Vietnam

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After last year's temporary slowdown growth is expected back on track of around 6,5% in the current year riding on high inflows of foreign direct investments which have also helped the central bank build reserves.

Country Risk analysis

Growth back on track: Last year severe drought in agriculture and lower oil production slowed the economy to only 6,2% expansion. In the current year, activity is poised to reach its previous trend of almost 6,5% annual growth on the back of buoyant investment inflows in export oriented sectors supporting the current account surplus, albeit a small one, facilitating the central bank to build more reserves while headline inflation stays close to the government's 4% target.

Financial policies need to be reined in. With a high annual fiscal deficit around 6%/GDP, the government debt ratio is growing rapidly soon breaching the self-imposed limit of 65%/GDP. While not yet alarmingly high fiscal space is being eroded thereby raising future vulnerabilities. New plans see the deficit cut to 3,5%/GDP by the end of the decade but they are challenged by the rising share of the foreign owned sector in GDP which encroaches on government revenues due to generous tax credits.

Lax monetary policies supporting credit expansion at 19% a year have inflated the banking sector to 120%/GDP an unusually high level for a $2300/capita economy. A handful of bank failures in 2016 is a reminder of continued financial sector vulnerabilities only few years after the last banking crisis. Such concerns have yet to hurt the domestic market or the exchange rate vis-à-vis the dollar. Last year the central bank had rather to soak up excess foreign currency thus building reserves to $40bn, 2,5 months of import cover but still low compared with peers.

Structural policies showing some signs of revival: In 2016, the government managed to sell a few state owned companies, including a 5% stake in *Vinamilk* after lifting the 49% cap on foreign ownership in domestic companies. That combined with an improved business climate as per the World Bank's *Ease of doing business* although reforms are still very gradual and often behind schedule.

Politics: Last January, party leader Nguyen visited Beijing after TPP was about to collapse. Perhaps not a snub to the US, but the government seems determined to hedge its opportunities.

Ratings: High growth without clear signs of overheating has yet to prompt positive rating actions. That in part reflects lingering concerns about ongoing policy stimulus that may eventually prove unsustainable. However, the government seems to understand the need to correct the situation and should still have time to do so

Recent economic developments

After last year's temporary slowdown growth is expected back on track of around 6,5% in the current year riding on strong consumer demand and high inflows of foreign direct investments which help the central bank build reserves.

Growth back on track: Last year the economy slowed by 0.3pp (percentage points) to 6.2% growth mainly because of drought in agriculture but also cuts to oil production in part due to low prices. This year the slack will be recovered as the economy is heading for 6,5% expansion in line with Vietnam's new growth trend. As before, that performance will be spearheaded by private consumption driven by healthy consumer sentiment, wage hikes and credit extension from banks. Also private investment will contribute aided by growing foreign investment inflows and public infrastructure spending while net exports probably stay put. The first two months of the current year presented a somewhat mixed picture, however. The Industrial Production index fell to only 2,4% yoy growth from almost 9% in December although that statistics may have been thwarted by the Tet-holiday at the beginning of the year.

Inflation to stay steady despite continued wage growth: Last year inflation shot up due to reduced supply of domestic food stuff but also sharply hiked fees for education and healthcare. The impact of those measures continues into the current year with the effect to raise average growth of consumer prices to almost 4% yoy (year-on-year), and up from last year's 2,7%. As such, confidence is growing that inflation expectations among households and investors are becoming more closely anchored around the central bank's target of 4% pa. supported by still more subdued core inflation. Until the end of last year, the foreign exchange market did not indicate strains on the currency. As to the labor market, wages will probably increase ahead of inflation. Last November the National Wage Council recommended raising the minimum wage by 7% despite low rate of unemployment at 1,8% according to official estimates.

External balances in the footsteps of last year: The growth rates of both exports and imports moderated in 2016 as a deep dip in rice shipments was offset by reduced auto imports following higher taxes and fees on cars. That left the trade balance in equilibrium and the current account in a small surplus estimated at 1,6%/GDP as growing services and repatriation of profits abroad were balanced by even more buoyant inflows from remittances. 2017 will likely present much of the same picture but slightly beat last year's performance as the current account surplus increases to 2,4%/GDP. On the capital account, FDI (Foreign Direct Investment) inflows continue strong with commitments estimated to rise slightly above last year's result of $24bn and realized FDI at a level one third below that. Last year, this included $2bn from Korea's LG company for a new manufacturing unit for electronics. Such products are now dominating 25% of total exports, up from 10% only 5 years ago. Much of the rest continue with focus on labor intensive and low-tech products including garments and footwear.

Maturing investment cycle? Buoyant FDI inflows also generate imports of machinery and equipment, which to some surprise dropped below expectations in 2016. That, according to some observers, may herald a maturing of the present investment cycle. Such a conclusion could be premature, in our view. Many investors, not least Chinese, are pursuing diversification out of China where labor costs have grown rapidly while also geopolitical considerations may weigh on their motivations.

Climbing reserves: Last year, the State Bank of Vietnam (SBV) -- central bank – for the first time in several years of successive current account surpluses and capital inflows bought some $11bn of foreign exchange in the domestic market thereby raising the reserve level to $40bn. While that should cover some 2,5 months of estimated imports in 2017 it is still a quite low level compared with regional peers. It helps though, that external short term debt is modest and covered almost three times by reserves. Total external debt, by contrast, is twice as high as reserves.

Policies

Over the past five years, macroeconomic stability have been gradually restored, even though fiscal policies have remained clearly accommodative while monetary policies have turned lax and maintained that stance into the current year. Structural policies have seen some revival including a few high-profile privatizations in 2016 but that is from a modest level.

Widening fiscal deficit: The fiscal shortfall of 2016 widened to 6,2% of GDP, up from an average of 5,5% over the last five years partly on account of ramped up government infrastructure expenditures focused on completing ongoing projects.[1] For the current year the plan appears to be a cut in the deficit to 4,5% which most observers believe is too ambitious and have rather penciled in an outcome some 0,5-1pp higher which will still mark a beginning to the government's end goal of a deficit at only 3,5%/GDP by the end of the decade.

Government debt about to breach the ceiling: Such a correction of fiscal policies is now urgent to avoid the government debt to breach the ceiling of 65%/GDP as enshrined in Vietnamese law. Last year it is estimated to have reached 64,9%, up from 55%/GDP only three years ago, and the government may be wary of its prestige within ruling political circles. So far, however, the government has had little problem in financing its shortfall including with concessional loans from donor countries, although that source of financing is about to run dry as Vietnam graduates into a middle income country. For 2017, the government plans to approach international capital markets to relieve the pressure on the local loan market where it has issued treasuries with gradually longer maturity. Since 2015, the average for the total outstanding has lengthened by 1,5 years to 8,5years. That is with a low rate of interest at less than 5%pa for more than half of the outstanding. Last year it declined further helped by monetary policy easing.

Easing monetary policy: Last year, the SBV continued easy monetary policies, in particular the macro prudential aspect of it, with the motivation to support rapidly expanding credit to reach the stated target of 19% loan growth. The point may have been to support economic growth when there were early signs of deceleration in economic activity including for agriculture, and at the same time alleviate the situation for many banks still struggling from the financial crisis four years prior. It achieved this mainly through unsterilized interventions in the forex market, buying foreign exchange and selling dong, the national currency. Presumably this had the aim to counter an undesirable appreciation of the

[1] This is in line with the presentation of the local World Bank office. In the government's presentation, by contrast, the deficit for 2016 is only 4,3%/GDP, lower than the preceding 5 years average of 5,2%

exchange rate while at the same time providing liquidity to the local interbank market to keep interest rates low in particular at the short end of the yield curve.

Will also 2017 see more of the same? For the current year SBV aims to curb credit growth slightly to 16%. However, concerns are rising that this is still too high year that the banking system may get inflated relative to the economy. Last year total outstanding assets of all banks exceeded 112%/GDP an extraordinary high level for a relatively poor country. One local bank comments in this context that "…supporting the growth at the moment may cause pressure on the banking system…" and thereby "…on interest rates, credit quality and financial capacity due to low capital adequacy ratio – CAR."[2]

Exchange rate policies: In principle SBV has introduced a relatively flexible exchange rate policy. The daily fixing is set according to an undisclosed formula based on the development of a handful regional and global exchange rates and economic/financial variables of the domestic economy with the objective to maintain overall stability in the market. Last year that permitted the central bank to buy $11bn of foreign exchange in the market improving its reserve position as noted above , although still short of significantly reducing vulnerability to shocks. In 2017, by contrast, the market seems to have flattened so far.

The banking system show signs of improvement: Tighter banking supervision, sales of bad loans to the national asset management company (VAMC) and overall accelerated economic growth since the banking crisis in 2011 have gradually helped improve the fundamentals of the banking system. For instance, the new boom in the residential real estate market has prompted banks to buy back loans or collateral swapped with the VAMC in exchange for liquid treasuries when this was established in 2013. That said, however, asset quality problems still remain a drag on many banks, not least the state owned. The actual NPL level relative to total assets has been reduced to less than 3% since peaking a few years ago at around 8% according to official estimates. In some cases that has happened through successful resolutions including sales of collateral or through sales to the many private AMCs that has sprung up in recent years. Moreover, the steep rise in total assets over the last couple of years may have contributed to a third of the decline in that ratio. In all, $4,3bn of NPLs have been settled one way or the other of which 53% have been written off and 21% sold to VAMC.

But bank rescues continue: However, many banks continue to struggle with quality problems in their loan portfolio thus forcing the SBV to rescue five smaller banks in 2016. Concerns are also that the high and still ongoing credit expansion of recent years could eventually grow into new financial sector turbulence before the "old" crisis has been resolved. That would be much due to a weak legal framework and a lack of an effective solving mechanism including for the VAMC.

Structural policies on the back burner: As stabilization policies have taken the front seat structural policies have been placed on the back burner. Most state owned enterprises (SOE) have been *equitized*, the code word for being prepared for eventual sale from the government portfolio. Last year the government sold a 5% stake in *Vinamilk*, a valuable asset that attracted much less interest than anticipated. It also sold a similar stake in state owned *Vietcombank* to a foreign financial institution. Such sales, however, are rare while transfers of ownership

[2] BIDV, Hanoi, February 2017

among public sector agents, including local governments, are more often the rule. Although the number of SOEs has dropped by a half since the process started more than a decade ago, actual sales have been less impressive. The SOE sector is estimated to still control some 25% of the economy.

Foreign investors allowed taking majority stakes: There are growing hopes, however, that privatization may speed up before long. In 2015 the government lifted the ban on sales to foreign interests of majority stakes in companies of certain sectors. That and other deregulations have helped gradually improve the business climate. According to the World Bank's survey, *Ease of doing business*, Vietnam has advanced 9 notches to the 82nd rank among 190 countries since 2011.

Politics

Last January Party leader Nguyen made a trip to Beijing after TPP was about to collapse. It may be too early to say if that was a snub to the US, but the government seems more determined to hedge its opportunities.

A new government one year in office: The new government in office for more than a year now, has mainly followed in the footsteps of its predecessor in terms of economic and financial policies, but taken a tougher stand on corruption and on dissidents in many cases. The latter is probably in part related to the new government's more conciliatory approach to China to forestall upsetting incidents as the spontaneous burning of Chinese factories and other properties a few years ago by activists. China remains unpopular with the mainstream population, but the government is likely bent on avoiding any diplomatic incident with its much bigger neighbor. It may also play a role that the new party boss, Mr. Trong, is regarded as more China friendly than the previous prime minister, Mr. Dung, who lost his job in the transition. In last January, following the collapse of the TPP agreement with the US, Mr. Trong paid a state visit to Beijing, the first high level meeting with China since he took office.

Outlook

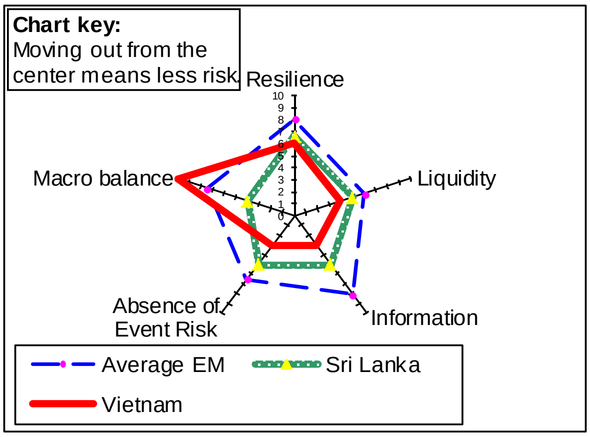
The near term outlook looks steady. Growth in the current year is estimated by various observers somewhere between 6,3% and 6,7% the latter also being the official estimate of the government. Our 6,5% estimate is also in line with long term economic growth. After a somewhat weaker 2016 one could imagine a slightly faster recovery this year, but headwinds such as the collapse of the TPP agreement with the US and other Pacific nations and lingering uncertainties over world growth could sap investor confidence and begin to moderate sentiment toward year end. Baring such a slightly negative scenario, we believe that our steady scenario is reasonably robust both for the current year and up to the end of the decade. We disregard possible security risks, such as regional military confrontations, not because they are insignificant, but because such analysis does not fit into the present format.

Our main risks are of domestic origins. First of all the rapid and ongoing credit expansion since a few years back, could eventually end in a new financial crisis before the last one, from five-six years ago, has been put properly to rest. That could combine with fiscal problems should the government continue to show complacency over the growth of public sector debt although the latter is not likely to trigger sharp a sharp market reactions on its own this side of the decade. This is so as long as the central bank keeps a watchful eye on the underlying stability in the foreign exchange market and lets the exchange rate take the hit rather than reserves and quickly adjust to any misalignment.

Has Vietnam found the right growth model? For the longer term, well into the next decade, it has been asked if Vietnam has found the right growth model. It is clearly nice to be an "investor darling", but is the country actually building a basis for further self-driven growth. The World Bank points out that in addition to policy stimulus, present growth is mainly underpinned by factor accumulation rather than so called total factor productivity, i.e. technology, learning by doing etc.[3] It notes the limited links between domestic firms and foreign companies which operates in isolation rather than serving as a broader catalyst for growth. Vietnam's export oriented development model is rather based on expanding labor intensive manufacturing with low wages but it has failed to stimulate the development of supplier industries. As wages inevitably rise traditional advantages could diminish leaving the country with outdated industries and not knowing how to renew itself.

However, Vietnam is not the only country that for a period has risen on foreign capital and entrepreneurs setting up shop. In fact, with the clear exception of capital intensive foreign investments in extractive industries, no example leap to our mind of a country that has failed to take good experience from foreign companies even if these firms did not stay forever. This subject obviously deserves a deeper discussion than is possible here, and we look forward to any follow up among our interlocutors in Vietnam.

Key ratios	**2017**
Population (mill.)	95
GDP/capita ($)	2299
GDP (change)	6.7%
Inflation	3.9%
Curr.Acc. Balance/GDP	1.1%
Reserves/imports (months)	2.5
Budget balance/GDP	-5.0%
Government debt/GDP	65%



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) remains a drag despite recent increase.

[3] Taking stock, World Bank Hanoi, 2016

Key data:	2012	2013	2014	2015	2016	2017	2018	2019
GDP (bill.US$)	155.6	170.5	185.8	191.4	201.4	219.2	237.6	257.8
GDP/capita (US$)	1721	1866	2011	2048	2134	2299	2468	2652
GDP (% chng)	5.2%	5.4%	6.0%	6.7%	6.2%	6.7%	6.7%	6.5%
Investments/GDP	27%	27%	28%	29%	30%	30%	30%	30%
Budget balance/GDP	-6.8%	-7.4%	-6.2%	-6.0%	-6.0%	-5.0%	-4.5%	-4.5%
Govt debt/GDP	0%	55%	59%	62%	65%	65%	63%	61%
CPI (% chng)	9.1%	6.6%	4.1%	0.6%	2.7%	3.9%	4.0%	4.0%
Money demand (%)	24.5%	21.4%	19.7%	14.9%	14.1%	10.6%	10.6%	10.8%
Stock prices (eoy)	85	101	120	119				
Interest rates	9.0%	7.0%	6.5%	6.5%	6.5%	5.8%	5.5%	5.5%
Exch. Rate ($) (avg.)	20859	21017	21189	21909	22355	22817	23287	23772
Trade/GDP (%)	157%	165%	170%	179%	184%	187%	191%	195%
Oil price (Brent)	$112	$109	$99	$52	$44	$52	$52	$59
Billions US $								
Export of goods	124.5	142.6	160.6	171.8	185.3	204.1	226.0	250.5
Imports of goods	119.1	138.9	154.5	170.3	185.5	205.2	227.9	253.2
Other (net):	4.0	4.1	3.3	-0.6	1.8	3.5	4.6	4.2
Current account	**9.4**	**7.7**	**9.4**	**0.9**	**1.6**	**2.4**	**2.8**	**1.5**
(% of GDP)	6.1%	4.5%	5.0%	0.5%	0.8%	1.1%	1.2%	0.6%
FDI	8.4	8.9	9.2	11.8	12.4	13.5	14.6	15.9
Loan repayments	-3.3	-3.3	-5.3	-4.9	-6.4	-7.2	-7.5	-7.5
Net other capital flows	-2.5	-13.1	-4.9	-13.7	4.6	-5.7	-6.1	-2.5
Balance of payments	**12.0**	**0.3**	**8.3**	**-5.9**	**12.2**	**3.1**	**3.8**	**7.5**
Reserves	25.2	25.5	33.8	27.9	40.1	43.2	47.0	54.5
Total debt	61.6	65.5	72.4	77.8	87.6	92.9	94.9	94.9
o/w short term debt	12.3	12.2	13.6	12.0	13.5	14.3	14.6	14.6

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

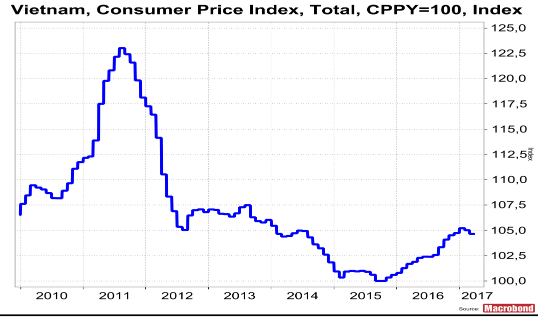
Rating history

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

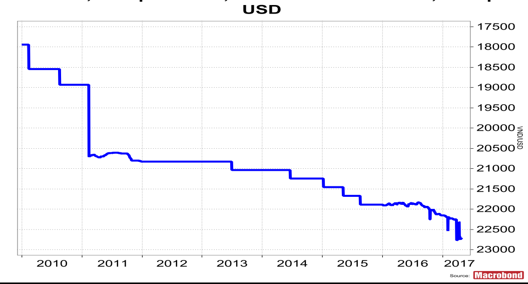
Type of government: Communist party
Next elections Partyconference in 2021
Other:
Latest PC deal 1993
Recent IMF programs PRGF (Poverty Reduction and Growth Prog. interrupted before expiry in 2004.

Vietnam, Equity Indices, Ho Chi Minh Stock Exchange, VN Index, Close, VND

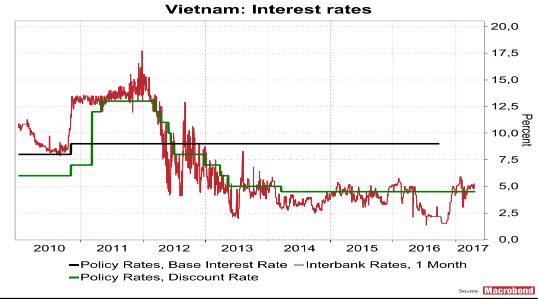
Vietnam, Consumer Price Index, Total, CPPY=100, Index



Vietnam, FX Spot Rates, State Bank of Vietnam, VND per USD



Vietnam: Interest rates



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