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VIETNAM: THE NEXT ASEAN TIGER?

Vietnam: The Next ASEAN Tiger

By Michael Kokalari and Arup Raha¹

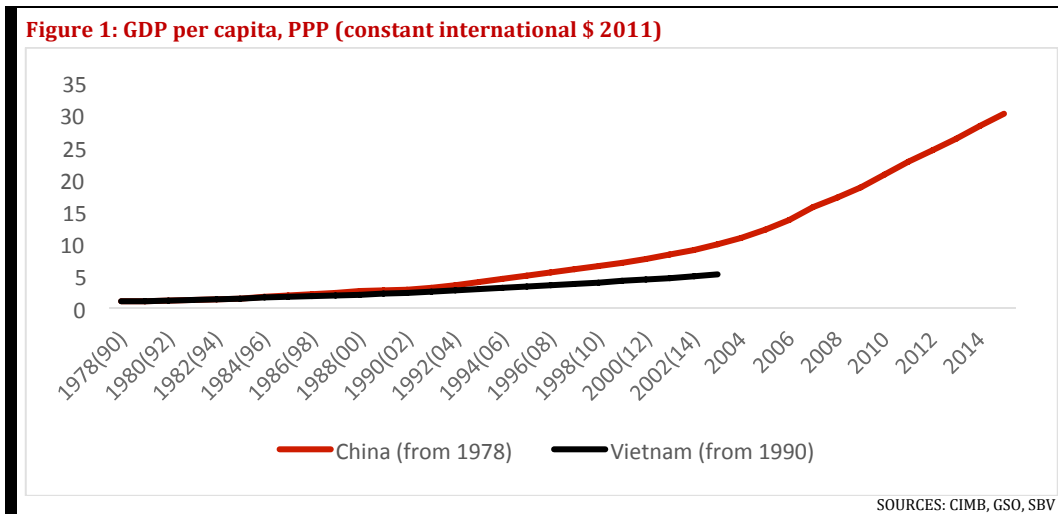
Summary

Vietnam Key Indicators	2015	Average (2009 - 2015)
Nominal GDP (USD bn)	193.4	
GDP growth (%)	6.7	5.9
GDP per capita (USD)	2109.0	
GDP per capita growth (%)	5.6	5.0
Population (millions)	91.7	
Inflation (%)	0.6	7.9
Trade (% of GDP)	178.8	
Agriculture (% of GDP)	18.0	
Industry (% of GDP)	33.3	

Long-term Sovereign Ratings	Foreign Currency	Local Currency
Fitch	BB- (Stable)	BB- (Stable)
Moody's	B1 (Stable)	B1 (Stable)
S&P	BB- (Stable)	BB- (Stable)

Vietnam is no ordinary growth story -- we believe it has strong potential to be the next ASEAN Tiger. For two decades after economic reforms started in 1986, Vietnam's per capita income growth was near to 6.5% a year and came close to the performance of China's growth post its economic liberalisation. The impact of the Global Financial Crisis (GFC) of 2008 slowed things down in the short term. However, Vietnam's potential to be a great growth story over the next decade is back in focus.

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The instability that came about when Vietnam entered the World Trade Organization in 2007 just ahead of the GFC of 2008 is now largely in the past. Government policies to address non-performing loans and reform the banking sector have made progress, though more is needed. Similarly, there is a need for fiscal consolidation. On the positive side, the demographics are good, wages remain low and the nation is attracting significant foreign direct investment. There is tremendous scope for productivity-led growth. At the same time, middle class spending power is on a steep upward trajectory and the underlying Vietnamese work ethic and entrepreneurial spirit remains strong.

Vietnam's GDP grew by 6.7% in 2015 but looks almost certain to drop back down to just above 6% in 2016, due to a severe drought in the early portion of this year, and a circa 10% collapse in Vietnam's oil production volume, due to low world oil prices. Both of these factors are likely to lessen in impact next year.

GDP growth in Vietnam is likely to remain around 6.3% in 2017 and 2018. Inflation has had a modest uptick but that is largely due to supply shocks in agriculture. We expect it to peak at around 5% and should not affect monetary policy, though credit growth will slow.

Strong FDI inflows continue to support the Vietnamese Dong. Indeed, given the reaction of regional currencies to higher US bond yields, the risk is an appreciation in trade-weighted terms.

Structure. This report is organised as follows: In the first section, we look at Vietnam's recent economic history with an emphasis on the last 10 years. That is followed by an analysis of Vietnam's strengths in the medium term and its unfinished reform agenda. We end with our view of the economic outlook for Vietnam for 2017-2018.

1: Background and Economic History

After many years of French colonisation, followed by a geopolitical war between the North and the South of the country, Vietnam embarked on a process of reunification in 1975. By 1985, its planned economy was effectively in crisis. Prices, wages and the exchange rate were all fixed by the state leading to severe imbalances. Inflation was running above 700%, there were shortages of essential goods, production was stagnant and external accounts were deteriorating. In 1986, a process of economic restoration, or “*Doi Moi*”, was launched.

Under *Doi Moi*, there was an effort to restore macroeconomic stability by allowing market mechanisms to play a greater role and promoting entrepreneurship. The political system remained socialist, but at the same time Vietnam developed some market characteristics.

New legislation. Two cornerstones of *Doi Moi* were the 1990 Corporate Law and Private Enterprise Law which provided a boost to entrepreneurship and the 1992 amendments to Vietnam’s Constitution which recognised the private sector’s role in the economy.

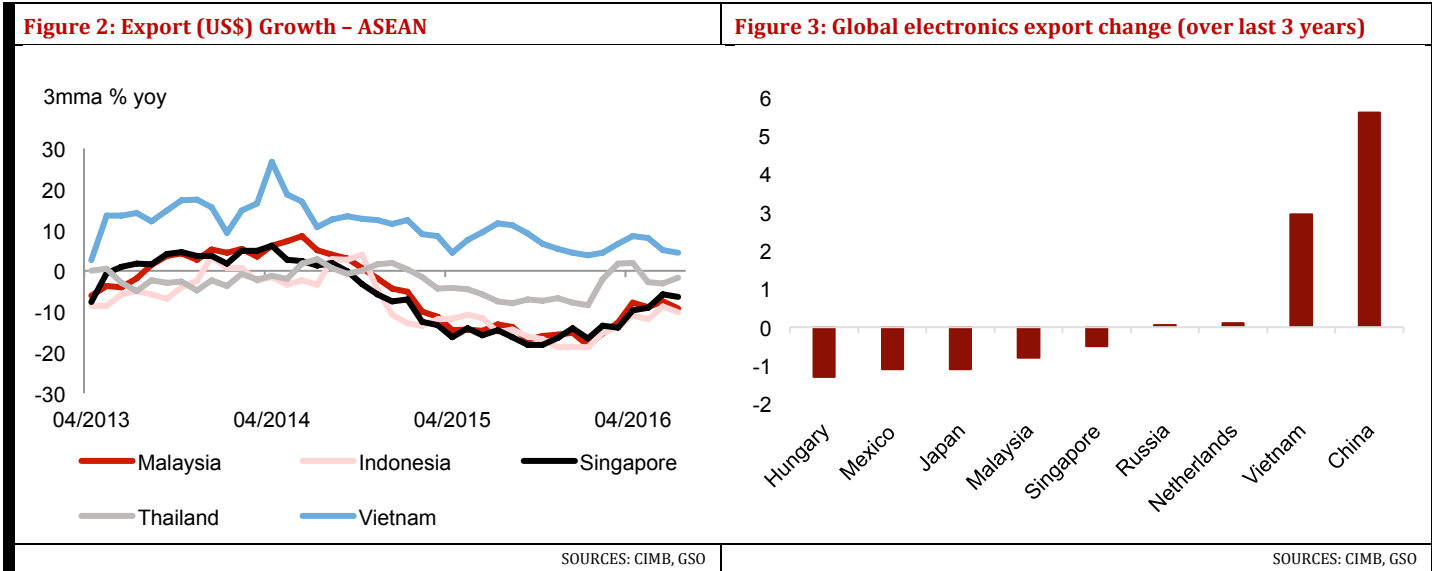
Unifying exchange rates. One of the first practicalities addressed under *Doi Moi* was the exchange rate of the Vietnamese Dong (VND). Previously the exchange rate was set by decree, and a vibrant black market developed to more fully reflect market realities.

Over time, a series of devaluations brought the official and unofficial rates closer together. Moreover, the central bank, State Bank of Vietnam (SBV), recognised the inflation rate and other variables when it set the exchange rate. By the 1990s, VND value was set via auctions, though the SBV did maintain a strong influence. Today, monetary and exchange rate policy remain an area where more reform is needed.

Agriculture. In agriculture, collective land was allocated to individual households on a long-term basis, and in 1993, a Land Law was passed which allowed for a greater security of tenure and the transfer of land-use rights to others. Tax reforms also helped improve the situation of farmers and these factors led to a significant improvement in Vietnam’s agricultural sector. By 1989, Vietnam became a rice exporter and according to World Bank data, average rice yields today are exceeded only by China among Asia’s emerging economies. The country now ranks among the top five global exporters in products as diverse as shrimp, coffee, cashews, rice, and pepper.²

Trade and openness. Perhaps, the single biggest change in Vietnam was a move toward more openness and an effort to integrate with the global economy. The Law on Foreign Investment was initiated in 1987, resulting in a surge of foreign direct investment (FDI), that rose from almost nothing to over 10% of GDP in 1994. Today, FDI is one of the main drivers of Vietnam’s growth.

² Transforming Vietnamese Agriculture: Gaining More from Less, Vietnam Development Report, 2016, World Bank.



Bilateral and Multilateral trade deals also followed. The U.S.-Vietnam Trade Bilateral Agreement was signed in 2001; Vietnam became a member of Association of Southeast Asian Nations (ASEAN) in 1995 and the Asia-Pacific Economic Cooperation Forum (APEC) in 1998 and a full member of World Trade Organization (WTO) in 2007.

External trade – exports plus imports – which was around 23% of GDP in 1986, climbed to 80% in 1990 and in 2015 stood at close to 180%. Today, besides having signed the (possibly defunct) Trans-Pacific Partnership, Vietnam has bilateral trade deals with China, Japan, India, Korea, Australia and New Zealand.³ Vietnam now has diplomatic relations with more than 170 countries in the world.

Economic and social dividend. The results of *Doi Moi* have been very impressive. Since 1990 until the mid 2000s, Vietnam's GDP growth averaged 7.5%, making it among the world's fastest economies over that period. Per capita income has increased about twenty-fold over 30 years, going from about \$100 in the 1980s to \$2,100 in 2015. Moreover, growth has been equitable with the number of people living in extreme poverty falling from 50% in the 1990s to 3% in 2012. Social indicators have also improved with many Millennium Development Goals achieved ahead of time.⁴

Vietnam's literacy rate is above 90% and life expectancy has risen to 76 years in 2012 from 67 years in 1980; for women, life expectancy is above 80 years, better than most countries with similar per capita income. Mortality rates have also dropped meaningfully. Access to basic facilities has improved. Today, electricity is available to almost all households, while less than half had access in the early 1990s. Similarly, more than 75% have access to clean water and modern sanitation versus 50% earlier.

The double whammy of WTO entry and the GFC. Vietnam's economy made significant and reasonably steady progress from the start of *Doi Moi* in 1986. Then two events changed the tone. In 2007, Vietnam became a full member of the WTO and there was a flood of FDI into the country. In 2008, the GFC gripped the world. The policy response to these two events resulted in two boom and bust cycles in Vietnam. The result was a banking system crisis, fuelled by excess liquidity, and an enlargement in the role of the state-owned enterprises (SOEs) in the economy.

³ <https://aric.adb.org/fta-country>

⁴ <http://www.un.org.vn/en/what-we-do-mainmenu-203/mdgs/viet-nam-and-mdgs-mainmenu-49.html>

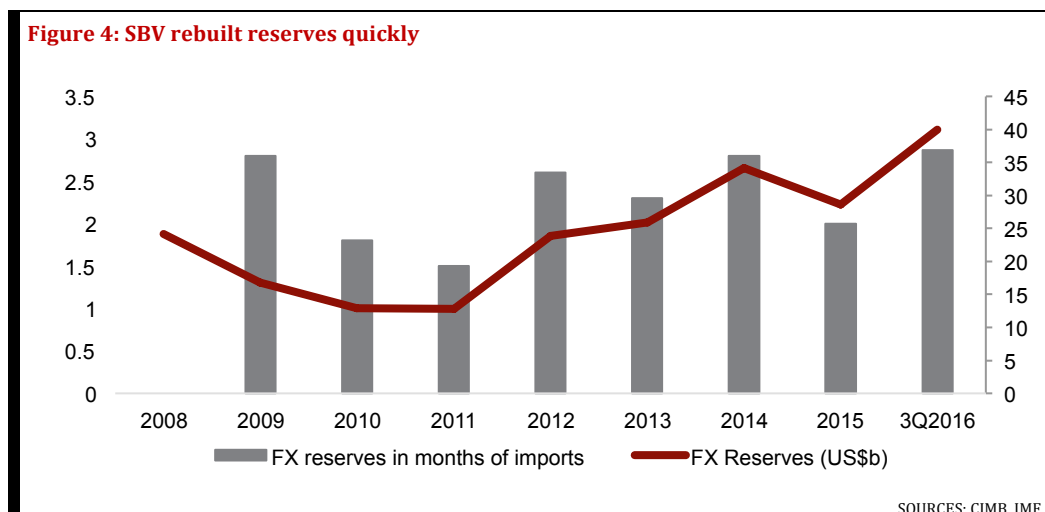
During the first boom (which coincided with a world-wide liquidity-driven emerging markets bubble) Vietnam's money supply (M2) grew by 49% in 2007. FDI inflows peaked at 11% of GDP in 2008. This enormous inflow of money into Vietnam fuelled a property bubble, drove the stock market to a peak valuation of 40 times price/earnings ratio in 2007, and inflation to a peak of 28% in August 2008.

By late 2008 and early 2009, the bubble had collapsed, as evidenced by the dramatic fall in inflation to 2% in August 2009. The stock market fell by 80% from its peak in early 2007 to its trough in early 2009.

Vietnam's economy and stock market did not stay down for long after the GFC, thanks to aggressive steps the government took to stimulate the economy. The central bank opened the monetary floodgates, as central banks in most countries did. Vietnam's government also launched an aggressive fiscal stimulus programme worth about 5% of GDP that took the form of a subsidised loan programme for businesses. At that time, businesses could take out loans for the purpose of financing their working capital needs at 400 basis points (bps) below the prevailing market rates.⁵

The combination of loose monetary policy and fiscal policies resulted in average credit growth of more than 35% over 2009-11, which in turn led to 23% inflation in late 2011. Excessive credit also fuelled a mini-boom in the stock market and real estate prices. As a consequence of the abundance of currency created at that time, the value of the VND against the USD fell by nearly 25% from late 2009 to early 2011.⁶

A good guess would be that Vietnam's foreign reserves probably fell to about four weeks of imports at that time (the actual number is a state secret), prompting widespread fears that the government would need to rely on International Monetary Fund (IMF) assistance to bail out the country.



Instead, the Vietnamese government decided to take aggressive steps to stabilise the macro economy, including aggressively raising interest rates. The government also instituted a range of macro-prudential regulations in the banking and real estate industries – including minimum absolute capital requirements

⁵ The government made payment directly to the banks to fund the subsidy.

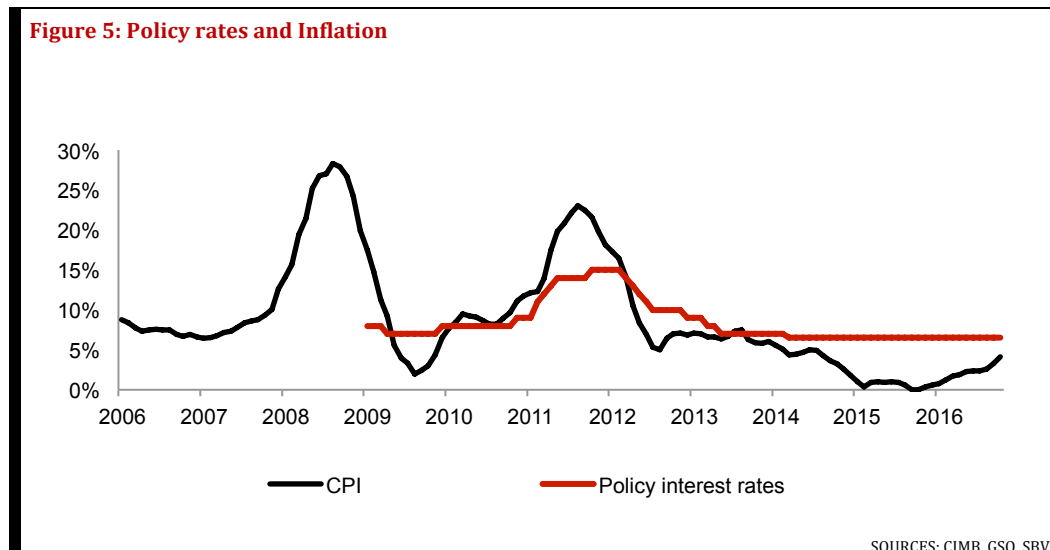
⁶ The 2009 balance of payments (BoP) statistics revealed an enormous 14% of GDP in "errors and omissions" in the BoP accounts. It is, at the very least, suggestive evidence that locals took their money out of VND and instead bought gold and USD.

for banks, maximum loan-to-deposit ratios, and a severe clamp down on property developers' ability to use "pre-sales" payments.

As a result, inflation plummeted to nearly zero by the beginning of 2015, real estate prices fell by about 50%, from the peak to the trough in 2013, and the VND stabilised as overseas Vietnamese rushed to play the "carry trade", in which they exchanged USD into VND and deposited the money into high-yielding local bank accounts. Remittances inflows from overseas Vietnamese soared by nearly 33% from 2009 to 2010 and have nearly doubled since 2010.

These inflows showed the confidence that savvy investors had in the country (most overseas remittances originate from the Vietnamese diaspora in the US. Moreover, Vietnam's Credit Default Swap rate has fallen from over 500 BPS around end-2011 to just close to 200 BPS at present.

Convincing stabilization of the economy. From 2012 to 2014, policy makers could again focus on growth. The central bank cut rates by 550 BPS as inflation had fell below 4%; the current account had a 4% of gross domestic product (GDP) surplus, supported by approximately 6% of GDP overseas remittances.



However, growth was anaemic by Vietnamese standards. GDP growth improved from 5% in 2012 to only 6% by 2014 because of the banks' inability to extend credit to the real economy.⁷ The primary issue was that non-performing loans (NPLs) -- which peaked at 17% in 2012 during the second boom and bust cycle -- were not decisively dealt with until 2014.

Once the banks had more clarity on the government's handling of NPLs and began aggressively cleaning up their balance sheets, credit growth resumed with a vengeance. Outstanding loans grew 17% in 2015, which helped fuel the 6.7% GDP growth that year.

⁷ We estimate that actual credit growth rates averaged 6-7% between 2012-2014. (Our definition of "actual credit growth" excludes the credit that banks extended to distressed borrowers which enabled those borrowers to continue making their loan payments.)

2: Securing the Future

Vietnam firmly remains a middle-income country. There is much to be done, and there is also a continued determination for the country's huge reform agenda. According to the World Bank, Vietnam's 2011 – 2020 Socio-Economic Development Strategy gives attention to structural reforms, environmental sustainability, social equity and emerging issues of macroeconomic stability. There is also an emphasis on reforms in the banking sector, state-owned-enterprises and public investment.⁸

We look at four key areas that we believe will be crucial over the next few years. First, the need for **macroeconomic stability**, which includes fiscal consolidation, more robust monetary management, greater exchange rate flexibility and preemptive action on any imminent bubbles, especially in real estate. Second, we look at the need for **banking sector reform**. Third, the continued need for **SOE reform and enabling entrepreneurial activities**. And lastly, we look the **potential drivers of growth** over the next decade or so.

Macroeconomic Stability

Fiscal consolidation. The fiscal deficit has averaged more than 6% of GDP since 2012 and is expected to be 6.5% of GDP in 2016. Public and public guaranteed debt is expected to be 62% of GDP. Without significant consolidation, Vietnam will clearly face issues regarding debt sustainability and macroeconomic stability. The government's plan is to reduce the deficit to 3% of GDP by 2020, but according to the IMF, there will be "substantial challenges" to achieving this goal.⁹

On the revenue side, oil revenues have come off and there is an expectation that export-import duties may decline given various trade agreements. In terms of non-tax revenue, the process of equitisation (more commonly understood as privatisation) may affect revenue. On the expenditure side, recurring expenditures have been rising, especially debt service as public debt has become larger.

Over the medium term, structural measures that would enhance revenues are needed. That means reforms that may not be comfortable in the near term. First, there is a need to use privatisation revenues to retire debt. Further, there is a need to broaden the tax base and improve revenue administration. Depending on priorities, fuel taxes probably need to be increased.

On the expenditure side, structural reforms are also needed. First, the efficiency of public expenditure needs to improve. Second, there is probably a need for civil service reform. The process of equitisation needs to continue and private-public partnerships need to be enhanced.

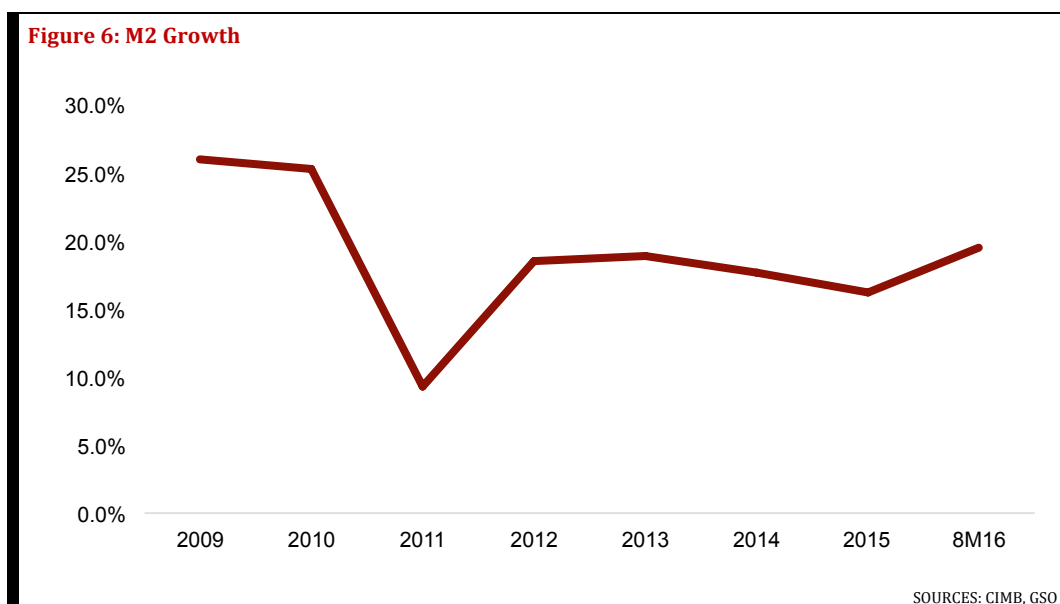
The good news is that the government is already aware of all this. Various measures are being studied including property and capital gains taxes on the revenue side and reducing the public sector wage bill on the expenditure side. Besides reaching the goal of a deficit of 3% of GDP, the deficit is meant to average 4% of GDP in the 2016-20 period. In the event, the ratio of debt-to-GDP should be maintained below the legal limit of 65%.

We would consider fiscal consolidation as a clear near-to-medium term priority.

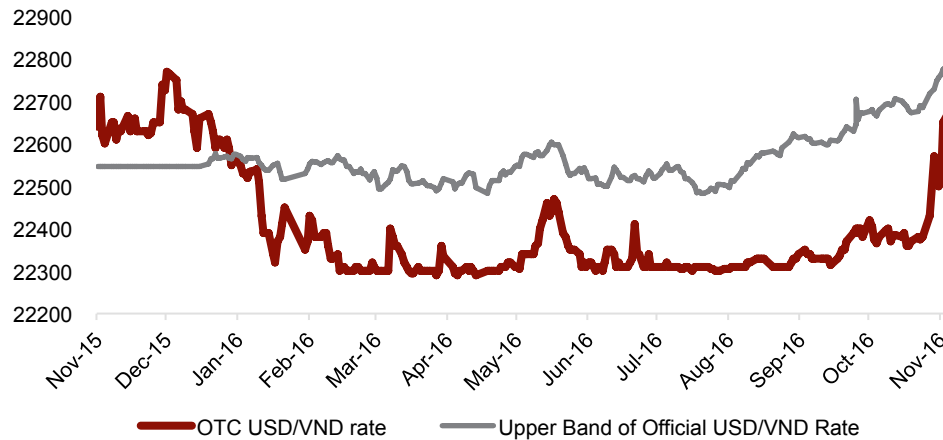
⁸ <http://www.worldbank.org/en/country/vietnam/overview>

⁹ IMF, Country Report No. 16/240, Vietnam: 2016 Article IV Consultation- Staff Report; July 18, 2016.

Monetary and exchange rate policy. Credit growth has been strong – expected to be about 17-18%% in 2016 – largely driven by monetary expansion in response to inflation coming off in 2015. According to the IMF, the authorities should try and restrict credit growth to below 15% to keep a lid on the credit-to-GDP ratio.



However, it is not just a matter of restricting credit growth. There are structural changes needed to allow more flexibility on monetary and exchange management. On the exchange rate side, while significant changes have been implemented over time, the value of the exchange rate is still set by the SBV based on the previous day's value vs the US dollar; the exchange rate of major trading partners; and domestic macroeconomic conditions. While there is currently no misalignment in the exchange rate, a regime like this can potentially lead to sudden and disruptive changes in the event of an external shock. Perhaps, most importantly, a flexible exchange rate allows for more monetary policy independence.

Figure 7: New exchange rate mechanism

SOURCES: CIMB, SBV

Currently the SBV works with credit growth targets in determining monetary policy, which depending on how demand for money evolves, can lead to inflationary pressures. Using inflation as a nominal anchor can work better in providing price stability.¹⁰ The IMF suggests various measures are needed to move to such a regime. These include strengthening monetary policy operations, improving communications and economic analysis and strengthening the institutional framework.

The current monetary and exchange regime is working for now but seeking greater flexibility would be part of the medium-term agenda. There isn't much of a threat from inflation. After falling close to 1% year-on-year (yoy) in 2015, inflation has ticked up and is likely to be about 5% for 2016. However, most of the rise is due to agricultural price increases on account of a drought, and does not reflect lax monetary settings.

Banking sector reforms.

The long-term potential of Vietnam's banking system is undeniable – only about a third of the country's 92 million citizens have a bank account, only a third live in its major cities, and Vietnam's per-capita credit card penetration rate is less than 25% that of Thailand. However, reform of the banking sector is a work in progress.

About half the banking sector's assets are represented by four state-owned commercial banks (SOCBs) that lend heavily to the country's SOEs. The rest of the banking system assets are represented by a host of private sector banks. At the peak in 1995, Vietnam had 54 banks which was an incredible number for a country of its size.¹¹ The number dropped after the 1997 Asian crisis, but Vietnam still had 43 local

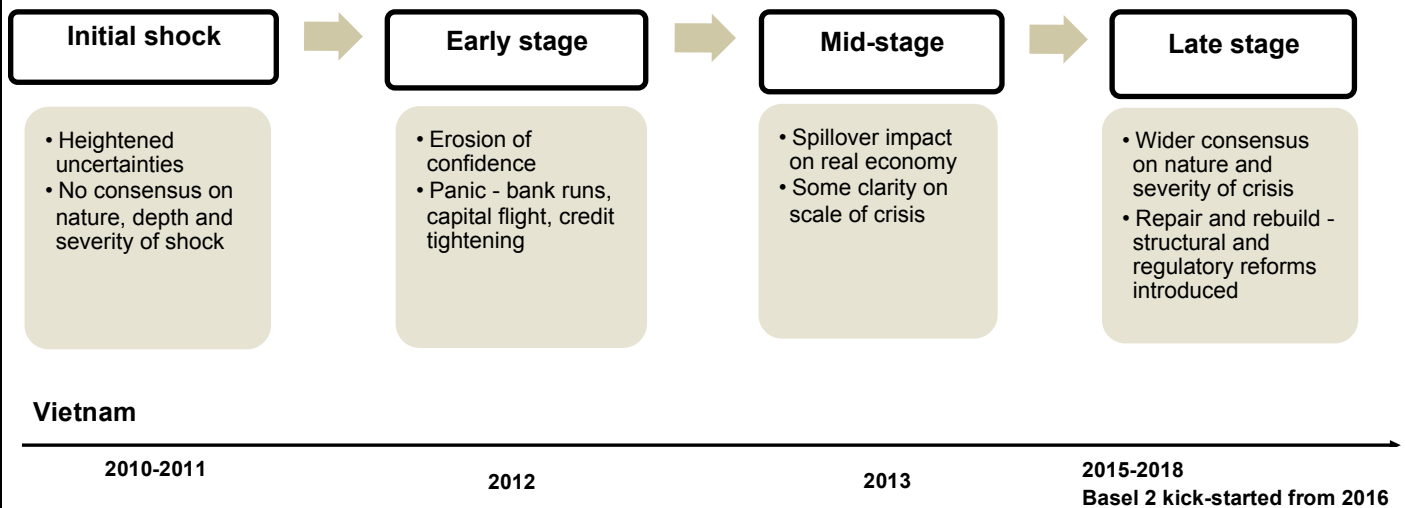
¹⁰ Using inflation as a nominal anchor means it is the one variable used to target a nominal price level or the variable used to shape the expectation of the private sector. As such if inflation rises/falls, one could expect tighter/looser monetary conditions. It is a weaker condition than inflation targeting where a target is announced explicitly.

¹¹ Although, recall that Malaysia had over 70 banks at that time.

banks in 2012. The government has had a long-standing objective to bring this number down to 15-17, but the time horizon to accomplish that keeps getting pushed back.¹²

To assess the rate at which the banks are moving to clean up their balance sheets, improve their operations and consolidate, it is first necessary to step back and take a quick look at where the industry is in the current recovery cycle.

Figure 8: Banks: Final stage of the recovery cycle



SOURCES: CIMB

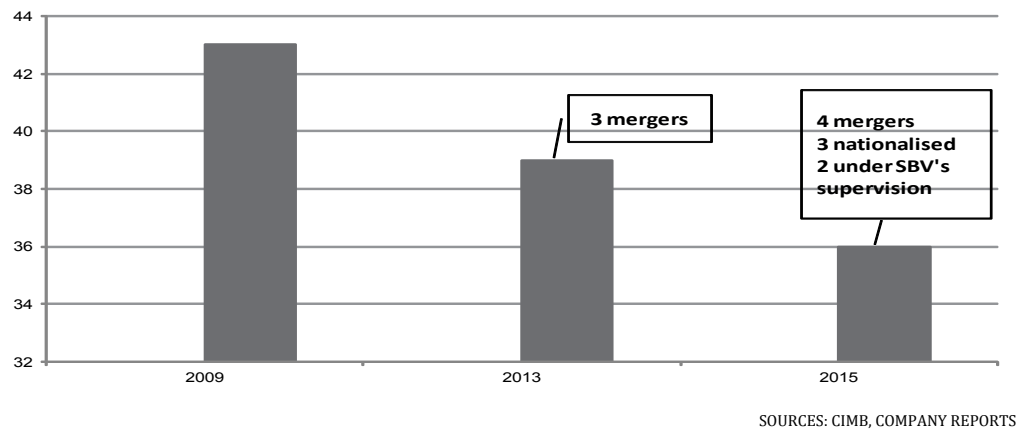
As discussed in the previous section on Vietnam's recent economic history, the government overstimulated Vietnam's economy in 2009 in the aftermath of the 2008 GFC through a combination of loose monetary policy and fiscal stimulus that took the form of a subsidized loan program. At that time, a complex network of cross shareholdings, coupled with loose macro prudential regulations in the banking system, facilitated the large-scale creation of NPLs when business owners, who were also bank shareholders, orchestrated lending back to their real estate projects and other businesses.

The central bank made its first attempt to rein in Vietnam's private sector banks in 2010, with stipulated maximum loan-to-deposit ratios, minimum absolute levels of capital and other rudimentary controls. However, at that time, the economy was still booming, so the technocrats in Vietnam's (non-independent) central bank were largely overridden by the private bank owners' patrons in the government. The smaller banks were particularly affected, both because they were overly aggressive in competing for deposits and because of their lax lending standards.¹³

In 2011, when the government prioritized macroeconomic stability over growth, the central bank was able to deal with these smaller banks by restricting their access to credit in the interbank market and orchestrating mergers, starting with the Saigon Bank, Ficombank, and Tin Nghia Bank amalgamation.

¹² The original plan was to have this happen by 2017, but the country currently still has 36 banks.

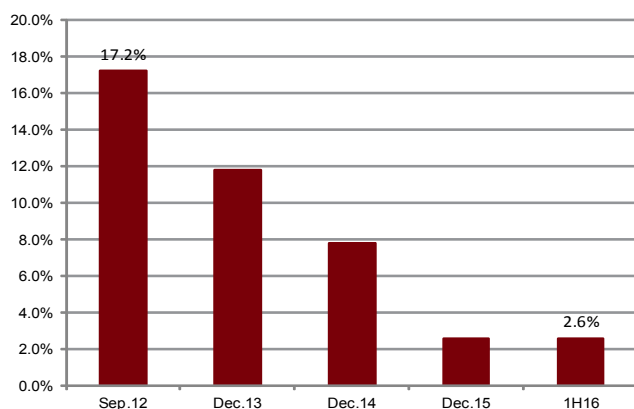
¹³ Some of the smaller banks ended up having NPL ratios of over 30% after the real estate market crashed in 2011.

Figure 9: The number of banks is falling - The central bank aims for 17 banks

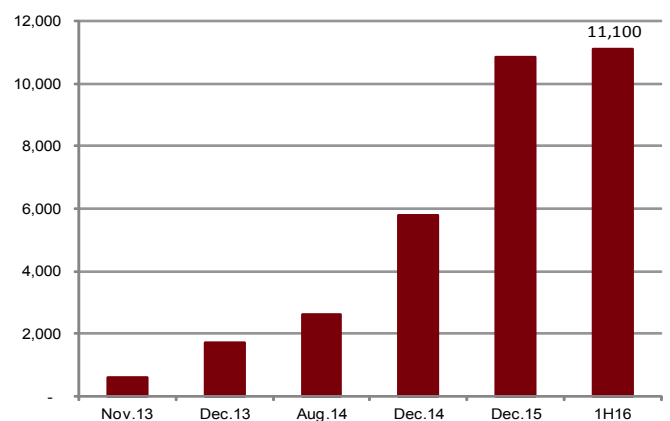
Having successfully initiated the consolidation of the banking sector (and the rehabilitation of the weakest banks), the next step for the central bank was to address the NPL problem. To accomplish this, the Vietnam Asset Management Company (VAMC) was set up in 2013.

The VAMC scheme is a rather benign one – banks transfer their NPLs to the VAMC at book value, and receive “special bonds”, aka “VAMC bonds”, that they must provision against over a five-year period.¹⁴

The net result was that banks transferred US\$6 billion worth of NPLs to the VAMC by the end of 2014, up from a negligible amount at the end of 2013. The amount was US\$11 billion by the end of 2015 and is about US\$12 billion at present.

Figure 10: System-wide NPL ratio (as per SBV)

SOURCES: SBV, CIMB

Figure 11: Total NPL's transferred to VAMC (US\$ m)

SOURCES: CIMB, COMPANY REPORTS

¹⁴ To be clear, the VAMC does not purchase distressed loans from banks for a cash consideration, and the banks do not record a significant loss at the time they dispose of their NPLs to VAMC.

As a result of these transfers, and the provisioning banks made against NPLs still held on their balance sheets, we estimate that Vietnam's system-wide NPL ratio fell from 17% in 2012 to below 3% at present – although about 5-6% worth of outstanding loans are still held by VAMC.

Figure 12: Key macro-prudential regulations, 2012-15

Key regulations

- Circular 21: restricts small banks' access to interbank funding
- Circular 09: accurate NPL recognition & provisioning
- Circular 36: stricter safety ratio (CAR, LDR, etc), and cross-shareholding limits
- Basel II: Ten banks to implement in 2018, remaining in 2019.

SOURCES: CIMB

Part of the central bank's clampdown entailed the introduction of a range of macro-prudential regulations, including a more robust NPL recognition framework.¹⁵ Vietnam's system-wide reported NPL figure is now much more accurate than it was under the previous regime (which was simply based on the number of days loan payments were overdue). However, banks incur rather onerous restrictions on their operations if they report (on-balance sheet) NPLs of above 3%. For that reason, the true NPL figure is still probably about 2-3 percentage points higher than the reported figure.

Finally, the next big challenge for local banks will be to raise capital to fund the ongoing expansion of their loan books, and to prepare for the implementation of the Basel II capital adequacy standard in 2018-19.¹⁶ Vietnam's system-wide capital adequacy ratio (CAR) stood at 13% at the end of 2015 but that is likely to change. First, by our estimates, the implementation of Basel II will reduce the sector-wide CAR ratio by 4 percentage points. Second, expected loan growth of 18-20% in 2016 will reduce the sector-wide CAR ratio by about 1.5 percentage points this year, all other things being unchanged. And third, the implementation of higher risk weightings on real estate loans from the beginning of 2017 (another macro prudential regulation) will likely further reduce the system-wide CAR by another 0.5 percentage points. If our estimates are correct, then local banks will need to raise about US\$7bn in new capital (including US\$5 billion of new equity capital) over the next few years, as can be seen in the table below.¹⁷

¹⁵ This move was also resisted by the banks, so its introduction was repeatedly delayed from 2013 to 2015

¹⁶ The first 10 banks selected will implement Basel II by the end of 2018, with another 15-17 earmarked to implement the standard by the end of 2020.

¹⁷ Note that our bottom-up estimates are consistent with the system-wide capital requirement published by the IMF and other observers, although more widely publicised estimates of the aggregate capital Vietnam need to raise have not been accompanied with detailed computations and we have no way of knowing the validity of those forecasts.

Table 13: ~US\$7b external capital needed by 2018 (after \$3.7b retain earn.)

(USD m)	Current CAR	CAR under Basel II	External capital needed
Sector	12.8%	8.5%	7,300
Listed banks			5,591
Vietcombank (VCB)	9.7%	7.2%	659
Vietinbank (CTG)	9.2%	6.1%	1,939
BIDV (BID)	9.0%	6.0%	2,061
Eximbank (EIB)	17.0%	11.4%	(2)
Military Bank (MBB)	12.7%	8.5%	65
Asia Commercial Bank (ACB)	13.0%	9.0%	81
Sacombank (STB)	9.6%	6.4%	789

SOURCES: CIMB, BANK REPORTS

The good news about these modest capital requirements is that the government is encouraging new investment in the sector from foreign investors – as evidenced by its moves to encourage Singapore’s sovereign wealth fund GIC to take an 8% stake in Vietcombank, the nation’s leading SOCB. This openness, coupled with foreign investors’ enthusiasm for Vietnam amid a slow-growth global economy means that we expect to see a lot more foreign investment pour into Vietnam’s banking sector over the next few years.

SOE reform and doing business in Vietnam.

If Vietnam expects to maintain its current growth rates, the need for SOE reform is paramount. According to the IMF, output per worker, or labour productivity, in domestic manufacturing, which includes SOEs, is about 20% that of firms that have foreign investment. Moreover, total factor productivity (TFP) growth has declined by 1.5 percentage points since the mid-2000s.

While a fair amount of progress has been made on the legal framework for SOE reform, there are plenty of SOEs that are fully owned by the government and have preferential access to land and capital. The IMF recommends that the equitisation process needs to be speeded up, there needs to more of an integration with foreign-invested enterprises, and private companies need to be encouraged to join the formal sector.¹⁸

Vietnam’s “Ease of Doing Business” ranking on the World Bank’s annual survey moved up by 9 positions this year but the country still ranks 82nd out of the 190 countries the World Bank surveys.

Encouragingly for investors, Vietnam’s “Protecting Minority Investors” ranking shot up by 31 positions thanks in part to the more stringent enforcement of existing regulations under the country’s new government leadership, which took office earlier this year. However, even with this improvement, Vietnam is still at the 89th position.

At the same time, the country’s “Ease of Starting a Business” ranking actually fell by 10 positions and is now at 121 out of 190. The slippage in Vietnam’s relative position is more due to an improvement in other countries rather than any backtracking on Vietnam’s part.

Much work needs to be done here. New businesses must navigate a series of 10 onerous processes to become a proper, licensed businesses included such oddities as registering the company seal at the local

¹⁸ IMF, Country Report No. 16/240, Vietnam: 2016 Article IV Consultation- Staff Report; July 18, 2016.

police department and publishing an announcement of the formation of the new venture in the newspaper, etc.

If the company wants to hire foreign employees, it will typically take 3-6 months to obtain a proper work permit for those overseas experts, and if the company wants to register its head office, it will generally take two months.

This cumbersome “official” business environment means the country’s unofficial economy is a significant component of Vietnam’s real economy - so the country’s official \$2,200 per capita GDP figure is almost certainly understated.

The positives of doing business in Vietnam include an abundance of motivated workers that generally have high ethical standards and a strong sense of pride in their work, favourable tax treatment for FDI companies, relatively easy access to credit (although Vietnam does not have centralized credit bureaus yet), very good availability of electricity, which is reasonably priced (although it can take nearly six months to hook up a factory to the grid), and a rapidly improving physical infrastructure.

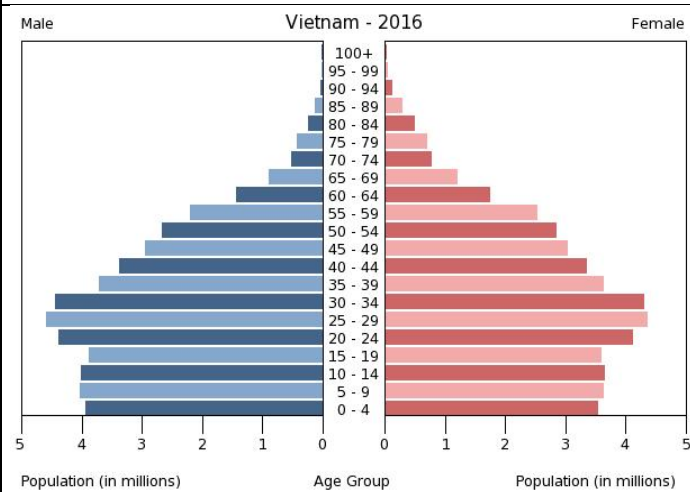
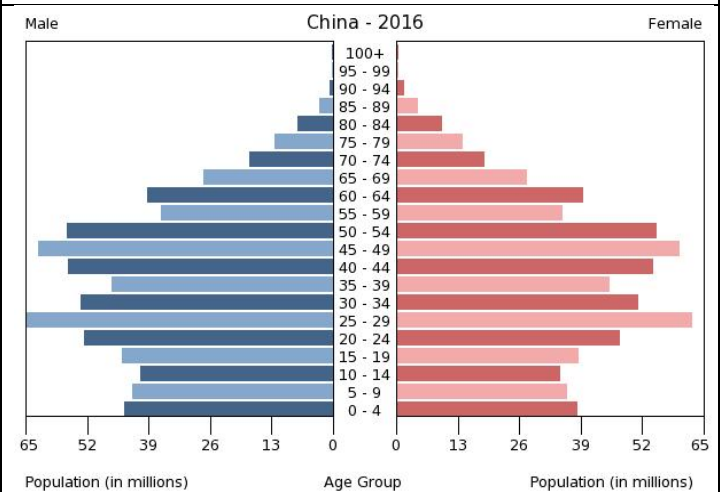
Finally, we note that Vietnamese companies and citizens are generally law abiding and that the adherence of the “rule of law” in Vietnam is quite strong, even among unofficial/ or unregistered businesses. Foreign businesses are unlikely to encounter outright fraud, or “bait & switch” business practices.

Drivers of growth.

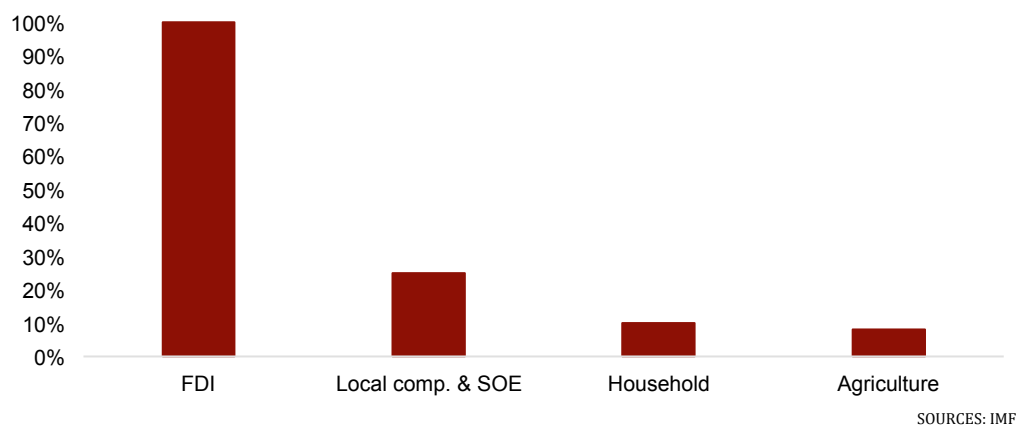
Three powerful secular drivers are currently propelling GDP growth:

- (1) Vietnam’s demographics and the improving utilization of its work force. From the supply side of the economy, there is the potential for a productivity boost. On the demand side, we are seeing an emerging middle class, which has a great appetite for a range of products and services, from smartphones to life insurance; both growing at 30%.
- (2) FDI-driven high-tech / high-value exports. For example, cell phones are now Vietnam’s single biggest export item; and
- (3) Infrastructure development. Another major potential structural growth driver, SOE reform, looks set to become a major growth driver within the next 3-4 years, following the assumption of power by Vietnam’s new reform oriented government at the beginning of this year.

Demographics. Vietnam’s has a relatively young population, with close to 40% of its people below the age of 25. However, the window to capitalise on this endowment is getting smaller and the demographic dividend is likely to decline. World Bank estimates show that the working age population is likely to decline over the next 25 years. Moreover, there is limited scope for increasing the labour force participation rate, which is close to 80% (higher than all Asian countries, except Cambodia). Thus, growth needs to come by increasing productivity.

Figure 14: Population pyramid Vietnam**Figure 15: Population pyramid China**

To some extent, there are easy gains to be made as about 45% of the population works in agriculture and can be reallocated to the more productive manufacturing sector. However, to fully benefit from such a reallocation there is a need for infrastructure development, urbanisation, and most crucially, investment. While FDI is strong, overall investment growth is not, and public investment is constrained by a lack of revenue.

Figure 16: Vietnam output per worker (FDI vs. Non-FDI workers)

The demand side of demographics though provides great promise. Based on studies by both Boston Consulting Group, and by AC Nielsen, Vietnam's middle class is on track to expand from about 15% of the country's population at present, to over 30% within the next five years, by which time Vietnam will have a middle class that is two-thirds the size of Thailand's middle class in absolute numbers. This growth presents enormous opportunities for companies that sell products and services targeted at the emerging middle class because the penetration rates for almost every type of middle-class oriented

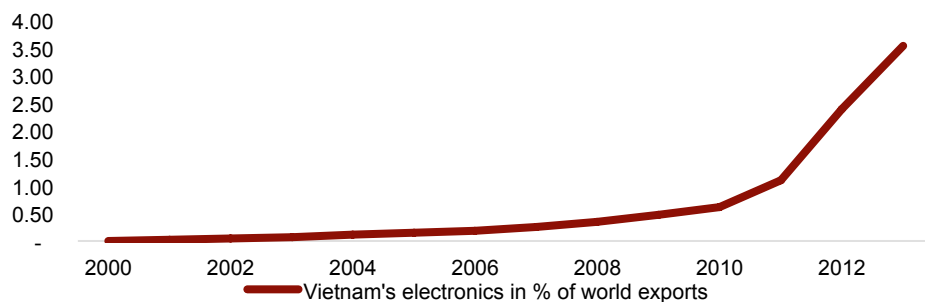
product are well below those in the rest of emerging Asia. For example, credit card penetration is 80% below that in Thailand, and Vietnam's per-capita milk consumption is 50% that of Thailand.

Tangible evidence of the exploding middle-class can also be gathered by observing the on-going transformation of the country's shopping streets; mom & pop shops are rapidly being displaced by coffee shops, clothing stores, pharmacies, and even McDonalds & Starbucks (both opened in Vietnam within the last few years). All of these thriving businesses cater to the country's burgeoning middle class, and the capital to start many of these enterprises originated from remittances by overseas Vietnamese.

The continued growth of Vietnam's middle class is heavily supported by current demographics and also by Vietnam's cultural emphasis on education and maintaining a strong work ethic. In a recent World Bank survey on income inequality, the majority of Vietnamese respondents across a range of income levels said that the gap between rich and poor is partly driven by differentials between talent and partly by hard work and effort levels, which gives an insight into the mentality of local workers.

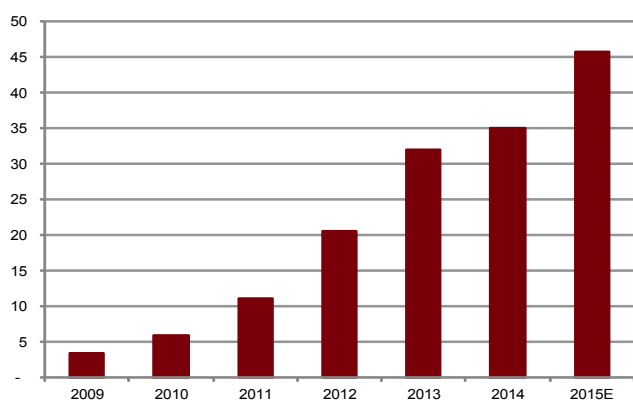
FDI-driven high-tech export growth. A steady stream of FDI inflows over the last decade has driven export growth and elevated the FDI sector to the point that it now represents about 20% of Vietnam's overall economy.

Figure 17: Vietnam market share of global electronics



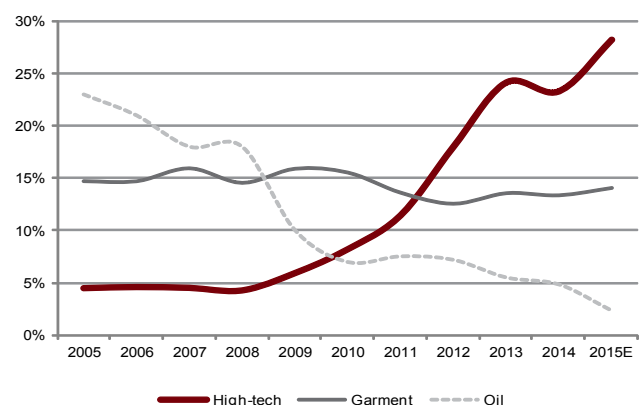
SOURCES: IMF

Figure 18: High-tech exports (US\$ bn)



SOURCES: GENERAL DEPARTMENT OF CUSTOMS

Figure 19: Vietnam's improving export composition (% of total)



SOURCES: GENERAL DEPARTMENT OF CUSTOMS

The result has been a stunning rise in Vietnam's high-tech exports (mobile phones, electronics, etc.) in both absolute terms and as a proportion of Vietnam's overall exports.

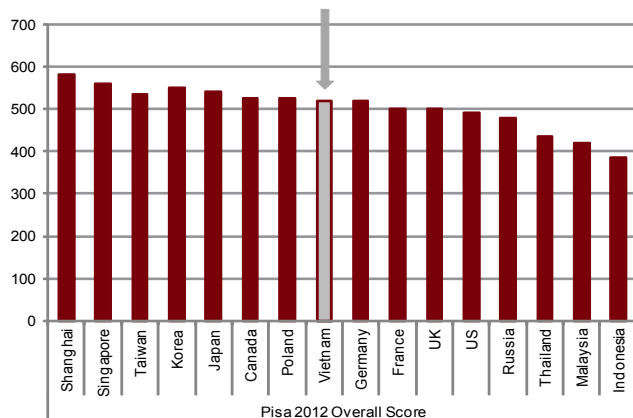
In 2012, half of Vietnam's FDI inflows originated from Japan, but Korea subsequently surpassed Japan as the biggest FDI investor in Vietnam. Korean FDI inflows have been driven by the tremendous rise of Samsung's investments in Vietnam from US\$680m in 2008 to more than US\$12bn of registered FDI projects at present, making it the largest investor in the country. Samsung currently produces nearly 20% of Vietnam's exports, so it's estimated that the difficulties with Samsung's Galaxy 7 smart phone could reduce the export growth rate by about 1 percentage point this year (from 8% yoy to 7% growth).

Japan and Korea are not alone. Taiwanese companies previously focused on producing garments and other low-value-added products in Vietnam, but now Wintek (a producer of electronic components) employs 10,000 people at its Vietnamese factories and has expressed a desire to increase its Vietnam-based production. Also, Thai companies are rapidly increasing their investments in Vietnam; their main interest is focused on petrochemicals and retailing.

The expectation that the Trans-Pacific Partnership (TPP) agreement would be enacted has prompted a blip of investments into Vietnam's textile industry. This is because the TPP would have meant that textiles which are currently imported from China would have to be made locally in order for the final garments produced in Vietnam to qualify for tax advantaged status. Now that the TPP appears to be all but dead, these inflows will almost certainly grind to a halt.

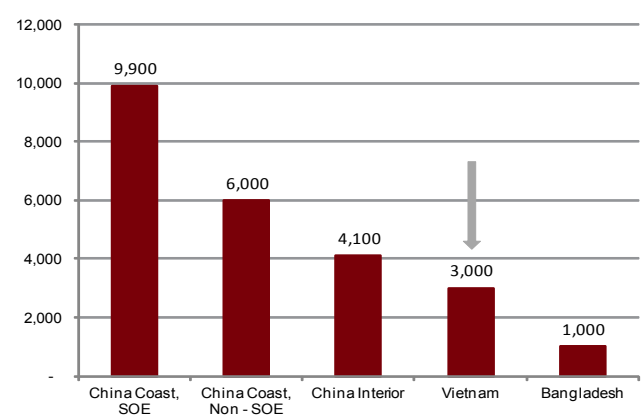
With the exception of the textiles industry, we don't expect the derailment of the TPP to have much impact on Vietnam's FDI inflows. The common theme for inward investments into Vietnam is that they are driven by low wages in Vietnam (less than half those in China/Thailand), and the good skill levels of Vietnam's labour force.

Figure 20: Pisa 2012 Overall Score



SOURCES: IMF

Figure 21: Annual Manufacturing Wages (USD)



SOURCES: IMF, JETRO

Samsung pays its factory workers about US\$350/month, indicating that Vietnam's abundance of cheap, highly skilled labour should support a steady flow of FDI inflows for years to come. One potential bottleneck to continued FDI inflows, the country's poor physical infrastructure, is being aggressively addressed, including the addition of more electricity generation capacity.

Also, a significant area of potential in Vietnam's FDI growth story is the manufacture of components for factories already in the country. The current position that only a minority of the input components used to assemble the products described above are actually made in Vietnam. And almost none of those inputs are made by local companies. In Samsung's case, less than half of its input components are made in Vietnam, and almost all of those components that are made in Vietnam are made by Korean suppliers that have co-located with Samsung in Vietnam.¹⁹

In the case of Japanese firms, the proportion of input components those firms can source locally is less than half the proportion of production inputs they source locally in China, according to Jetro (Japan External Trade Organisation) surveys. Furthermore, the products and services provided by local companies to high-tech FDI companies are currently limited to rudimentary, low-value-added offerings, such as packaging and printing.

Given the highly entrepreneurial nature of the Vietnamese, we expect a significant proportion of FDI factory managers and production engineers to start their own companies to supply those FDI funded industries. In the event, Vietnam's FDI-driven export growth story will become much more deeply rooted, and no longer predicated on cheap wages and generous tax incentives fuelling the proliferation of light assembly plants.

The country's motorcycle parts industry is possibly a harbinger of things to come for other industries, particularly the electronics industry. Over 90% of the input components used by Honda, Yamaha and SYM to manufacture motorcycles locally (mainly for domestic use) are now made by domestically by Vietnam's motorbike parts industry.

Infrastructure development. We estimate that infrastructure spending in Vietnam jumped from 2-3% of GDP in the years preceding 2013 to 5-6% of GDP at present. This jump in spending is evidenced by a plethora of highly visible, large construction projects, including roads, bridges, a new subway in Ho Chi Minh City and new power stations. Vietnam's construction steel production grew by about 25% both last year and this year, while cement consumption is up about 13% this year.

Figure 22: Major infrastructure projects

Project name	Time frame	Description
Long Thanh Airport	2015-2020	Help to ease pressure on Tan Son Nhat Airport, which is expected to become overloaded by 2017
HCMC - Long Thanh - Dau Giay Expressway	2012-2015	12km section with a 4 km bridge and 8km approach roads
Ben Luc - Long Thanh Expressway	2014-2018	57km long, four lane highway linking Long An province, in Mekong Delta, with Southern Dong Nai Province
Metro Line 1 - HCMC	2014-2019	Connecting HCMC's CBD (Ben Thanh Market) and Eastern Ho Chi Minh City (Suoi Tien Park)
Metro Line 2 - HCMC	2016-2020	Connecting HCMC's CBD (Ben Thanh Market) and North-West Ho Chi Minh City (An Suong in District 12)
Metro Line 2 - Hanoi	2016-2020	Connecting Hanoi's CBD and Hanoi's new urban area (Nam Thang Long)
Metro Line 2A - Hanoi	2011-2017	Connecting Dong Da District and Ha Dong District
Metro Line 3 - Hanoi	2014-2019	Connecting Hanoi's CBD and West Hanoi (Tu Liem)
Noi Bai - Lao Cai Expressway	2009-2014	Vietnam's longest expressway (245km), cutting Hanoi - Lao Cai travel time in half
Dau Giay - Lien Khuong Highway	2015-2018	200 km highway connecting Dau Giay district of Dong Nai Province to Lien Khuong airport in Lam Dong Province
Hanoi - Hai Phong Highway	2008-2015	105 km highway
Danang Quang Ngai Expressway	2011-2018	140 km highway
Nhat Tan Bridge	2011-2015	Vietnam's longest cable-stayed bridge, with a length of 8.9km, connecting Hanoi to Noi Bai Airport
Dong Tru Bridge	2006-2014	Vietnam's first concrete-filled steel tubular arch bridge, with a length of 1.1km and eight lanes linking Dong Anh District with Long Bien District
Trung Luong - My Thuan Expressway	2014-2019	54km long, four-lane highway connecting HCMC with Can Tho City

SOURCES: CIMB

¹⁹ An interesting corollary to this problem is that Samsung's US\$12bn Vietnam investment will ultimately attract a much higher amount of actual FDI inflows to Vietnam as supporting industries also relocate.

The spending on these mega projects will help drive GDP growth for years to come, but the longer-term implications are even more important for the country because Vietnam's poor physical infrastructure is a bottleneck to growth and could impede the flow of FDI into the country if this problem is not addressed.

3: The Outlook for Vietnam's Economy (2017-18)

Vietnam's GDP grew by 6.7% in 2015, propelled by 17% credit growth, but the country's GDP growth looks almost certain to drop back down to just above 6% in 2016, due to a severe drought in the early portion of this year, and a circa 10% collapse in Vietnam's oil production volume, due to low world oil prices. Both of these factors are likely to lessen in impact next year.

In light of the discussion above about Vietnamese banks' need to raise capital we expect credit growth to slow to 14-15% next year, and 12-14% in 2018, which means that GDP growth in Vietnam is likely to remain around 6.3% in 2017 and 2018. Inflation has had a modest uptick but that is largely due to supply shocks in agriculture. We expect it to peak at around 5% and should not affect monetary policy, though credit growth will slow.

Strong FDI inflows continue to support the Vietnamese Dong. Indeed, given the reaction of regional currencies to higher US bond yields, the risk is an appreciation in trade-weighted terms.

Vietnam has made tremendous progress developing the industrial sector of its economy, which currently contributes about 33% of GDP, but agriculture still contributes about 18% of GDP, and employs half of the country's workforce. The El Nino weather phenomenon, which has resulted in flat agriculture production this year, has depressed income growth, constraining consumption growth to about 8% this year, which is low by Vietnamese standards. (Consumption makes up about 60% of GDP).

Some areas of consumption growth are likely to regain some strength next year given banks' aggressiveness in lending to consumers. Further to that last point, we expect retail lending to grow by about 40% in 2016 and 30% in 2017, which should help fuel 30% automobile sales growth in both years. We expect outstanding mortgages to grow 18% in 2016 and 14% in 2017; household credit in Vietnam is less than 30% of GDP.

There are other areas of strength. The manufacturing sector is growing by about 10% this year, and we expect comparable growth next year, given an 8% increase in FDI inflows this year. Construction activity is up about 9%, driven by a 25% increase in housing investment and a surge in infrastructure spending (we expect housing investment growth to moderate to 15% next year, and spending on infrastructure development to accelerate).

Despite the anti-trade rhetoric of U.S. President Elect Donald Trump, we expect Vietnam's exports to grow by 7% yoy in both 2016 and 2017, and that about 25% of Vietnam's overall exports will continue to be shipped to America (Vietnam is ASEAN's biggest exporter to the US).

America's "pivot towards Asia" may be over under Mr. Trump, but its "pivot towards Vietnam" is likely to accelerate as Mr. Trump has a difficult relationship with China and both the Philippines and Malaysia have moved politically closer to China in recent months. We think it is very unlikely that Mr. Trump will push to impose stiff tariffs on products imported from Vietnam.

Although Vietnam was touted as the biggest beneficiary of the TPP, our view is that the benefits of the TPP were overestimated, so we are not concerned that the TPP may not see the light of day. We have always been sceptical of claims by the World Bank and others that the TPP could add 0.5% to Vietnam's GDP growth rate because only about 15% of Vietnam's overall exports are garments and other items that carry high tariffs. Technology-related items, such as cell phones, electronics etc. now comprise 30% of Vietnam's overall exports, and such items were unlikely to get much of a boost from the TPP. The fact that wages in Vietnam are about half those in China, with an equally skilled workforce is much more important in our opinion.

Next, the monetary and fiscal policies the government pursued this year are likely to linger into 2017. Specifically, we expect relatively loose monetary policy to continue next year (M2 growth was 17% in the first nine months of 2016), in order to help facilitate the disposal of bad debts by VAMC. Less than 10% of the US\$11 billion NPLs which local commercial banks transferred to the VAMC have been resolved. That said, we also expect relatively high real rates (policy rates are 6.5%, while inflation is below 3%), which will help support the currency.

Finally, the government needs to rein in its near 6% of GDP budget deficit because the country's government debt-to-GDP ratio is likely to reach 65% next year, which is its statutory maximum level. Tax revenues grew 13% yoy in the first nine months of 2016 due to better enforcement, and we expect the introduction of a property tax in 2017.

Figure 23: Key Indicators and Forecasts

Annual Data	2015					
Nominal GDP (USD bn)	193.4					
GDP per capita (USD)	2,109					
Population (mln)	91.7					
	2013	2014	2015	2016F	2017F	2018F
Real GDP growth (%yoy)	5.4	6.0	6.7	6.2	6.5	6.5
Real consumption growth (%yoy)	5.4	6.2	9.1	7.0	9.0	8.0
- Public consumption (%yoy)	7.3	7.0	7.0	7.0	6.0	7.0
- Private consumption (%yoy)	5.2	6.1	9.3	7.0	10.0	9.0
Real gross capital formation (%yoy)	5.4	8.9	9.0	9.0	9.0	8.0
Real export growth (%yoy)	17.4	11.6	12.6	7.0	9.0	8.0
Real import growth (%yoy)	17.3	12.8	18.1	2.0	5.0	5.0
Nominal export growth (%yoy)	15.4	13.7	7.9	6.0	9.0	8.0
Nominal import growth (%yoy)	16.1	12.0	12.0	2.0	5.0	5.0
Trade balance (USD bn)	0.1	2.4	-3.6	-	-	-
- % of GDP (%)	0.0	1.3	-1.8	3.0	-2.0	-1.0
Current account balance (USD bn)	-	9.4	0.9	-	-	-
- % of GDP (%)	-	5.0	0.5	0.5	-1.0	-2.0
Reserves, end of period (USD bn)	26.3	34.6	28.6	-	-	-
- foreign reserves to months of imports	2.1	2.5	1.9	2.9	2.7	3.5
- short term debt (% of total reserves)	47.1	38.2	-	-	-	-
Fiscal balance (% GDP)	-7.4	-6.1	-5.9	-6.4	-5.5	-4.5
Retail sales growth (%yoy)	12.3	11.6	10.9	7.0	9.0	9.0
Industrial Production Index growth, average (%yoy)	7.7	7.5	11.7	9.0	11.0	9.0
Narrow money (M1) growth, average (%yoy)	22.0	24.5	19.7	20.0	17.0	15.0
Broad money (M2) growth, average (%yoy)	25.4	19.6	16.8	20.0	17.0	15.0
Domestic credit to private sector (% GDP)	96.8	100.3	111.9	125.1	135.8	138.0
Consumer Price Index (CPI), end of period (%yoy)	6.0	1.8	0.6	4.0	4.0	3.0
Consumer Price Index (CPI), average (%yoy)	6.6	4.1	0.6	2.0	4.0	3.0
Policy rates (end period)	7.0	6.5	6.5	6.5	6.5	6.3
Exchange rate vs. USD, end period	21,036	21,246	21,890	22,100	22,500	23,200
Quarterly data	2Q15	3Q15	4Q15	1Q16	2Q16	3Q16
GDP (%yoy)	6.3	6.4	6.7	5.6	5.6	5.9
CPI, average (%yoy)	1.0	0.5	0.3	1.7	1.9	1.8
Exchange rate vs. USD, end period	21,673	21,890	21,890	21,857	21,873	21,941

SOURCE: CEIC, CIMB Research

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