Vietnam

SEB MERCHANT BANKING – COUNTRY RISK ANALYSIS May 6, 2016

Analyst: Rolf Danielsen. Tel: +46-8-7638392. E-mail: rolf.danielsen@seb.se

The gradual strengthening of the economy has solidified with signs of growth rates established in the 6-7 percent range. It is now imperative that the government under its new PM takes this opportunity to build reserves and rein in the budget deficit to shield still vulnerable banks from possible new bouts of market volatility.

Country Risk analysis

Growth remains robust. Following a surprisingly strong performance in 2015, growth in the current year is expected to cool slightly but still remain broad based, spearheaded by exports and foreign direct investments. As a result, the external sector remains strong notwithstanding the reduction of the current account surplus as imports outpace exports. However, the import growth is largely of capital goods for new industrial plants and factories that will boost future exports.

Reserves remain low: Curiously, the central bank did not take advantage of recent years' strengthening of the external accounts to build reserves before the current account surplus disappeared. Reserves have rather remained stuck at a low level of less than three months of import cover. Last year, market concerns about eroding competitiveness caused bouts of pressure on the exchange rate prompting the central bank to sell dollars thus reducing reserves by some 10%.

Fiscal deficit close to breaking the debt limit: While the exact fiscal deficit is obscured by idiosyncratic accounting standards it is clear that the budget deficit has grown too high and needs to be cut in 2016 and going forward. Otherwise the new government will be responsible for breaking the law on the government debt/GDP ratio set at 65%. Such a situation, combined with the low reserve level noted above, could gradually undermine investor confidence in policy intentions with potential consequences for stability in domestic financial markets.

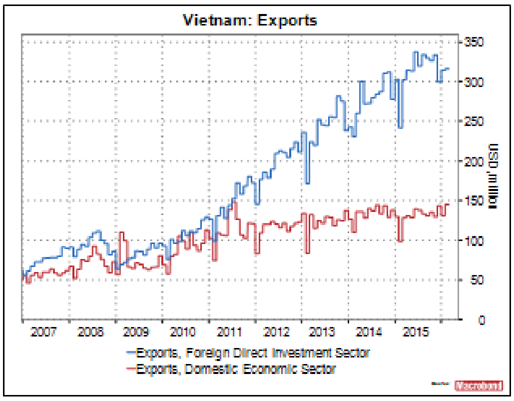
External security remains tenuous: While the recent Party Conference has settled scores domestically for the next five-years period, regional tensions focused on maritime borders continue to fuel concerns. That said few believe in any serious near term escalation between China and its neighbors including Vietnam, as strong trade continues among them.

Risk rating: Over the recent 12 month period the sovereign ratings have remained stable. That also reflects on country risk although a gradual strengthening of the banking system – even though from a poor risk level -- is now preparing the grounds for a possible improvement to country risk in the not too distant future.

Recent economic developments

Following a surprisingly strong performance in 2015, growth in the current year is expected to cool slightly but remain broad based, spearheaded by exports and foreign direct investments. At the same time it is notable that the central bank has failed to build reserves which remain too low for comfort.

Growth accelerates: Activity surprised on the upside in 2015 to an estimated 6,7% growth of GDP, up from 6% of the preceding year and 0,5 percentage point (pp) higher than targeted by the government. Economic expansion was broad based and spearheaded by exports and investment demand both related to the foreign invested export sector. Rising purchasing powers of households propelled private consumption as wage growth continued while the rate of inflation fell more than expected to 0,7%. That was in part due to lower energy and food prices – the latter despite adverse climatic condition for agriculture. An ongoing revival of the real estate market buoyed sentiment of domestic consumers and investors and was further lifted by accelerating government expenditures, including for infrastructure. As a result, industrial production and construction activity expanded by some 10% in real terms.



2016 set for another strong expansion: Most of these tendencies are likely to continue into the current year although some government efforts to rein in the budget deficit will act as a moderate drag on the economy. On that basis the end result could prove to be a slightly lower growth rate of 6,5% in 2016 with the rate of inflation set to pick up to 2% as energy prices rebound.

Foreign trade in continued expansion mood: Growing exports of recent years continued in 2015 rising 8% in US dollar terms. That trend is poised to rise in the current year to 9% growth including raw materials and energy for the many new industrial plants in the export sector. They include factories for the production of textiles, apparel and shoes, the traditional mainstay of Vietnam's export sector, but also production units for consumer electronics such as handsets produced by the foreign invested sector. This sector has grown rapidly in recent years and churn out some two thirds of the total national export volume. However, due to even faster growth of imports -- around 12% in 2015, Vietnam's trade surplus has all but disappeared. As robust imports continue into the current year the trade balance is set to dip into red numbers. The current account balance should nevertheless remain in a small surplus of $1,4bn – 0,7% of GDP, down by a half from 2015, supported by buoyant inflows of remittances. That development might have raised concerns but a large part of imports are capital goods for the foreign investment export sector.

Foreign investment inflows set to reach new records. Vietnam's success in attracting foreign direct investments (FDI) about a decade ago ended in overheating and abrupt slowdown. The new wave of foreign investments over the last couple of years has been less spectacular but likely more robust. It is now less driven by real estate investments or hopes for quick money from land acquisitions. On the contrary, new industrial production units have become the driving force. Last year, the inflows of FDI rose almost 20% to $13bn. Even higher numbers of "commitments" at $23bn pay tribute to prospects of growing foreign investor interests in coming years. Taking also some investment outflows into account the net of in- and outflows of FDI ended at about $10bn in 2015.

Reserves fall from an already modest level. Notwithstanding the current account surplus and the net inflows of FDI, reserves at the hands of the central bank failed to grow in 2015 but instead fell by almost $5bn. That suggested a net outflow of other capital of nearly $16bn. of which less than half can be attributed to scheduled loan repayments.

Are reserves too low? It is customary to set a minimum limit for official reserves at three months of imports. In those terms, Vietnam's reserves are already too small at the estimated level of $30bn by the end of 2015 -- equivalent to only two months of imports.[1] Due to the country's still limited integration with global financial markets this has nevertheless worked for several years after the severe turbulence in 2011 when reserves at one point in time were down to little more than one month of import cover. However, despite continued strict capital controls financial integration with the outside world is rising and the portfolio of domestic money that investor might at some time in the future wish to diversify into foreign currencies is growing fast. Other countries, admittedly with a more open capital account, feel safer to keep the reserve level at least at six months of import cover. We once predicted that the SBV would take the opportunity of growing FDI inflows to build reserves but since 2014 they have rather remained quite constant. We may have been wrong in our reading of SBV's intentions but we believe the bank have been lucky not to encounter more market turbulence in the meantime.

Moderate foreign debt level. At about 40%/GDP Vietnam's foreign debt is not excessive and smaller than that of many peers. It is also notable that most of it is related to government borrowing from multilaterals at concessional rates and repayment terms. At such it does not represent a volatile element in the balance of payments thus to some extent mitigating concerns about low reserves.

Policies

Concerns about the budget deficit. Last year the budget deficit of the fiscal sector rose sharply to 6,9%/GDP up from 6,2% of the preceding year. That was mainly the result of the government accelerating capital expenditures while pension and wages for public sector employees continued growing. Revenues were hit by declining import tariffs, a new 2pp cut in corporate taxes to 20% as previously promised and low oil prices for its national oil company. Altogether these items outweighed a greater tax take in line with economic growth. This brought government debt to 63% of GDP including some 11%/GDP of guarantees for state owned enterprises (SOE). The debt ratio has grown quickly in recent years to 40%/GDP.

More austerity on its way? Because the law sets a debt limit of 65%/GDP the government is now in a hurry to reduce the annual deficit to limit further rise of the debt ratio. The budget for 2016 was presented with a reduced deficit of 6,4%/GDP.[2] That is still insufficient to stabilize the debt ratio at 65%/GDP which requires a nominal deficit of only 4%/GDP. We believe the new prime minister expected to be anointed by the National Assembly in late May will have to tackle this challenge at least for the next budget year despite possible negative short term effects on growth.

[1] SBV is among the few central banks around the world not to publish foreign reserves in a timely manner. Instead publication comes with long lags up to six months or more. In May 2016, the latest published number is still from November 2015.

[2] This estimate is adjusted to conform with the GFS methodology as presented by the World Bank in its publication "Taking Stock", Hanoi December 2015. The rating agency Fitch makes other adjustments and come to a budget deficit for 2015 at 6%/GDP and for 2016 at 5,4%/GDP.

Deficit funding at crossroads: funding of the deficit has so far not posed much of a challenge. The government has for many years kept good relations with international donors and multilateral financial institutions like the World Bank and the Asian Development Bank. In recent years, it has also been able to tap a growing domestic capital market and for the current year the latter is expected to meet some 60% of the government's total financing needs. As a result, outstanding government debt is on the one hand strongly exposed to exchange rate risks. On the other, it is vulnerable to domestic financial conditions in particular interest rate volatility as experienced last fall when refinancing rates rose 150bsp to 6,7%pa. on 5 years government bonds. Next year this set up is bound for a change as Vietnam graduates from concessional borrowing from multilateral and bilateral lenders. That will increase the country's exposure to private domestic and international capital markets.

Monetary tightening fails to stem exchange rate weakening: Since early 2014 the SBV has held the policy rate unchanged at 6,5%pa despite the steep fall in the rate of price inflation. Last year that implied a rise in the real rate of more than 5pp. Nevertheless, this was not sufficient to motivate investors to keep their money in dong assets. Pressure on the exchange rate which had been pegged to the dollar since a string of heavy devaluations in 2010-2011, persisted during most of the past year. This reflected investor concerns about loss of competitiveness vis-a-vis neighbouring currencies which had looser ties to the strong dollar. The pressure culminated when the central bank of China, the Peoples Bank, in a surprise move devalued the Reminbi in August thus prompting the State Bank of Vietnam (SBV) – central bank -- to reduce its central rate by 1% and widen the intervention band to 3% from 1% on each side of the reference rate. Coming on top of two previous devaluations of the same magnitude wrote down the Vietnamese currency, Dong, by a total of 3% during 2015. So far in 2016, the currency has remained within its margin bands despite rumours of SBV selling more foreign currency to stabilise the exchange market early in the year.

Structural policies out of the dead water?

<u>Trans-Pacific Partnership</u>: Last year Vietnam and other Pacific Rim countries signed up for the US initiated multilateral trade agreement TPP. In the case of Vietnam, TPP is: expected to yield "considerable benefits" amounting to 8% of GDP over 20 years by intensifying the country's comparative advantages while supporting the liberalization of services, including financial services and telecommunication. It is believed this could serve as an anchor for further structural reforms and argued that Vietnam's WTO accession in 2007shows the country's ability to leverage external commitments for the advancement of domestic reforms. An agreement in principle on a separate free trade deal with the EU has also been concluded.

<u>Equitization</u>: Vietnam's equitization process – preparing state owned enterprises (SOE) for commercialisation and eventual privatization -- has quickened. A total of 344 SOEs have been equitized, short of the original target, though, of 531 for the period 2011-15. Plans have been announced to disinvest fully also from well-performing SOEs such as Vinamilk. Last September the government lifted the general 49% cap on foreign ownership in Vietnamese businesses (Decree 60) which should further support the privatization process. However, so far the government has not sold many majority stakes in former SOEs which could defer potential investors.

<u>Corruption and reputation risks</u>: Vietnam has not improved much on the various surveys of corruption and ranks among the worst tertile on the Transparency International survey of 170 countries. According to one rating agency this may represent a reputation risk in doing business with Vietnamese entities. In 2015,

Japan temporarily suspended overseas development assistance to Vietnam over graft fears.

Banking sector on the mend albeit slowly and grdaually: Last year domestic banks continued selling bad loans to the government supported Vietnam Asset Managemt Company (VAMC). Since it commenced operations two years ago VAMC has acquired more than VND200trillion of non-performing loans (NPL), some 5% of total bank loans reducing the level of NPLs to 3% according to official estimates. However, VAMC has so far had limited success in disposing of these assets with only 7% sold by October of last year. That is due to several factors including the personal responsibility of the VAMC staff for selling assets below book value which can be punishable by law.

Tightening credit classifications and reporting standards: New regulations are aiding the process of cleaning up banks' balance sheets after they got burdened with bad loans following the banking crises some five years ago. They include SBV Circular 02 of 2013 which finally became effective in 2015 and gives guidelines for the classification of loans according to their individual credit standard much in line with international practice. They also include Circular 36 of late 2015 which sets new standards for financial sector transparency and helps address cross-ownership issues which can pose systemic threats to sector stability.

Weak profitability and capitalization. Heavy provisioning continues to weigh on banks' profits and delays their rebuilding of capital which remains at a relatively moderate average of 9.5%. But pick up in credit growth over the last three years to still reasonable levels should gradually help improve their performance. Credit to GDP which peaked at 125% in 2010 and then declined rapidly to 104% in 2012 had in 2014 recovered to 114%. That said, banking problems continue to pop up. Last year, SBV took over four weak banks to prevent their collapse.

Political developments

New leadership: In January, the12th National Party Congress re-elected party secretary, Nguyen Phu Trong, for a new 5-year term and signaled the replacement of PM, Nguyen Tan Dung, who had served the maximum two terms. He will now be succeeded by the Deputy PM Nguyen Xuan Phuc. That means a new leadership expected to continue trade related reforms but probably with more focus on macroeconomic stability than the outgoing PM who had to take much of the blame for the sharp economic slowdown in 2011. These appointments are expected to be confirmed by the National Assembly in late May.

Persistent regional tensions: After his reelection, the party secretary visited Washington and spoke out strongly in favor of TPP – a gesture many observers saw as a statement on regional security related to tensions with China. Vietnam has not yet benefitted from the US Maritime Security Initiative, but there are ongoing discussion for assistance from this initiative in 2017. In contrast, since 2015 Vietnam has expanded security cooperation with Singapore.

Outlook

We repeat our assessment from a year ago that the near term future looks good. Vietnam is likely to remain a regional investor favorite and this will continue fuel growth and exports while maintaining a reasonably upbeat domestic sentiment. Beyond the short to medium term, however, uncertainty begins to rise unless the government takes the warning signals seriously.

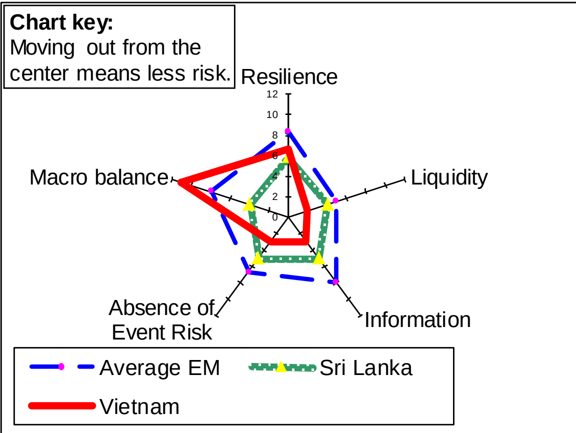
Strong growth set to continue. With no end in sight to the inflows of foreign direct investment money, the economy can continue growing by more than 6% in the current and the next year. That is likely even if the world economy should start to trail. Vietnam's comparative advantages are still strong enough, despite robust wage growth, to attract investments diverted from China and other regional emerging markets. The external current account may slightly weaken further but that might only be a sign of cementing the country's future as an export nation.

Two important dangers which the authorities should mitigate. The main danger we see to this scenario is the country's vulnerability to short term investor sentiment should that once again turn bearish as it apparently did last year. The government could then either continue meeting market expectations by letting the exchange rate yield to pressure. However, that is a proposition that has often proved dangerous in other countries within a semi-pegged managed float. In return, we believe markets will take confidence from the fact that the SBV has upheld the policy rate despite weakening price pressure. Against that background the monetary authorities should be able to convince markets that the dong is not likely to collapse anytime soon. It should the use this respite to aggressively by foreign exchange with the aim to double its reserve level over a two years' period.

The second danger that may not have the same urgency except for political reasons, is the fiscal deficit. With a deficit above 6%/GDP the cap on the government debt/GDP ratio at 65% could be exceeded before the end of 2017. The government should have ample levers to arrest such a development and would even be under legal obligation to do so. If it does not take the necessary counter measures, markets may take notice.

Some negative but not dramatic effects on growth: Fiscal austerity and monetary tightness may to some extent damp growth in the short to medium term but not enough to inflict any long term damage on the economy or on social or political stability. If not implemented, however, the cost could turn up in the longer term with negative effects on market confidence in the context of a still struggling banking system.

Key ratios	**2016**
Population (mill.)	94
GDP/capita ($)	2147
GDP (change)	6.5%
Inflation	1.9%
Curr.Acc. Balance/GDP	0.7%
Reserves/imports (months)	2.3
Budget balance/GDP	-5.7%
Government debt/GDP	50%



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

Peers:
Sri Lanka
Tunisia
Kasakhstan

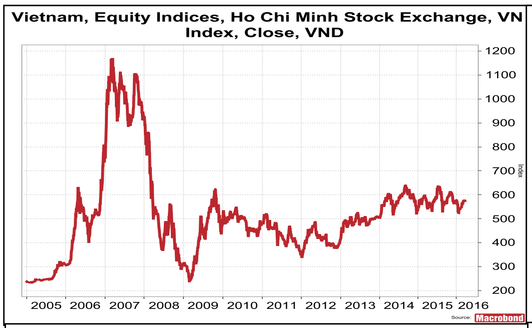
Graph: The pentagon shows Vietnam's credit profile dominated by event risk and poor information. Strengths lie in improved macro balance while weak liquidity (low foreign reserves) is an increasing drag.

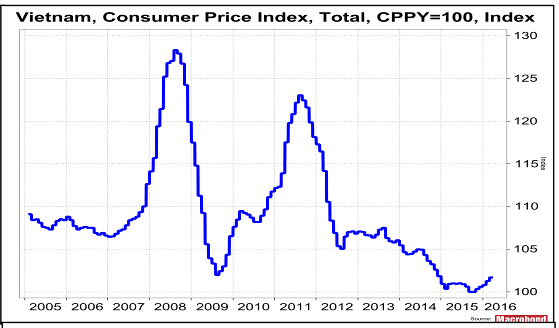
Key data:	2012	2013	2014	2015	2016	2017	2018
GDP (bill.US$)	155.6	170.5	185.8	191.4	202.6	221.4	239.2
GDP/capita (US$)	1721	1866	2011	2048	2147	2322	2484
GDP (% chng)	5.2%	5.4%	6.0%	6.7%	6.5%	6.9%	6.7%
Investments/GDP	27%	27%	28%	29%	30%	30%	30%
Budget balance/GDP	-3.7%	-5.3%	-4.5%	-5.4%	-5.7%	-4.5%	-3.8%
Govt debt/GDP	39%	42%	47%	49%	50%	50%	49%
CPI (% chng)	9.1%	6.6%	4.7%	0.9%	1.9%	3.3%	3.7%
Money demand (%)	24.5%	21.4%	19.7%	17.1%	12.0%	10.6%	10.6%
Stock prices (eoy)	85	101	120	119			
Interest rates	9.0%	7.0%	6.5%	6.5%	6.6%	6.8%	7.1%
Exch. Rate ($) (avg.)	20859	21017	21189	21909	22450	22693	23237
Trade/GDP (%)	157%	165%	170%	180%	187%	191%	197%
Oil price (Brent)	$111	$112	$109	$99	$52	$32	$40
Billions US $							
Export of goods	124.5	142.6	160.6	172.4	187.9	209.6	234.8
Imports of goods	119.1	138.9	154.5	172.1	190.9	213.0	237.2
Other (net):	4.0	4.1	3.4	2.4	4.4	5.4	6.2
Current account	**9.4**	**7.7**	**9.5**	**2.8**	**1.4**	**2.0**	**3.8**
(% of GDP)	6.1%	4.5%	5.1%	1.4%	0.7%	0.9%	1.6%
FDI	8.4	8.9	9.2	9.5	10.0	11.0	11.8
Loan repayments	-3.3	-3.3	-5.3	-6.5	-7.7	-8.5	-8.7
Net other capital flows	-2.5	-13.1	-5.1	-9.7	1.9	-0.5	-1.9
Balance of payments	**12.0**	**0.3**	**8.3**	**-3.9**	**5.7**	**4.0**	**5.0**
Reserves	25.6	25.9	34.2	30.3	36.0	40.0	45.0
Total debt	59.1	65.5	71.9	79.7	87.6	92.9	94.9
o/w short term debt	9.9	12.2	13.1	14.5	15.9	16.9	17.2

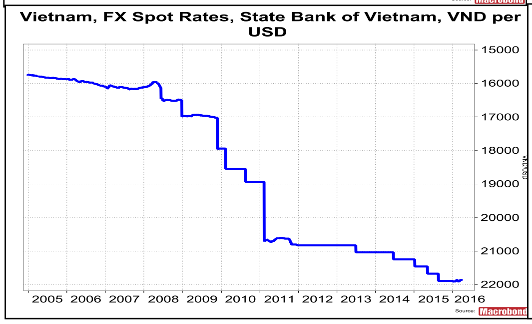
Source: OEF (Oxford Economic Forecasting) and SEB estimates.

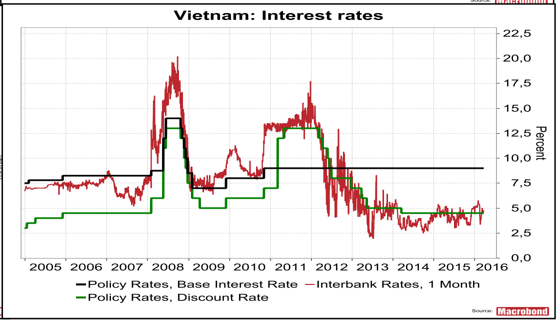
Rating history				
Fitch (eoy)	B+	B+	BB-	BB-
Moodys	B2	B2	B1	B1

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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