Vietnam

SEB GROUP – COUNTRY RISK ANALYSIS June 3, 2019

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Last year's resurgent 7,1% annual expansion of GDP is not set to continue in view of weakening regional trade and global growth. However, supported by still buoyant consumer and investor confidence and record FDI inflows expectations are still for 6-7% annual expansion going forward. But questions are rising – how sustainable is this? The low-cost, low-skills era of Vietnam may be nearing its end.

Summary and conclusions

Growth set to moderate: Looking back, the 7,1% growth achieved in 2018 was the highest on record boosted by a world economy firing on all cylinders. That however is unlikely to be repeated in the current year as trade conflicts are rising between the two major global economies, the US and China, with Vietnam in between. Consensus appears now that the first reaction will be negative for Vietnam as exports meet growing headwinds. However, still buoyant consumer and investor sentiment will make sure that activity holds up helping the economy reach a decent expansion of more than 6,5% in the current year but with no apparent signs of overheating. Inflation remains within the authorities' target of 4% and the current account balance for the current year will bounce back to 5%.

Outlook – more of the same barring threats to regional stability: Provided the government in office since 2016 holds up the good work on macroeconomic stabilization, the future of Vietnam looks favorable as concerns the economy and its finances. The country has so far in this cycle been able to manage high growth around 6-7% without running into problems of overheating that otherwise could have resulted in high inflation and an unstable exchange rate like the run-up to Vietnam's financial crisis in 2011. That said, it is still reason to closely monitor any signs of excessive growth in non-financial activities including of non-banks – so far not a major concern, though. As regards reforms, some observers have complained about reduced government ambitions of recent years in particular as regards privatization. It may still be argued, though, that as long as they are not derailed completely but are held up as a potential check on vested interest, a slowdown is no disaster. The economy is still subject to unusually strong stimulus from foreign investors. The economy might be better served with the authorities letting it chum along with gradual consolidation of fiscal balances and a persistent external surplus on the balance of payment to facilitate the building of foreign reserves.

Rating upgrades: In August 2018, Moody's raised its sovereign rating by one notch to Ba3 based on Vietnam's lengthening track record of good economic management and reduced inflation prospects with declining reliance on foreign currency borrowing. More recently, the rating agency Fitch affirmed its BB rating, adding a "positive outlook". Much of the same can also be credited country risk in its present non-investment grade, but for the longer term the Vietnam needs to better integrate in the regional supply chain and gradually delink from a development model overly dependent on foreign investment inflows.

Recent economic developments

Growth back to normal: Looking back, the 7,1% growth rate achieved in 2018 was the highest on record and boosted by a world economy firing on all cylinders. That scenario is unlikely to be repeated in the current year as trade conflicts are rising on the horizon between the two major global economies, the US and China. Many observers have in recent times argued that such a position leaves Vietnam with unique opportunities to attract trade and capital that would otherwise have gone to China. While that could be a longer term proposition, consensus appears now to be that the first reaction could rather be negative for Vietnam as exports meet growing headwinds. However, still buoyant consumer and investor sentiment will make sure that activity holds up helping the economy reach a decent expansion of more than 6,5% in the current year.

Overheating not in sight: Prices and wage-formation remain well-behaved. Even with unemployment at steady 2% and underemployment at 1-2% according to official estimates which could be too conservative, though, wage formation around 10,5% a year over the last decade – or 4% in real terms -- has stayed well-tuned to productivity growth. Last year the statistics recorded a 3% rise in wages buoyed by an unusual high participation rate of 77% among the working age population. In the event, the annual rate of consumer price inflation has gradually come down to a sustainable rate of 3-4% a year from double digit rates at the beginning of the decade. Last year, the CPI (Consumer price index) ended at 3,9% higher mainly reflecting hikes in fees for medical services and education. For the current year such price performance will continue but remain in line with the government's target of 4%. Core inflation, by contrast, will remain moderate at only 1,8% with an overall taming effect on overall price developments.

Strong external balances: Reflecting the souring of the global environment, Vietnam's export performance may have seen its best years looking back. Last year the current account surplus fell to 2,4%/GDP, only a quarter of the record 9,9%/GDP set in 2017. For the current year it may bounce halfway back to a more normal but still strong surplus of 4,8%/GDP. That said, exports could still meet headwinds while domestic demand continue to pull imports at a rate that may prove higher than estimated so far in the year. The uncertainty about trade flows are heightened by structural changes in the composition of exports and thereby also imports used in their production into more high-tech and less labor intensive goods. (Conf Box 1). However, the main determinant of the current account balance of recent years is net trade in services including inbound foreign tourism. This booming industry is poised for continued growth around 15% a year based in particular on rising demand from a growing Chinese middle class.

Box 1: Structural export changes: Recent trends in Vietnam's export structure are set to continue for several more years but are gradually changing. First of all, agricultural products, including maritime products, are seeing their importance wane while manufacturing exports now occupy some 85% of total shipments, up from 65% a decade ago. Moreover, what used to be exports of labor intensive products like footwear and garments are gradually overtaken by electronics including telecommunication equipment and handsets. After growing 11% in 2018, exports of smart phones now make up some 20% of the total.

Buoyant FDI inflows continue: Inbound FDI (Foreign Direct Investments) in 2018 set a new record of $16bn. with an addition of some $25bn in future commitments (i.e. in form of a license that must be utilized within 5 years). Japan and Korea have normally been the main investors with growing emphasis on electronics, and indications are that their appetite for more production facilities in Vietnam will continue at a rate of 7% expansion for the current year. Total FDI disbursements in 2019 are estimated to grow by another billion USD to more than $19bn. reaching almost a tenth of GDP, more than seen in any other country since the beginning of the decade. While that episode ended in a financial crisis as domestic banks had lent too much including to real estate and residential housing, new restrictions imposed on lending activities by the central bank are likely to guard against that now.

Reserves rising to about 2,5 months of import cover: The current account surplus combined with net FDI inflows to yield a basic balance of $18bn. in 2018. However, a third of that was used for repayment of external debt while other capital flows – some of them are likely to have represented capital flight – were placed abroad with foreign financial institutions. That left only some $4-5bn for the central bank to build reserves in order to keep abreast of growing imports to maintain at least some 2,5 months of import cover. Compared with peers that is regarded as a bare minimum which may to some extent still be justified in view of Vietnam's relatively modest exposure to international portfolio flows.

Policies

Fiscal consolidation continues: Since taking office in 2016, the new government has persevered with efforts to rein in the budget deficit after it had threatened to break the stipulated maximum debt level under previous administrations. Last year the deficit to 4,2% of GDP and for the current year the goal is to see it shrink to 4,1%/GDP, that is closer to the 3,5%/GDP goal set in the current long term economic plan ending early next decade. That will be the outcome of more rationalization of social benefits while higher fees for government services and utilities help compensate for 7% higher government capital expenditures including for infrastructure.

Smooth deficit financing: The financing of the deficit over recent years has been facilitated by a growing domestic capital market. In 2018, this bought some three quarters of new public sector debt issuance.

Declining government debt ratio: As a result of improved budget control the public debt has begun to shrink as a share of GDP below the legal limit of 65%. Having almost breached that level in 2017, last year it fell to 59%, much helped by continued strong growth of the denominator, nominal GDP and also ongoing privatizations – *equitizations* in Vietnamese parlance. For the current year expectations are for further reduction to below 60%/GDP of which some 8pp (percentage points) is associated with government guarantees mainly for state owned enterprises (SOE) and banks (SOB). Good debt management has improved the maturity profile of government debt to an average of almost 7 years and contributed to less expensive market financing. By contrast, suspected underreporting of bad loans in many banks could indicate that contingent liabilities on the government may eventually prove higher.

Monetary policy to remain steady: As credit growth proved faster than expected in the second half of last year, the State Bank of Vietnam (SBV) – central bank – slammed the breaks with stricter regulations on lending to risk areas, including real estate and housing, lending for security investments and private consumption. That helped contain total lending growth within the 14% planned limit at the beginning of the year. With the same credit expansion target for the current year, the regulations are expected to remain in place thereby making it possible for the central bank to keep its policy rate steady at 6,25%pa. That is also in view of what appears to be an increasingly robust anchoring of inflation expectations. A never-ending concern, though, is if this rate of credit expansion could still prove too high for the economy. While it has come down from more than 17% growth rate before 2018, total credit outstanding of last year reached 136%/GDP, a high level compared with most peers. That said, though, other forms of financing, including shadow banking, are still in their early stages.

Exchange rate policies: Since the Dong (national currency unit) was officially de-pegged from the dollar in 2016, the central bank has conducted a flexible exchange rate policy. In practical terms, this has implied a rather managed, albeit crawling peg with periodic minor interventions with the intention to keep orderly conditions in the domestic foreign exchange market. In 2018, that resulted in some interventions as global market turbulence escalated when international investors lost their appetite for emerging market exposure. So far in 2019, market conditions have remained relatively calm allowing the SBV to continue a crawling peg approach to keep a check on any tendency for real appreciation in line with Vietnam's inflation differential vis-à-vis competitors.

Structural policies still in the molding: In contrast to the government's successes on the macro side, its domestic reform efforts have been more mixed. The World Bank's ease of doing business indicator last year fell slightly to the 64th rank out of 190 countries. And while the preferential tariffs on external trade has dropped from 13% in the early 2000s to 6%% in 2015 the number of non-tariff measures (NTM) has mushroomed from 15 to 330 during the same time span. Despite a recently established Trade Information Portal, the NTM system remains complicated, opaque and costly for entrepreneurs containing a large number of legislative documents, compliance procedures and forms to be filed often to different agencies.

Privatization: Of the 85 SOEs slated for privatization – *equitization* in Vietnamese parlance -- in 2018, only 28 were actually sold to private investors down from 69 in 2017. That does not necessarily signal a pause in the reform process, but that most low-hanging fruit have already been picked. Many of the remaining government enterprises are of special significance and their sales could be contentious. They include some of Vietnam's largest SOEs which may have acquired political significance. In this respect, it is notable that in late 2018 the government established a Committee for management of State Capital. That gave rise to rumors about the largest bank, Agribank, being prepared for an IPO over the next couple of years.

External trade agreements: The above stands in clear contrast to efforts on external trade initiatives, though. The Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) was recently ratified and the same is widely expected in the near future for the EU-Vietnam free trade agreement (EVTA). Against this background one may be excused for wondering if this apparent vacillating on the domestic reform front could be the result of macro prudential perspectives at play. As noted above, at near 7% growth rate the economy may not be able to digest more stimuli.

Improving balance sheets but banks have still some way to go: Vietnamese banks have come a long way since its home-grown financial crisis broke out in 2011. Capitalization has reached 12% and most banks have achieved reasonable profitability. But rapid loan growth over several years until the central bank's clamp down late 2018 – at periods more than twice the annual expansion of the nominal economy, has raised eyebrows as regards the quality of banks' loan books. Compared with many regional peers capital buffers remain thin and an overhang of legacy loans in many banks cannot be ignored. Although NPL levels according to official estimates have come down to a manageable 2%, that does not include NPLs warehoused by the Vietnam Asset Management Company (VAMC), an agency organized under the SBV in 2013. Including the latter and other high risk loans in danger of becoming non-performing the total bad-loan number rises to 6,5% according to World Bank estimates. On a more positive tune, though, the strong recovery in the domestic housing market has encouraged banks to sell collateral and in some cases to buy back associated NLPs from VAMC, a process that may continue.

Politics

Little has transpired over the last year from Vietnam's highly non-transparent political system. However, as to economic policies the present government -- in office since 2016, have encountered few complaints from the private sector. Human right issues, by contrast, arise from time to time, but so far they have either been quelled or not been serious enough to reach the headlines of international media. Investor concerns have rather focused on the smoldering US-China trade war and potential implications for Vietnam.

Outlook

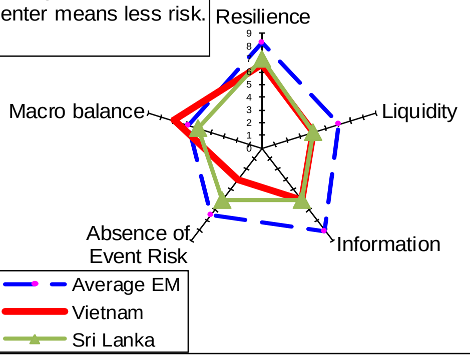
So far so good: Provided the government holds up its good work on macroeconomic stabilization, the future of Vietnam looks favorable in terms of its economy and finances. The country has so far in this cycle been able to manage high growth around 6-7% without running into problems of overheating that otherwise could have resulted in high inflation and an unstable exchange rate like in the run-up to Vietnam's financial crisis in 2011. That said, it is still reason to closely monitor any signs of excessive growth in non-financial activities including of non-banks – so far not a major concern, though.

Reform pause: As regards reforms, some observers have complained about reduced government ambitions of recent years in particular as regards privatization. It may still be argued, though, that as long as reforms are not derailed completely but are held up as a potential check on vested interest, a slowdown is no disaster. The economy is still subject to unusually strong stimulus from foreign investors. In this vein, the economy could continue chumming along with gradual consolidation of government balances and a persistent external surplus on the balance of payment facilitating further building of official foreign reserves.

Risks: The threat to this scenario at the present stage is now mainly coming from the outside world. Up to this point Vietnam has been able to stay out of the fray in the smoldering US-Sino trade war. In the longer term, it may also be able to benefit from it should investors begin to relocate from China into other Asian countries in massive way although that may take place only after a period of softer growth in prompted by a more severe downturn for the global economy than expected at this point. – In such a context, the relative economic isolation of Vietnam may be a blessing in disguise. But beyond the present situation it needs to improve interaction with regional supply chains as pointed out by observers. Today such interaction takes place in the foreign invested sector but with little contribution from domestic firms which are too small, too technically underdeveloped or suffering from insufficient financing at reasonable pricing.

Key ratios	**2019**
Population (mill.)	97
GDP/capita ($)	2661
GDP (change)	6,4%
Inflation	4,1%
Curr.Acc. Balance/GDP	1,8%
Reserves/imports (months)	2,2
Budget balance/GDP	-4,1%
Government debt/GDP	58%

Chart key:
Moving out from the center means less risk.



External ratings:
Fitch: BB
Moody's: Ba3
S&P: BB-

Peers:
Croatia
Costa Rica
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	2020
GDP (bill.US$)	155,6	170,5	185,8	191,4	201,4	220,6	243,8	259,2	279,7
GDP/capita (US$)	1719	1863	2008	2045	2131	2310	2528	2661	2844
GDP (% chng)	5,2%	5,4%	6,0%	6,7%	6,2%	6,8%	6,6%	6,4%	6,2%
Investments/GDP	27%	27%	28%	29%	30%	31%	32%	32%	32%
Budget balance/GDP	-6,8%	-7,4%	-6,2%	-6,2%	-6,3%	-4,5%	-4,2%	-4,1%	-4,1%
Govt debt/GDP	0%	55%	59%	57%	60%	60%	59%	58%	58%
CPI (% chng)	9,1%	6,6%	4,1%	0,6%	2,7%	3,5%	3,9%	4,1%	4,0%
Money demand (%)	24,5%	21,4%	19,7%	14,9%	17,9%	17,6%	16,4%	10,8%	10,7%
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%	6,8%
Exch. Rate ($) (avg.)	20859	21017	21189	21909	22355	22705	22750	23680	24240
Trade/GDP (%)	157%	165%	170%	179%	185%	203%	205%	211%	208%
Oil price (Brent)	$112	$109	$99	$52	$44	$54	$67	$65	$73
Billions US $									
Export of goods	124,5	142,6	160,6	171,8	188,6	226,7	248,9	271,7	288,6
Imports of goods	119,1	138,9	154,5	170,3	183,4	220,5	252,0	274,0	293,0
Other (net):	4,0	4,1	3,3	-0,6	3,1	3,7	5,5	7,1	8,6
Current account	**9,4**	**7,7**	**9,4**	**0,9**	**8,2**	**9,9**	**2,4**	**4,8**	**4,3**
(% of GDP)	6,1%	4,5%	5,0%	0,5%	4,1%	4,5%	1,0%	1,8%	1,5%
FDI	8,4	8,9	9,2	11,8	12,6	14,2	16,0	17,2	18,6
Loan repayments	-3,3	-3,3	-5,3	-4,9	-5,7	-6,6	-6,9	-6,9	-6,9
Net other capital flows	-2,5	-13,1	-4,9	-13,7	-6,8	-10,5	-7,7	-7,6	-5,5
Balance of payments	**12,0**	**0,3**	**8,3**	**-5,9**	**8,3**	**7,0**	**3,8**	**7,5**	**10,4**
Reserves	25,2	25,5	33,8	27,9	36,2	43,2	47,0	54,5	73,2
Total debt	61,6	65,5	72,4	77,8	87,0	92,9	94,9	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	15,3

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

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

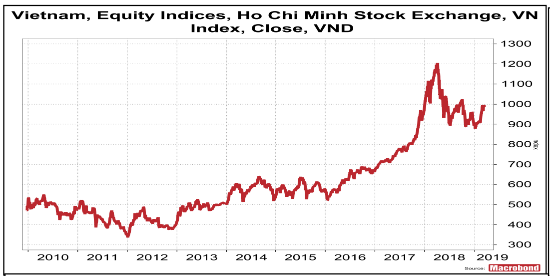
Type of government: Communist party

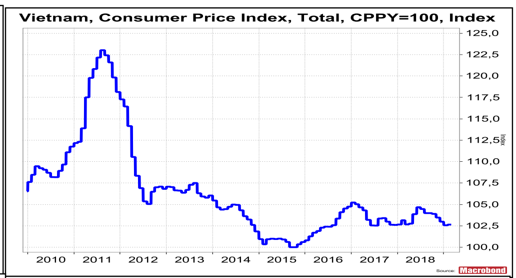
Next elections: Next 5-yearly partyconference in 2021

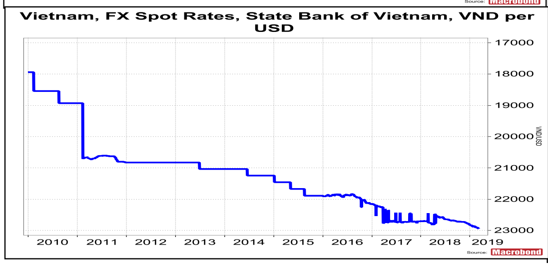
Other:

Latest PC deal: 1993

Recent IMF programs: PRGF (Poverty Reduction and Growth Prog. interrupted before expiry in 2004.







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