Vietnam

SEB MERCHANT BANKING – COUNTRY RISK ANALYSIS **May 16, 2018**

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Last year's resurgent growth to 6.8% annual expansion of GDP is set to continue for the current year on the back of booming exports and capital inflows boosting foreign reserves to three months of import cover. Large-scale privatizations of SOEs have strengthened investor confidence while banks have begun to reduce their stocks of bad debt.

Country Risk analysis

Growth has strengthened: Last year activity quickened to 6,8% economic expansion on the back of surging exports and a gradual growth of private consumption. Fiscal expenditure, by contrast, in particular for infrastructure projects, remained a drag on demand with negative spill-over effects on private investments. While exports may slightly moderate in the current year, overall growth should remain strong provided the government acts as promised to enforce more effective implementation of capital expenditures. Despite accelerating growth and job creation, there are hardly any signs of overheating. Price pressure remains contained within the 4% annual inflation target.

Reserves are growing: A strong current account surplus of 4%/GDP in 2017 has combined with privatization receipts and buoyant FDI inflows to help the central bank build reserves to three months of import cover at the end of last March. That is up from only two months cover in 2016. A milestone may have been passed with positive effects on investor sentiment as seen in fast rising activity on the stock market.

Macroeconomic fine-tuning still in the molding: Loose fiscal policies over several years had brought the government debt/GDP ratio close to the statutory limit of 65% before the present government last year began to rein in the budget deficit to 4,5%/GDP. Monetary policies have remained moderately accommodative thus maintaining liquidity in the banking system where some banks continue to struggle with bad loans. That seems to have propelled credit growth raising concerns about parts of the banking system despite an overall strengthening of its fundamentals. Structural issues are still high on the agenda. Last year the government made good progress on privatization including sales to foreign investors and plans are to uphold the momentum in 2018.

Political calm prevails: Since the new government took office in 2016, political calm has prevailed under the supremacy of the Communist Party. The regional security situation, however, is of growing concern. Some of the flash points including the Korean peninsula are among Vietnam's most important FDI sources while China is its main source of imports. ..Risk of simmering tensions with its big neighbor to break out into open hostilities have increased after Vietnam recently approved a less restricted use of live ammunition for its cost guard.

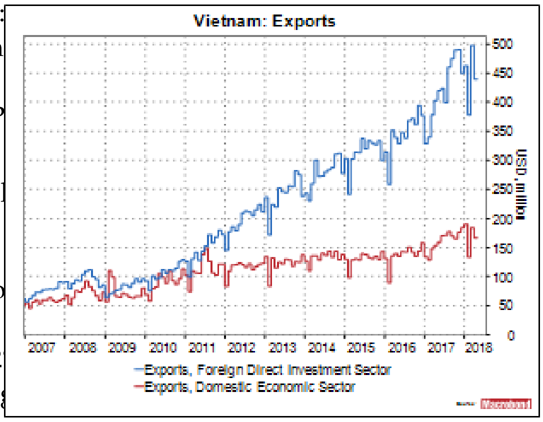
Outlook and ratings: Provided regional security and continued global growth Vietnam should be set for another year of robust economic expansion at more than 6,5% with reasonable prospects extending well into the next decade. On that basis one rating agency recently upgraded the sovereign one notch while still clearly below investment grade. For the longer term Vietnam will face less positive demographic developments, but can still benefit from rural immigration into higher productivity sectors in the cities.

Recent economic developments

Growth has strengthened and last year activity quickened to 6,8% economic expansion on the back of surging exports and a gradual improvement to private consumption. Fiscal expenditure, by contrast, in particular for infrastructure projects remained a drag on demand with negative spill-over effects on private investments. While export growth is likely to moderate in the current year, overall growth should remain strong provided the government now acts as promised to enforce more effective implementation of capital expenditures. Despite accelerating growth and buoyant job creation, there are hardly any signs of overheating. Price pressure remains well contained within the central bank's 4% annual inflation target

Growth is picking up: After a moderate performance in 2016 caused by drought in agriculture and other adverse events, the economy last year regained strength accelerating through the year to end at 7,4% growth in the last quarter and on average 6,8% for the full year. That was on the back of resurgent exports from foreign owned companies and soaring foreign tourism rising almost 30% year-on-year (yoy). Private consumption also strengthened although in a more gradual manner on easing credit conditions and rising confidence. The government, by contrast, did not contribute as it continued to rein in the budget deficit by cutting capital expenditure, that unfortunately with negative spill-over effects on domestic investor demand. For the current year most observes foresee much of the same with average estimates around 6,8% as fading impetus from world trade should be offset by growing investments provided better performance of the government's capital budget.

Labor market and prices: Last year the foreign invested sector created some 400,000 new jobs while the private non-rural sector contributed with about 100,000. As such all new entrants were absorbed into the labor force and also a part of the rural to urban immigration while still leaving two thirds of the total population in rural areas. The informal sector which makes up a substantial part of the labor market is likely to have soaked up the rest leaving outright unemployment at a rather stable 2% of the work force. -- Despite labor market tightness and the quickening economic activity, price pressure remained moderate with headline inflation picking up only slightly to 3,5% in part driven by more than 8% wage hikes in private sector. Core inflation by contrast stayed very low at less than 1,5% pa. For the current year consumer prices are estimated to rise close to the government's target of 4% annual increase.



External balances strengthen further: Since the banking crisis in 2011 Vietna current account balance has remained very strong in the range of 4-5%/GDP most years. Last year it ended at 4,5%/GDP, up 0,5 percentage points (from the year before, spearheaded by rising exports of electronics from the foreign invested (FDI) sectors and stro tourism revenues. As a result, total exports growth increased to almost 22 while imports trailed some 2 percenta points (PP) behind. For the current year most observers have so far forecast a smaller current account surplus based on assumptions of stronger import growth related in particular to new government projects. However, newly released preliminary data for the first quarter of the current year indicate continued strong export growth around 22% annualized expansion in contrast to imports which fell further behind expanding only 13%.

However, that was probably a temporary reaction in response to reported new delays in the implementation of government projects.

Growing foreign reserves: The current account surplus of almost $10 bn in 2017 combined with a FDI surplus of some $14bn and privatization receipts around $8bn. to yield a gross inflow of $32bn. of which an estimated $7bn went to repayment for the country's external debt.[1] The State Bank of Vietnam (SBV) bought some $7bn of the surplus leaving the remainder, $18bn to be explained by other capital outflows. The latter may include privatization receipts, however, as the government reportedly parked these receipts with one of the state banks probably to avoid excess dong-liquidity in the local banking system. This reduces the unexplained net amount to $11bn. Suffice to say that had the government rather placed the privatization receipts with its own bank, SBV, reserves of the latter could have increased even more. The unexplained amounts of net outflows may suggest capital flight despite an interest differential to foreign countries that would not motivate it. If such flight occurred, however, it could probably reflect a desire among investors to diversify cash balances.

Box 1: FDI: Since Vietnam joined the WTO in 2007, Foreign direct investments (FDI) have soared to a cumulative $313bn. in terms of commitments. Disbursements have so far been much smaller around a cumulative $100bn., or an annual average of $10bn. a year. Last year exports from FDI companies dominated more than two thirds of total merchandise exports and contributed to a fifth of GDP and to the government budget revenues. In 2017 FDI commitments soared by 47% on the year before, but so far this year they have declined 25% yoy believed to be in response to the recent cut in US corporate taxes from 35% to 22% prompting some investors to go back home.

Reserves leapfrog in the first quarter 2018: In the first quarter of the current year reserves jumped twice as much as they did through the whole of 2017. Early last April it was reported -- although no yet officially -- that the reserves of SBV had passed $60bn. That is about 4 months import cover and suddenly makes the country look much less vulnerable compared to the time when reserves languished around two months of imports only a few years back.

Policies

Loose fiscal policies over several years had brought the government debt/GDP ratio close to the statutory limit of 65/GDP% before the present government last year began to rein in the budget deficit to 4,5%. Monetary policies have remained moderately accomodative thus maintaining liquidity in the banking system where several smaller banks continue to struggle with bad loans and profitability. Structural issues are still high on the agenda, but last year the government made good progress on privatization including sales to foreign investors.

Reining in the budget deficit: Perhaps more by accident than design last year's budget shortfall narrowed almost 2pp to 4%/GDP according to the official representation which could be translated into 4,5% by the accounting standards of most other countries. On the revenue side a more efficient tax collection including buoyant VAT and tax receipts from private sector companies combined with stronger oil revenues while expenditures struggled to keep pace with nominal GDP growth. The latter reflected mainly inefficient implementation of the government's own capital budget for infrastructure projects. That unfortunate development seems to

[1]It is unclear whether these privatization receipts were included in the statistical recording of FDI inflows. If they were included, this would mean that other FDI inflows would have dropped from the year before when privatization receipts were much smaller which may seem counter intuitive.

have continued into the current year with reports noting implementation of no more than 8% of its 2018 capital budget in the first quarter of the current year. As a result of this and also solid 12% revenue growth the first quarter deficit shrank further to 3,5%/GDP on an annualized basis below the budgeted shortfall of 4%/GDP.

Government turning to domestic market for deficit financing: In an environment of declining deficits budget financing has not proved problematic. However, as the foreign owed part of the current debt dominates some three quarters of the total – most of it on concessional terms from multilaterals, though -- and is already close to the 50%/GDP statutory ceiling the government has turned to the domestic investor market. With domestic yields sinking to 6% on 15 years maturity, government bonds have proved popular with domestic investors. In the first ten months 2017, Treasury issued bonds for VND153tr. ($6,7bn) about 83% of the whole year plan. With the economy expanding three times more, by $19bn in nominal terms, the debt to GDP ratio last year ended slightly down to below 60%/GDP the first decline in six years. A further decline in that ratio is now expected into the next decade.

Monetary policy follows a steady path: Despite clearly tapering price pressure over recent years the State Bank of Vietnam (SBV) -- Central bank -- has maintained steady policy rates and cut them only once, last June, by a moderate 25bsp to 4,25%pa in terms of the discount rate which then still remain clearly higher than the headline rate of inflation. The policy rate is now also higher than the interbank rate, another sign of some monetary tightening on these merits alone. On other merits policies may still seem much too loose. Rapid credit growth, sometimes exceeding nominal growth of the economy by a wide margin, has been allowed to prevail over many years bringing total outstanding loans to over 120% of GDP, a high number compared with most peers. Last year the general credit growth target was first set to 18% before hiked mid-year to 21%, apparently as the authorities feared economic slowdown, but then cut again before long back to 18% for the rest of the year.

2018: So far in the current year, the central bank, SBV, has kept monetary policies steady except for the cut in the credit growth target to 17%. As in 2017, that target refers to small and medium sized banks only, whereas for the handful of Vietnam's largest banks -- most of them state owned -- the lending ceiling was set 3-4 pp lower. As a result, other banks are now set to outgrow the state banks to dominate more than 50% of the loan market.

Exchange rate policies: Since the introduction of a somewhat more flexible exchange rate policy in 2016, the dong rate to the US dollar has followed a relatively smooth path. The depreciation over the last two years from 21900VND/$ to 22750VND/$, i.e. almost 4%, is somewhat below interest and inflation differentials but reflecting Vietnam's overall competitiveness premium which attracts massive foreign capital inflows.

Financial markets

Banking sector recovery: Since the outbreak of Vietnam's homegrown financial crises in 2011, banks have staged a gradual recovery. Data from late 2017 show capital ratios among private banks at 12,4%, and for the state-owned banks (SOB) at 10%. The average level of bad non-performing loans (NPL) has reduced to 2,5% according to official estimates, which, however, may understate the problem by a factor of more than two when applying international standards. Many observers agree that banks and the supervisory agencies have taken note of the hard lessons learned during the banking crisis 7 years ago: Banks have become more prudent in their credit extension while the SBV have become more vigilant. Last year, noting new vigor in the housing market, it restricted mortgage lending to 70% of the property value. That action was also strengthened by a new shared credit information system which can track credits down to VND5mn.

Bad loans have likely peaked: Much of the noted decrease of NPLs, however, reflects the opportunity presented banks to place bad loans with Vietnam Asset Management Company. VAMC is the government agency established in 2014 to temporarily free banks from their NPL burden. The term for that relief was last year lengthened from five to ten years, as some banks continued facing problems in buying back their bad loans. Some banks, by contrast, are voluntarily buying back bad loans from VAMC because collateral have regained lost value along with recent years' economic upswing. In 2017, VAMC holdings shrunk more than the equivalent of $1bn from a peak of $12bn in 2016. New regulation for dealing with NPLs has also helped. Last year the SBV issued Resolution 42 that allows more flexibility in dealing with undervalued collateral and enhances the trading of such debt in secondary markets. It is however, not yet clear to which extent that also includes state-owned collateral which makes up a significant part of the NPL problem for many banks. .

Other financial markets: Non-bank financial markets are showing increased activity. The stock-market is booming with its main index doubling over the last two years. That appreciation is much in excess of the average rise of corporate profits, reflecting also ample market liquidity. New draft regulations since the beginning of the current year is setting stricter limits to margin lending including from security companies.

Shadow banks: Such and other financial firms -- some of which can be characterized as "shadow banks", have recently mushroomed. They are growing fast but are far from attaining systemic proportions as yet. Some of them specialize in consumer lending often demanding exorbitant interest rates. As they may be funded by banks their activity needs vigilant monitoring by the regulatory authorities going forward.

Fixed income: There is a slowly growing corporate bonds market with so far no official trading floor. The Ministry of Finance is reportedly mulling the establishment of an information base at the request of many would-be bond investors.

Structural policies making progress but areas of improvement far from exhausted:

1. Improving business climate: Since 2016 its "Doing business" indicator of the annual World Bank survey has improved 14 ranks to the 68th place almost in the best tertile among 190 countries. Improvements include in particular *enforcing contracts* and *paying taxes*.
2. Privatization: The government has taken major steps forward on privatization. Last year it sold blue-chip state owned enterprises including Vinamilk the dairy company and early this year it followed up by offering part of Petro Vietnam, Power Generation Corp. among others, and a 54% majority stake in Saigon Beer Alcohol and Beverage Corp. to the Thai company ThaiBev raising almost $5bn for the Treasury in that transaction alone. Selling a part of Agribank, Vietnam largest state owned commercial bank, has reportedly also been announced.
3. Government administration remains an Achilles heel: By contrast, the slowness in pushing budget money out of the door is a major Achilles heel. According to the World Bank this may have several causes including managerial problems in dealing with a diversified government structure that relies heavily on local administrative units. This often has the effect that many projects become too small to be effectively managed. In addition many projects are also delayed due to complicated land-use rights and compensation to owners
4. High government salaries: While officials point out that government base salaries have been rising slowly at an annual rate of only 2-3% over several years, non-base salaries and allowances has been main driver of labor

remuneration in public sector. That combined with rapid employment growth in public administration has raised the government wage bill twice as high as in Indonesia relative to GDP. l

Politics

The new government that took office in early 2016 was first feared as being dominated by hardline ideologues in contrast to the incumbent respected by many as a liberal but also criticized as unable to rein in powerful state owned enterprises. Since then the government has set out to address such concerns. Last year it sacked two ministers on corruption charges. The new approach has l been instrumental in improving Vietnam's image as reflected in the higher scoring on Transparency International corruption prevention index. Otherwise, political calm has prevailed under the supremacy of the Communist Party, which at the same time has been accused of intensifying the clamp down on peaceful political and religious dissenters.

The regional security situation, however, is of growing concern. Some of the flash points, including the Korean peninsula, are among Vietnam's most important FDI sources while China is its main source of imports. Risks of simmering tensions with its big neighbour to break out into open hostilities have increased after Vietnam recently approved a less restricted use of live ammunition for its cost guard while China is fortifying its military installations in the South China Sea without basis in international law.

Outlook

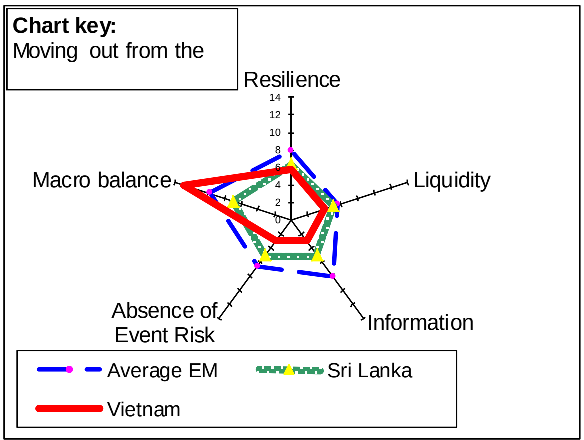
Improved short to medium term outlook: Over the recent couple of years the short term outlook of Vietnam has improved markedly. Economic growth has picked up by some 0,5-1pp firmly within a 6,5-7% annual growth scenario considered aligned with the economy's underlying potential. That has been achieved without causing troublesome overheating. Inflation is down to manageable levels, well within the government's 4% target. The external balances are healthy with a current account surplus around 2%/GDP for the current year and 2019. Foreign reserves have reached a decent, albeit still moderate level of three months of import cover. The new government since 2016 is committed to reducing the fiscal imbalance that had accumulated over several years as a result of overambitious attempts by the previous government at stimulating the economy to counter spill-overs from the global financial crisis.

That is not to say that the country cannot face adverse developments. Like other emerging markets it could be hit by events beyond its control in the global economy including capital outflows for example as investors rediscover opportunities in the US after recent deep cuts to US corporate taxes. However, that is unlikely to affect FDI capital flows too much, the dominating part of Vietnam's capital inflows over the last decade. The country could also be hit by any escalation of regional insecurity. The Korean peninsula is a case in point inasmuch as South Korea is Vietnam's paramount source of productivity enhancing capital inflows.

Longer term outlook: Beyond the next few years and further into the next decade, the future becomes more clouded. Without doubt, Vietnam could follow in the footsteps of China some two decades ago with prospects of a similar strong development. It has many of the preeminent characteristics that guided China's path into a middle income country not least in terms of demographics and potential productivity gains. While the growth of the working age population has begun to slow, it is still around 0,7% a year. In China it is now declining at a rate around 0,3%/year. That said, however, both countries can still rely on productivity gains when workers move from low productivity agriculture into higher productivity urban jobs. China has some 40% of its population left in rural districts. Vietnam has 65% in such places. That means Vietnam is about at the place where China was at the end of the 1990s. In return, as a much bigger country, China may have more clout as regards international trade and finance, whereas Vietnam will struggle more to make its voice heard.

Ratings: A week ago, one rating agency took notice of recent positive developments in Vietnam's economy, its finances and structural policies including privatizations which started in earnest last year and has continued at full steam into the current year. The agency subsequently upgraded the country one notch to BB from BB-. Moody's, traditionally the foot-dragger among the agencies in upgrading Vietnam, last February in a recent *Credit Opinion* pointed to high ggovernment debt, high loan growth combined with still weak banks and contingent liabilities on the government from loss-making SOEs as grounds for maintaining its sovereign but with a positive outlook, though.

Key ratios	**2018**
Population (mill.)	96
GDP/capita ($)	2528
GDP (change)	6,8%
Inflation	3,9%
Curr.Acc. Balance/GDP	2,1%
Reserves/imports (months)	3,0
Budget balance/GDP	-4,2%
Government debt/GDP	59%



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

Peers:
Sri Lanka
Tunisia
Kasakhstan

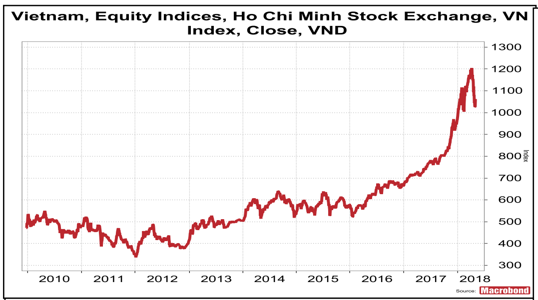
Graph: The pentagon shows Vietnam's credit profile dominated by event risk and poor information. Strengths lie in improved macro balance while weak liquidity (low foreign reserves) remains a drag despite recent increase.

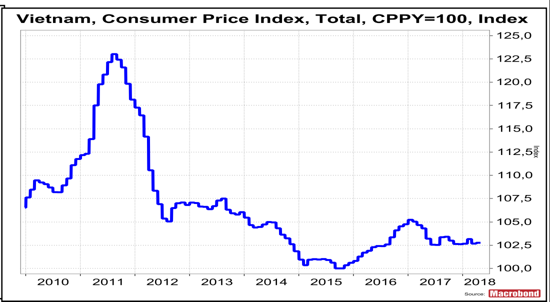
Key data:	2012	2013	2014	2015	2016	2017	2018	2019
GDP (bill.US$)	155,6	170,5	185,8	191,4	201,4	220,6	243,8	259,2
GDP/capita (US$)	1719	1863	2008	2045	2131	2310	2528	2661
GDP (% chng)	5,2%	5,4%	6,0%	6,7%	6,2%	6,8%	6,8%	6,6%
Investments/GDP	27%	27%	28%	29%	30%	31%	32%	32%
Budget balance/GDP	-6,8%	-7,4%	-6,2%	-6,2%	-6,3%	-4,5%	-4,2%	-4,1%
Govt debt/GDP	0%	55%	59%	57%	60%	60%	59%	58%
CPI (% chng)	9,1%	6,6%	4,1%	0,6%	2,7%	3,5%	3,9%	4,1%
Money demand (%)	24,5%	21,4%	19,7%	14,9%	17,9%	17,6%	16,4%	10,8%
Stock prices (eoy)	85	101	120	119	129	161		
Interest rates	9,0%	7,0%	6,5%	6,5%	6,5%	6,3%	6,3%	6,5%
Exch. Rate ($) (avg.)	20859	21017	21189	21909	22355	22705	22750	23680
Trade/GDP (%)	157%	165%	170%	179%	185%	203%	205%	211%
Oil price (Brent)	$112	$109	$99	$52	$44	$54	$67	$65
Billions US $								
Export of goods	124,5	142,6	160,6	171,8	188,6	226,7	248,9	271,7
Imports of goods	119,1	138,9	154,5	170,3	183,4	220,5	252,0	274,0
Other (net):	4,0	4,1	3,3	-0,6	3,1	3,7	8,1	7,1
Current account	**9,4**	**7,7**	**9,4**	**0,9**	**8,2**	**9,9**	**5,0**	**4,8**
(% of GDP)	6,1%	4,5%	5,0%	0,5%	4,1%	4,5%	2,1%	1,8%
FDI	8,4	8,9	9,2	11,8	12,6	14,2	16,0	17,2
Loan repayments	-3,3	-3,3	-5,3	-4,9	-5,7	-6,6	-6,9	-6,9
Net other capital flows	-2,5	-13,1	-4,9	-13,7	-6,8	-10,5	-10,2	-7,6
Balance of payments	**12,0**	**0,3**	**8,3**	**-5,9**	**8,3**	**7,0**	**3,8**	**7,5**
Reserves	25,2	25,5	33,8	27,9	36,2	43,2	47,0	54,5
Total debt	61,6	65,5	72,4	77,8	87,0	92,9	94,9	94,9
o/w short term debt	12,3	12,2	13,6	12,0	14,0	15,0	15,3	15,3

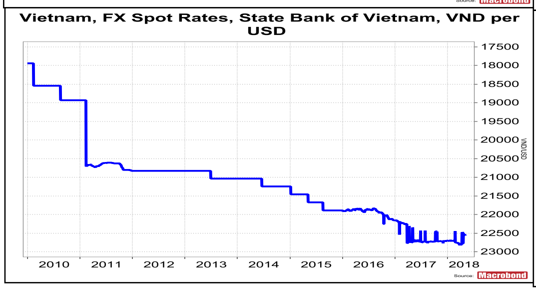
Source: OEF (Oxford Economic Forecasting) and SEB estimates.

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







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