth come to a halt? The combined surplus of the current account balance and the FDI inflows in 2014, the so called basic balance, would suggest further accumulation of foreign exchange reserves at the central bank – State Bank of Vietnam (SBV). Curiously that did not happen. In the first half of the year, reserves rose to around $36bn, but in the second half of the year the reserve level stagnated before starting to trail at the end of the year. Scheduled loan repayments do not seem to explain this development while revaluation effects from the surge in the dollar against other reserve currencies are unlikely to explain more than a minor part. That may suggest short term capital inflows turned negative undermining consensus about solid exchange rate confidence and officially stated policies aimed at further reserve accumulation. Because even if reserves today are three times larger than during the currency crisis in 2011, they still cover only 2.4 months of merchandise imports – quite an under-performer among emerging markets including regional peers. The semi-peg of the dong to the US dollar for more than three years now, also argues for larger reserves.



External debt manageable: At 38% of GDP (end 2013) Vietnam's external debt is quite manageable by most metrics. Almost three quarters of it is owed by the government of which one half is on concessional terms.

Policies

Kick-starting the reform process has been the much touted hallmark of the government action plan since the launch of stabilization policies in 2011. Nevertheless, progress has been slow and the government's resolve in implementing well-intended measures has more than once met with doubtful

markets. In addition, fiscal stimuli to sustain growth at a decent level have begun to undermine the government's capacity to meet future demands on resources to support potentially failing banks or companies as a result of the same reforms.

Fiscal stimuli becoming cause of concern: Last year the government deficit jumped to 6,6% of GDP, up 1,2pp (percentage points) on the preceding year.[1] In 2011 the deficit was only 1,1% but tariff reductions and tax cuts have eroded the revenue base. The first was an inevitable result of Vietnam's WTO entry in 2007. Corporate taxes, in contrast, have been cut in several stages in part as a counter - cyclical stimulus. Last year the tax rate was cut to 22% as part of a deal to lower it further to 20% in 2016. The VAT rate was also lowered significantly for certain housing projects, presumably to put a floor under the collapsing real estate market. At the same time the secular decline in oil revenues, once a significant government cash cow, accelerated in 2014 under pressure of weaker global oil prices. The situation would have been worse still without offsetting expenditure restraint including the public payroll and wage bill.

Will fiscal restraint be more successful in 2015? For the current year the government has targeted a budget deficit of 6,1%/GDP – slightly lower at 5,3% according to the government's own accounting standards. The oil price effect will strike with full force in 2015, shaving 0,5 percentage points (pp) off budget revenues. In return, the projected acceleration of the economy should support tax revenues unless companies are motivated to defer recording of profits to 2016 when further tax cuts are expected. As important is the success in pushing profitable SOEs to pay dividends to the Treasury. All the same, a deficit of 6,1% is still high for an economy that may not expand more than 8-9% in nominal terms. With a primary balance deeply in deficit to the tune of 4,6%/GDP – albeit down from 5,1% in 2014, the government debt ratio is likely to climb further.

Government debt an "increasing concern": In 2014 direct government debt ended the year at 44% of GDP. Counting also guarantees adds 11%/GDP. The total, 55%/GDP, was up from 51,6% the year before. Neither the government itself nor outside observers expect this rise to stop before reaching 60%/GDP – close to the ceiling set by law – probably in 2017. The problem is that cleaning up the banking sector and state-owned enterprises could cost as much as 18%/GDP and 26%/GDP respectively, according to one rating agency. Should such a worst case scenario materialize, the debt ratio could reach unsustainable levels. So far, however, markets have shown appetite for more debt. Last year the government tested market reactions by selling $1bn. of USD denominated bonds with a coupon of 4,8% and also issued VND210tr. ($10bn) in the domestic market. Nevertheless, both the IMF and the World Bank office in Hanoi have described the government debt situation as a growing concern.

Monetary policy easing: Since the last cut in March 2014, the SBV has kept its key policy rate unchanged at 6,5%pa. Since then, consumer price inflation has fallen to less than 1% yoy raising the real interest rate to 5,5%, in that sense being quite a restrictive stance. Even though that would suggest further monetary policy easing SBV may still take a cautionary stance against the background of some new pressure on the exchange rate and the relatively high interbank rate - although still lower than the policy rate. Moreover, the high real rate since late

[1] These numbers are calculated by FitchRatings to conform to international accounting practices. They include off-budget expenses but exclude loan transactions.

2014 does not seem to have restricted a new bout of lending from banks. Last fall, the IMF assessed the central bank's monetary policy stance adapted to circumstances.

Exchange rate – is the dong rightly valued? The central dong/US-dollar rate is set daily with a fluctuation band of ± 1%. That has meant a high degree of stability since the last major devaluation in 2011. Nevertheless, last January the SBV devalued the central rate of the dong to the US dollar by 1% following a similar move six months earlier. That offset some part of the nominal effective exchange rate appreciation since the US dollar began its rapid rise early last fall. However, it is still likely that the dong has lost much competitiveness in recent times. This comes on top of the accumulated inflation differential since 2011 of about 25%. Last fall the IMF found "no convincing evidence of miss-alignment" of the exchange rate, an assessment we believe it may not uphold in its next update.[2]

Box 2: The banking sector:
Vietnam's banking sector is highly concentrated with five state owned banks representing some 40% of the total system in terms of assets and 45% of deposits. The rest is shared among 34 so-called joint stock banks with mixed private and government holdings. Over the past decade credit growth was highly volatile, in part reflecting erratic macro policies. But since 2012, lending has calmed down and last year it almost ground to a halt. That appears to have changed late 2014 as credit expansion picked up and accelerated to 15% yoy in the first quarter of 2015. The SBV has said it may allow up to 17% growth in 2015.

Banks in the purgatory: Non-performing loans have come to dominate many Vietnamese banks. First there were legacy loans from Vietnam's past of state planning. Those were topped off by subsidized loans to the private sector, including for agriculture and real estate as a part of countercyclical policies since 2009. Many of the latter have now seasoned and become non-performing (NPL) after subsidies were removed. The government vowed not to use tax-payers money to save any bank but organized instead an asset management company[3] with the mandate to swap NPLs from banks against five years bonds. These bonds were accepted as collateral for cash from SBV. That went a long way in solving banks' liquidity problems but not solvency problems. The VAMC bonds are not marketable, carry zero interest and lack government guarantees. At only VND500bn ($24mn) the capital base of VAMC itself is very thin compared with the underlying problem. As a result the VAMC bonds may be no better than the NPLs swapped out. The swaps require banks to provision for the bad assets before the end of the deal. If that fail banks are apparently back to square one.

How big is the NPL problem? There is a lot of confusion about the size of the NPL problem. In last September, the SBV governor reportedly noted that the present NPL problem stood at VND249 tr. (USD11bn) some 7% of total loans, down from VND465tr. 12 months earlier. That was more than the 4,2% reported by the IMF of last October based on latest official information up to that point. In the 12 months period up to September 2014 VAMC reportedly took over VND90tr of NPL from banks leaving a balance of VND125tr. probably reflecting write-downs. Discrepancies may also be due to the valuation of NPLs which depends on the method of classification. In Vietnam that is compounded by the lack of clear definitions. In early 2013, SBV published Circular 02 in order to clarify the definition but its full implementation has been delayed several times.

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[2] 2014 Article IV Consultation : IMF Washington DC, October 2014
[3] Vietnam Asset Management Company (VAMC)

At the moment of this writing it is not yet clear if the SBV has delivered on its most recent promise to settle the matter by the end of April 2015.

Can it be solved? The financial sector problems in Vietnam are closely intertwined with the dominating position of SOEs. Connected lending between SOEs and SOBs (State Owned Banks) has been an engrained feature of the economy for decades, a pattern that is not yet broken. Two of the largest SOBs hold almost 60% of all bank exposure to SOEs. Lack of transparency in the SOE balance sheets makes it difficult to assess the banks they have borrowed from. [4] What is clear is that many of the SOEs are in very poor financial shape, with some of the largest effectively in default. However, connected lending has also been growing among banks themselves and between banks and their private sector clients. This goes far beyond the SOBs and into the territory of many fast growing joint stock banks (JSB). Such interconnectedness and cross-ownership complicates the task of disentangling individual bank problems in particular when also vested interests are at stake often with political contacts. The government should still have the capacity to solve the problem provided it is prepared to dig deep into own pockets. Any solution would also involve comprehensive SOE reforms.

SOE reforms: The SOE reform program was officially announced in the government's Socio-Economic Development Plan of 2011. Since then, comprehensive restructuring plans have been published but implementation has been uneven. Some large SOEs – effectively in default – have continued operations in the absence of relevant bankruptcy legislation. That should be taken care of by a new bankruptcy law adopted in 2014. In the same year, the government also prepared for the "equitization" of 200 SOEs, a prerequisite for later privatization. In 2015, it plans the same for 280 more SOEs including large companies like Vietnam Airlines, Petro and Vinatex (garment producer). However, before any privatization a new law demands SOEs to divest from non-core risky activities. It may give an impression of the transparency problem at stake when a law passed in 2013 calls for SOEs to provide detailed reporting to parent ministries twice a year. Total SOE debt has been estimated at 42% of GDP, of which 16%/GDP is from non-bank sources and 10%/GDP from abroad.

Political developments

At the next Conference of the Vietnamese Communist Party in 2016 leading positions including that of the Prime Minister, is up for change. While there is no formal opposition in this one party state, there are factions within the polity vying for power and influence. In this situation it may not be advantageous to attract unnecessary attention by doing anything political courageous. As such, key policy decisions on privatization and easing of foreign investment restrictions could be delayed till after the conference. Nevertheless, it has been speculated that populist may not be able to resist the temptation to burnish nationalist credentials by conveying anti-China sentiments. China remains a contentious issue in the population with arguments in the blogosphere even disputing the longstanding subordination of the armed forces to the Party presumably because that restrains the army from playing a more assertive role.[5] Otherwise, the popular violence that erupted in 2014 against local Chinese businesses particularly in HCM City has calmed down at least for now.

[4] News and analysis, Moody's, March 19, 2015

[5] ISDP (Inst. of Security and Development Policies) Stockholm, Policy Brief 168, January 2015

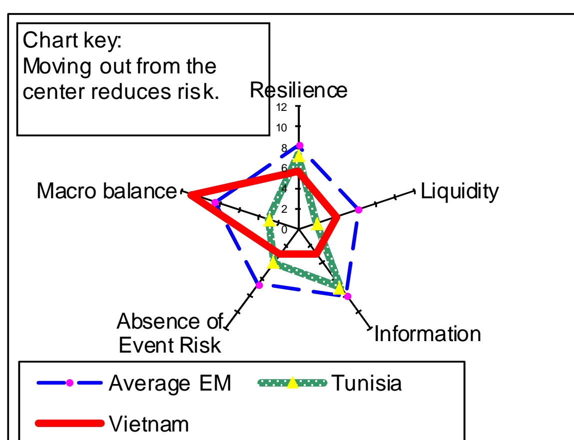
Outlook

Near term outlook is positive: Our main scenario for the current and next years is one of gradual acceleration of growth to above 6% pa. Improving investor and consumer sentiment will strengthen domestic demand while continued foreign investments will result in higher exports although not sufficient to prevent the current account surplus from gradually shrinking. The fiscal budget, by contrast, will present a drag on the economy provided the government lives up to intentions to stop the erosion of the fiscal balance and rising government debt.

This scenario comes with a few caveats. In the run-up to the conference of the Communist Party in 2016, reforms may be delayed and a new leadership may require some time to formulate its own agenda. That could send unfortunate signals to markets as regards the resolve to clean up of banks and restructure state-owned enterprises including privatization. Turbulence in global financial markets as the US begins to normalize monetary policies over the next 12 months period could also have ramifications for Vietnam. In that situation some investors might conclude that the dong looks ripe for a correction after having been quite closely tied to the US dollar for several years. But there are also upside risks. Continued softness of global energy markets would overall benefit Vietnam by facilitating easy monetary policies while supporting the external balance and the central bank's effort to build reserves.

In the longer run, much depends on what will happen in the shorter term. Government resolve to see the reform process through before the party congress next year despite possible inter-party resistance would reassure domestic and foreign investors that Vietnam remains a new beacon in Asia. So will resisting the temptation to ease fiscal policies for any sign of weaker than expected activity over the next one or two years. Beyond that it will probably prove paramount that the authorities are vigilant as to how markets perceive current exchange rate and monetary policies. But most of all, it may prove imperative to show flexibility as how to resolve the still rumbling banking crisis. While it may be ideologically valiant to pledge no use of tax-payers money that has seldom worked in practice in other places around the world.

Key ratios	**2015**
Population (mill.)	93
GDP/capita ($)	2170
GDP (change)	6.3%
Inflation	2.7%
Curr.Acc. Balance/GDP	4.4%
Reserves/imports (months)	2.6
Budget balance/GDP	-6.1%
Government debt/GDP	46%



External ratings:
Fitch: BB-
Moody's: B1
S&P: BB-

Peers:
Sri Lanka
Tunisia
Kaxakhstan

Graph: The pentagon shows Vietnam's credit profile dominated by event risk and poor information. Strengths lie in improved macro balance and liquidity.

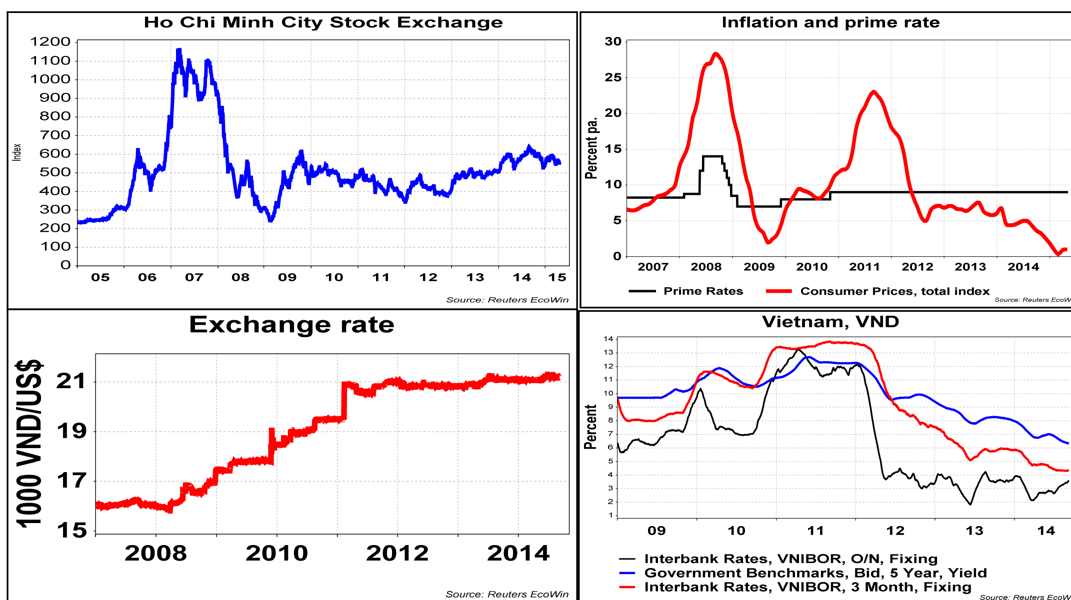
Key data:	2011	2012	2013	2014	2015	2016	2017	2018
GDP (bill.US$)	134.6	155.6	170.5	186.6	202.7	219.3	240.0	261.3
GDP/capita (US$)	1497	1714	1861	2017	2170	2330	2530	2733
GDP (% chng)	6.2%	5.2%	5.4%	6.0%	6.3%	6.4%	6.9%	6.5%
Investments/GDP	28%	27%	27%	28%	28%	29%	29%	29%
Budget balance/GDP	-1.1%	-6.8%	-5.6%	-6.6%	-6.1%	-5.7%	-4.5%	-4.0%
Govt debt/GDP	39%	39%	42%	44%	46%	47%	46%	46%
CPI (% chng)	18.7%	9.1%	6.6%	4.1%	2.7%	4.2%	4.9%	4.7%
Money demand (%)	11.9%	24.5%	21.4%	18.0%	12.0%	10.7%	10.6%	10.6%
Stock prices (eoy)	89	85	101	118				
Interest rates	12.8%	9.1%	7.1%	7.4%	7.6%	7.9%	8.3%	8.6%
Exch. Rate ($) (avg.)	20649	20859	21017	21189	21300	21833	22378	22915
Trade/GDP (%)	163%	157%	164%	168%	170%	174%	177%	182%
Oil price (Brent)	$80	$111	$112	$109	$99	$61	$70	$74
Billions US $								
Export of goods	106.9	124.5	143.0	160.3	174.6	191.6	211.9	235.5
Imports of goods	112.4	119.1	136.1	153.9	169.6	191.1	212.5	239.3
Other (net):	5.8	3.6	2.5	3.4	3.9	4.4	4.8	5.3
Current account	**0.2**	**9.1**	**9.5**	**9.7**	**8.9**	**5.0**	**4.2**	**1.6**
(% of GDP)	0.2%	5.8%	5.6%	5.2%	4.4%	2.3%	1.7%	0.6%
FDI	7.4	8.4	8.9	9.7	10.6	11.4	12.5	13.6
Loan repayments	-3.1	-3.3	-3.9	-4.2	-4.6	-5.4	-5.9	-6.5
Net other capital flows	-3.5	-2.1	-14.2	-10.6	-8.4	-3.1	-2.2	0.5
Balance of payments	**1.1**	**12.0**	**0.3**	**4.7**	**6.5**	**7.9**	**8.6**	**9.2**
Reserves	13.1	25.2	25.5	30.2	36.7	44.6	53.2	62.4
Total debt	53.1	59.1	65.5	67.7	70.6	75.6	79.3	83.0
o/w short term debt	10.0	9.9	10.6	10.9	11.4	12.2	12.8	13.4

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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