Vietnam Economic Insight

2015

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Executive Summary

Recent Developments

- Vietnam is a standout performer in Emerging Markets (EMs) in terms of real GDP and export volume growth
- Real GDP growth picked up to 6.5% year on year in Q3 2015 due to a pickup in domestic demand and high export growth, boosted by the signing of the Trans Pacific Partnership (TPP) and other trade deals
- Inflation fell to 0.3% year on year in November 2015, in line with lower international food and oil prices
- The budget deficit averaged 6.8% of GDP in 2012-14, raising public debt to over of 60% of GDP this year
- The current account surplus has fallen in 2015, despite strong export growth, as imports grew even faster due to purchases of machinery and equipment in foreign direct investment (FDI) sectors
- In the banking sector, the real estate recovery and improving liquidity have boosted credit growth to 19.2% year on year in September 2015

Macroeconomic Outlook (2015-17)

- We expect real GDP growth to accelerate from 6.4% in 2015 to 7.0% in 2016 and 7.5% in 2017 as domestic conditions improve further and free trade deals come into force
- Inflation is expected rise (1.5% in 2016 and 3.3% in 2017) in line with global commodity prices and stronger demand
- The budget deficit is expected to push public debt through the legal limit of 65% of GDP in 2017 as the government avoids sharp reductions in spending
- An import surge may lead to a small current account deficit in 2015, but high export growth should lead to surpluses of 1.7% of GDP in 2016 and 6.4% in 2017
- The banking sector should continue to recover with credit growth outpacing deposits

Background

Vietnam is an export-oriented economy with 91m people and a highly competitive labour force

Vietnam has emerged over the last three decades as one of the world's economic success stories. In 1986, in response to poor economic performance, reforms were initiated to shift from central planning to a market economy. Since then, real GDP growth has averaged 6.6%, barely interrupted by either the Asian financial crisis in 1997 or the global financial crisis in 2008. This was mainly achieved by a focus on labour-intensive manufacturing for export. A young population has driven labour force growth while a steady supply of workers moving to the cities from rural areas has kept wages competitive. Vietnam is also well placed on the trade routes of South East Asia and close to China, helping integration into the supply chains of "factory Asia". As a result, the value of goods exports has grown from 2.9% of GDP in 1988 to 80.7% in 2014.

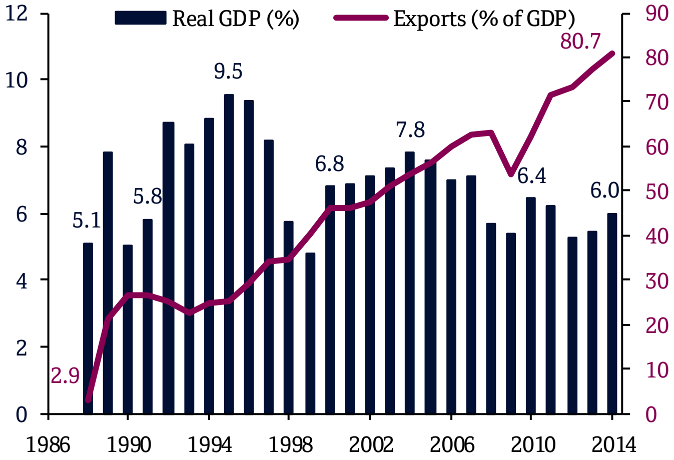
Economic restructuring and the opening up of markets has driven growth

Vietnam is endowed with fertile land and, as a result, agriculture played a significant role in the economy. However, since 1986, the economy has been restructured with an increasing allocation of resources into more productive sectors, such as hydrocarbon extraction, manufacturing and services. The economy was also opened up to FDI, encouraging the transfer of know-how in strategic sectors and enhancing productivity. Permitting private competition encouraged the development of strategic sectors, such as food processing for export and banking. In recent years, the government has continued to liberalise the economy, focusing on "equitizing" state-owned enterprises (SOEs) with current plans to sell off stakes in over 400 companies.

Vietnam is one of the world's most attractive destinations for FDI

Foreign investors are attracted by the competitive labour force, large domestic market, political stability, sound macroeconomic conditions and an improving business environment. Additionally, restrictions on foreign ownership have gradually been lifted. In 2007, Vietnam joined the World Trade Organisation (WTO), leading to a surge in FDI. More recently, restrictions on foreign ownership in real estate have been lifted, mainly benefitting foreign individuals. Most investment from corporations has gone into manufacturing of clothes, textiles, electronics and consumer goods. Furthermore, Vietnam is currently negotiating a raft of free trade deals, including the TPP, which should lead to even deeper integration with the global economy and stronger FDI.

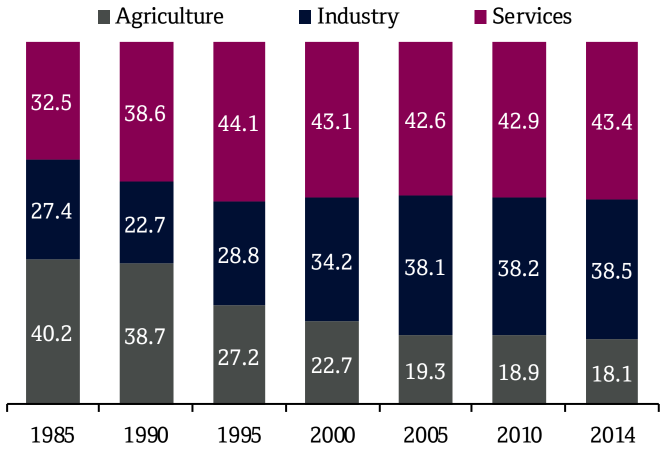
Exports and real GDP growth



Sources: IMF, State Bank of Vietnam (SBV), Asian Development Bank and QNB Economics

GDP by sector

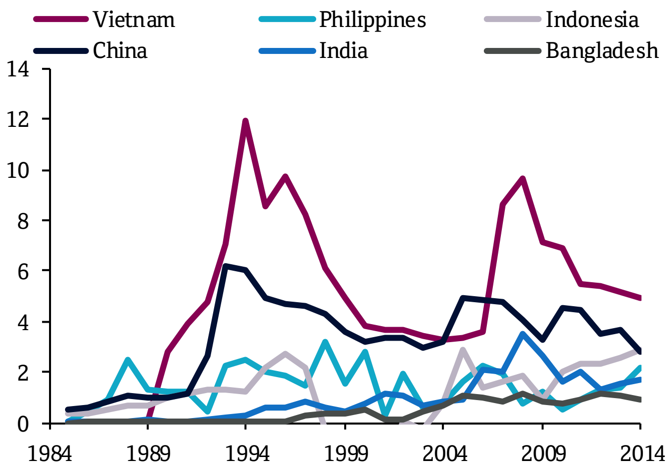
(% shares)



Sources: World Bank and QNB Economics

FDI peer group comparison

(% of GDP)



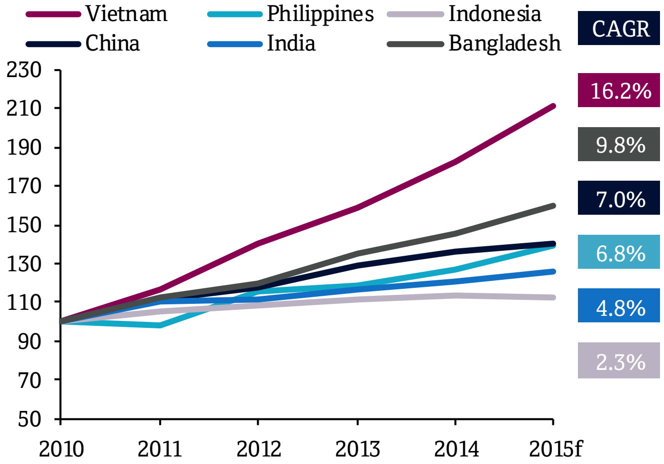
Sources: World Bank and QNB Economics

Recent Developments

Vietnam is a standout performer amongst EMs

Vietnam has outperformed its EM peer group in recent years in terms of export volume growth. Export volumes rose around 16% in 2015, despite weak performance in other EMs, for a number of reasons. First, Vietnam is attracting strong investment in low-end manufacturing for export, thanks to competitive wages and free trade deals. The latter give investors a competitive advantage in terms of access to large markets. For example, an initial agreement on the TPP was signed in July and a free trade agreement (FTA) with the EU was concluded in December. Second, low-end manufacturing exporters are shifting from China to Vietnam as China shifts to higher-end manufacturing and as Chinese wage levels rise. Finally, Vietnam's exports have been resilient to the global slowdown as demand for its products is relatively inelastic (food, clothes and textiles, for example).

Export volume growth, peer group comparison
(Indices, 2010=100)

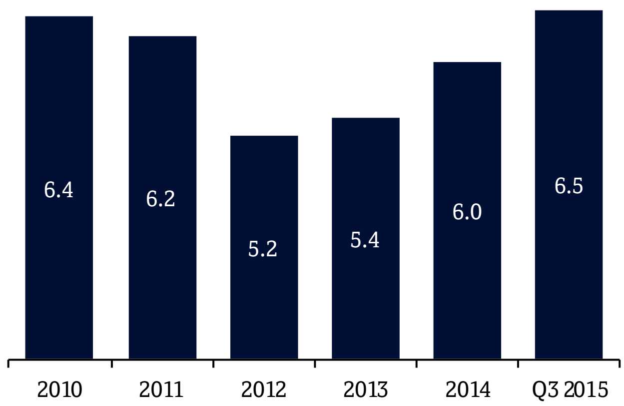


Sources: IMF and QNB Economics

Real GDP growth is accelerating on domestic demand gaining momentum and strong exports

In addition to strong export growth, domestic demand has picked up, benefiting from rising real wages and a recovery in credit growth and real estate. Since 2011, inflation has fallen from high levels to almost zero, raising real incomes and driving domestic consumption. This has benefited sectors like retail trade (vehicle sales are up 57% so far in 2015) and the major conglomerate, VinGroup, plans to open 2,000 retail stores in the next two years. Meanwhile, strong exports are raising incomes and domestic investment. A pickup in real estate activity (prices were up 5-7% in Q3, year on year) is having positive wealth effects, although this does come with risks of a real estate correction. Finally, the fiscal stance has been expansionary, supporting growth.

Real GDP
(%, year on year)

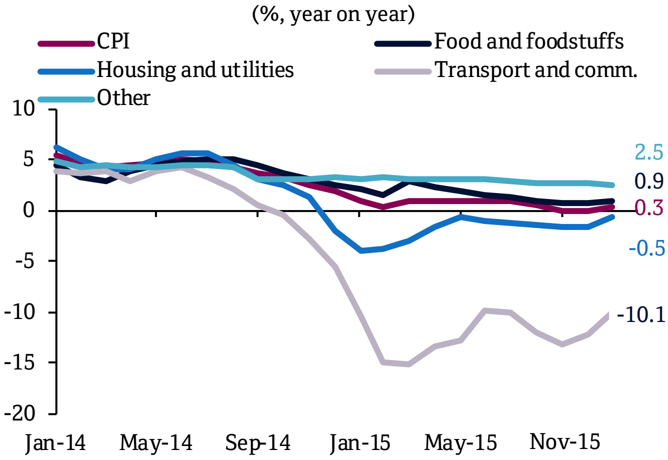


Sources: IMF and QNB Economics

Inflation is falling in line with lower international food and oil prices

Inflation has been dragged down to 0.3% year on year in November 2015, compared to 4.1% in 2014. Foodstuffs account for 40% of the CPI basket with inflation of 0.9%. Lower inflation is, therefore, largely due to the sharp decline in international food prices in 2015 (-15%). Oil prices have had a deflationary impact on the next two largest components of CPI. Both transport and communications (9% of the basket) and housing and utilities (10%) are in deflation. The other CPI components (such as clothes, household equipment, education and health) recorded inflation of 2.5% in November, compared with 4.4% in 2014. Lower inflation in the price of necessities such as food and housing is having a positive impact on disposable incomes, supporting domestic consumption.

Inflation
(%, year on year)



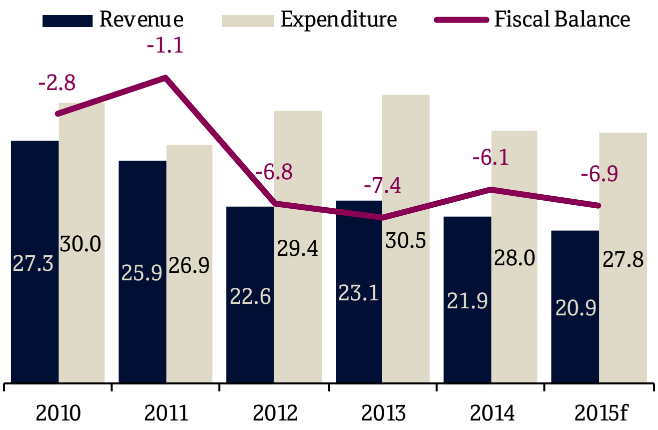
Sources: General Statistics Office of Vietnam (GSOV) and QNB Economics

The budget deficit is high and rising, raising public debt

In 2012-14, the budget deficit averaged 6.8% of GDP, according to the IMF, well above the historical average of around 2%. The larger deficit arose in 2012 as a result of cuts to corporate tax rates as well as tariff reductions and exemptions. In 2014-15, revenue declined further due to lower international oil prices (oil accounted for 12% of total government revenue in 2013). Consequently, the budget deficit is estimated to have widened to 6.9% of GDP in 2015. Persistent budget deficits have pushed up public debt from a low of 46.5% of GDP in 2011 to over 60% currently. Most public debt is in local currency (62%), but it is increasingly short term (53% of debt matures in the next five years). The IMF has expressed concerns about the rising level of public debt.

Fiscal deficit

(% of GDP)



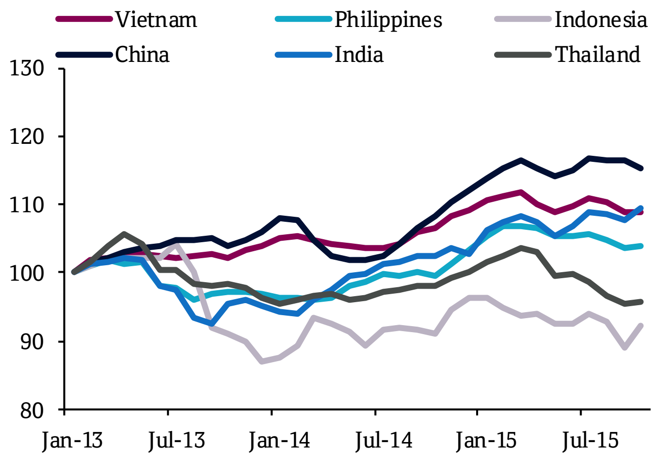
Sources: IMF and QNB Economics forecasts

The trade-weighted exchange rate is appreciating, reducing competitiveness

The SBV targets a daily exchange rate versus USD, with a price that is permitted to deviate within a trading band. Historically, SBV has gradually weakened VND against USD to try and conserve competitiveness. China is the largest trade partner (20% of trade), so Vietnam is sensitive to Chinese Yuan (CNY) movements. In August, in response to a 4.7% devaluation of CNY, SBV devalued VND against USD and widened the trading band from 1% to 3%. In 2015, while VND has weakened against USD it has strengthened against other currencies, eroding competitiveness. The REER captures this lost competitiveness. It is a trade weighted currency index that also adjusts changes in nominal exchange rates for differences in inflation. The appreciation of the REER partly explains Vietnam's widening trade deficit, robust domestic demand and falling inflation.

Real effective exchange rate (REER) comparison

(Indices, Jan-13=100)



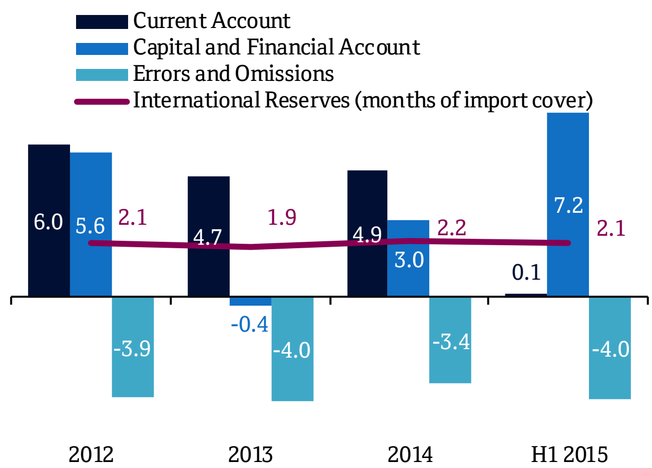
Sources: J.P. Morgan and QNB Economics

The current account surplus has evaporated in H1 as imports grew on the back of higher FDI inflows

Despite strong export growth, the trade balance fell into deficit in 2015. Imports outpaced exports, equating to 96% of GDP up from 87% in 2014. The fastest growth area was machinery and equipment in FDI sectors. Foreign investment has flowed in as the anticipated approval of TPP is expected to drive up domestic and external demand, pushing up capital goods imports. In terms of exports, lower oil prices have offset the positive impact of higher export volumes. On the rest of the current account, repatriation of corporate profits creates an outflow that is offset by inflows of remittances from workers overseas. The capital and financial account (CFA) recorded a large surplus in H1 thanks to FDI and other inflows. However, this was offset by errors and omissions, probably related to underestimation of investment outflows or changes in household holdings of foreign exchange. As a result, we estimate that international reserves fell slightly this year to around 2.1 months of prospective import cover.

Balance of Payments

(% GDP)



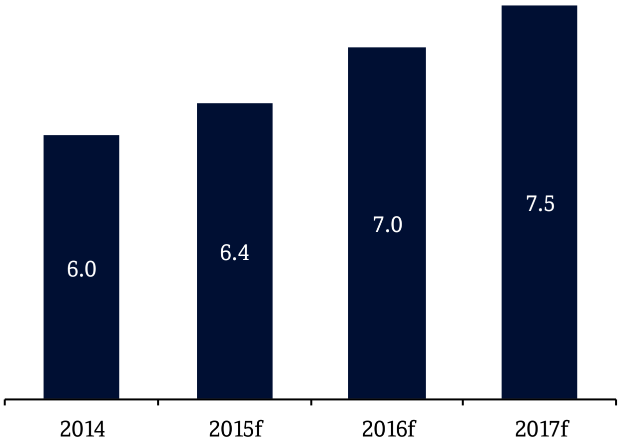
Sources: Asian Development Bank, State Bank of Vietnam and QNB Economics

Macroeconomic Outlook (2015–17)

Real GDP growth may accelerate as free trade deals are finalised and as domestic conditions improve further

We expect real GDP growth to pick up to 7.0% in 2016 and 7.5% in 2017. The positive forces driving exports (such as low wages and shifting supply chains) will persist. FDI has already risen after trade agreements were signed in 2015, but the strongest impetus to growth and exports will come once the TPP comes into force, likely in 2017. Domestic demand should remain strong. Incomes could be boosted by the strong export sector, while the housing recovery is in its early stages and may bolster investment and consumer sentiment. Finally, the Communist Party is holding its National Congress in early 2016 and appointing a new leadership. No major policy changes are anticipated, but uncertainty could be holding back investment, which will be released after the Congress, adding to growth during H2 2016 and in 2017.

Real GDP
(%, year on year)



Sources: GSOV and QNB Economics forecasts

Free trade deals should provide a large economic boost

Vietnam is part of the TPP, is negotiating a raft of other trade deals and has concluded an FTA with the EU. TPP involves 12 Pacific Rim economies accounting for 37% of global GDP and 26% of world trade. It is the largest trade pact in two decades. An initial agreement was signed in July, but needs to be ratified by national parliaments. If approved, which is likely, TPP would deepen Vietnam's access to large markets (US and Japan), boosting exports. In anticipation, FDI is pouring into Vietnam. Samsung has announced USD6bn of investment in smartphone and display factories. LG, Microsoft and Intel are expanding in Vietnam. In garments and textiles, FDI is rising from China, Japan, South Korea, Australia and US. One estimate expects the TPP to add, on average, 1.0% to real GDP growth and 2.5% to export volumes, each year for 10 years. We estimate that the boost from trade deals added 0.5% to real GDP in 2015, which will rise in 2016-17.

Estimated Average TPP Gains 2016-25
(% addition to the baseline growth)

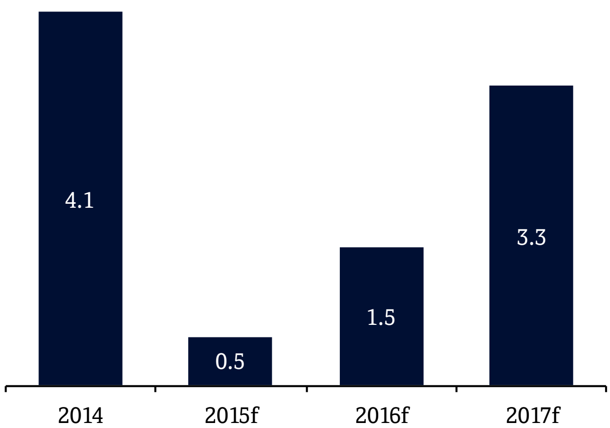
	Exports Volumes	Real GDP
Vietnam	2.5%	1.00%
Malaysia	1.1%	0.55%
Japan	1.1%	0.20%
New Zealand	0.7%	0.20%
Peru	0.6%	0.12%
US	0.4%	0.04%
Singapore	0.4%	0.19%
Mexico	0.4%	0.05%
Australia	0.3%	0.05%
Brunei	0.3%	0.09%
Chile	0.2%	0.09%
Canada	0.2%	0.04%

Sources: Petri (2015), "Understanding the Estimated Gains from Trade Pacts" and QNB Economics

Inflation is expected to move in line with global commodity prices and stronger demand

In 2016, flat oil prices and an appreciating trade-weighted exchange rate are expected to keep inflation low at 1.5%. We expect oil prices to be largely unchanged, on average, leading to flat housing, utilities and transport inflation. The World Bank expects less of a decline in international food prices, leading to slightly higher Vietnamese food prices. Inflation in other categories may rise due to stronger domestic demand and a tighter labour market. Unemployment fell to 2.5% in 2015 and is expected to bottom out at that level, which, over time could lead to higher wages and more inflation. In 2017, we project inflation will rise to 3.3% due to higher expected international oil prices, the continued tightening of the labour market and a further acceleration of domestic demand.

Inflation
(% change, annual average)



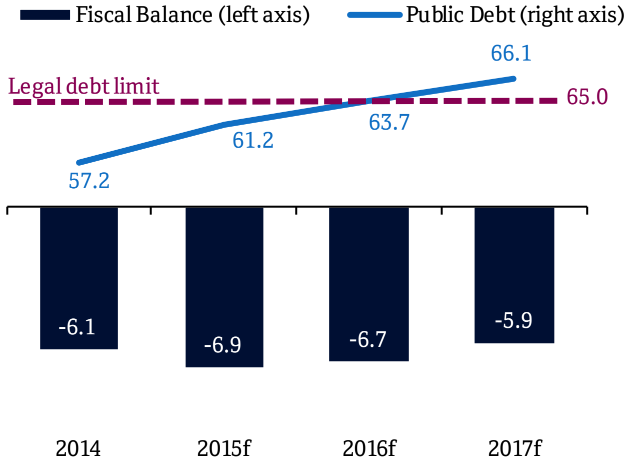
Sources: GSOV and QNB Economics forecasts

The budget deficit is expected to push public debt through the legal limit in 2017

The budget deficit is expected to fall to 5.9% of GDP in 2017, a relatively high level. Revenue should rise as the economy picks up and as oil prices recover in 2017. The government is likely to consolidate expenditure as public debt (~61% of GDP) is nearing the legal limit (65%). Nonetheless, we expect the debt limit to be breached in 2017 and the government is expected to either raise or ignore the limit. The alternatives are unpalatable. First, sharper than expected spending cuts would negatively impact the economy. Second, the SOE privatisation programme is behind schedule and revenue is unlikely to surprise on the upside. Third, foreign exchange reserves are low and are, therefore, unlikely to be used to reduce debt. We expect fiscal consolidation to have a small impact on growth in 2016 and a larger impact in 2017 as expenditure is reined in.

Fiscal Deficit and Public Debt

(% of GDP)



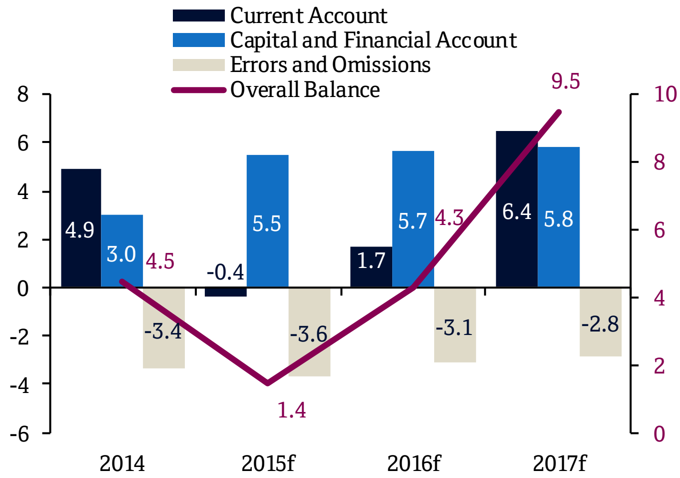
Sources: IMF and QNB Economics forecasts

An import surge may lead to a current account deficit in 2015, offset by stronger exports in 2016-17

The current account may record a deficit in 2015 due to surging imports. TPP encouraged manufacturing FDI in 2015, leading to higher imports of machinery and equipment. In 2016, we expect a small current account surplus as import growth abates and as exports pick up on trade deals. In 2017, we expect TPP to come into force, boosting exports and generating a higher current account surplus. On the CFA, strong FDI inflows into manufacturing for export will support a stable CFA surplus. The CFA should be resilient to the capital flight that has blighted other EMs for a number of reasons. First, the stable macroeconomic environment. Second, FDI dominates capital inflows and is not prone to flight. Third, the capital account is tightly controlled. Outflows through errors and omissions are probably related to dollarisation of cash, which we expect to moderate going forward as VND devaluation slows.

Balance of Payments

(% of GDP)

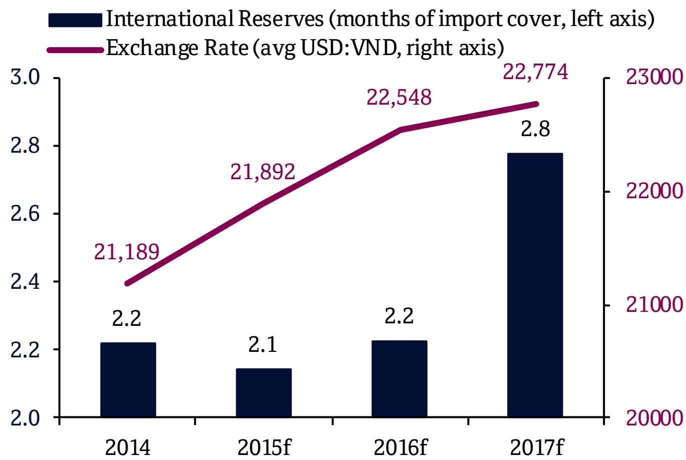


Sources: Asian Development Bank, IMF, SBV and QNB Economics forecasts

VND is likely to be devalued gradually against USD to try and conserve export competitiveness

SBV is likely to gradually devalue VND against USD. First, the trade balance has fallen into deficit, making competitiveness more important. Second, rising short-term US rates, particularly in 2016, should lead to a stronger USD. As a result, VND will likely appreciate against trading partners with floating exchange rates unless it is devalued against USD. Third, in December, China switched to targetting a trade weighted basket of currencies, which means CNY may weaken against USD. This could push the SBV to devalue against USD as well, as happened in 2015. Fourth, low international reserves limit SBV's capacity to support VND against USD if external deficits arise. Finally, devaluation would help lift inflation towards the 5% target. In 2017, devaluation should slow as the Fed nears the end of its tightening cycle, international reserves increase on strong FDI and inflation picks up.

Exchange Rate and International Reserves



Sources: Asian Development Bank, SBV, Vietcombank, World Bank and QNB Economics forecasts

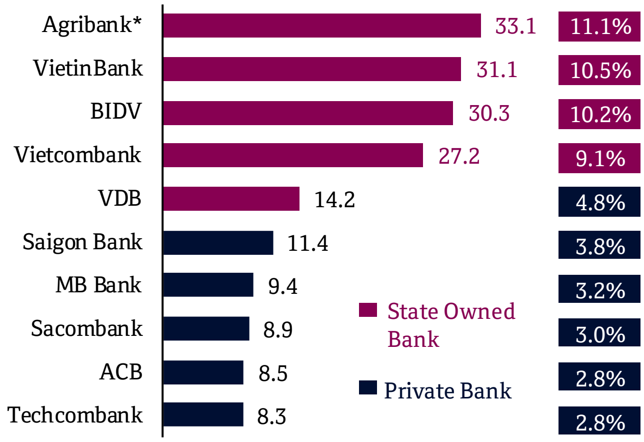
Banking

The largest banks are state owned and have relatively high exposure to SOEs

There are 40 banks in Vietnam. The sector is dominated by four large majority state-owned banks, which account for 41% of banking sector assets. The government banks were originally established as specialised government credit institutions and they are still relatively exposed to SOEs, which account for 20-30% of their loan books. Government banks are also influenced by government policy directives and SBV advice to offer lower interest rates to priority sectors. In addition to the government banks, there are five wholly owned foreign banks, five joint venture foreign/local banks and the remainder are private banks. Foreign ownership is capped at 30% (20% for a strategic investor and 15% for non-strategic), but the government is expected to raise this limit.

Largest banks by assets

(as of end-2014, bn USD; market share, %)



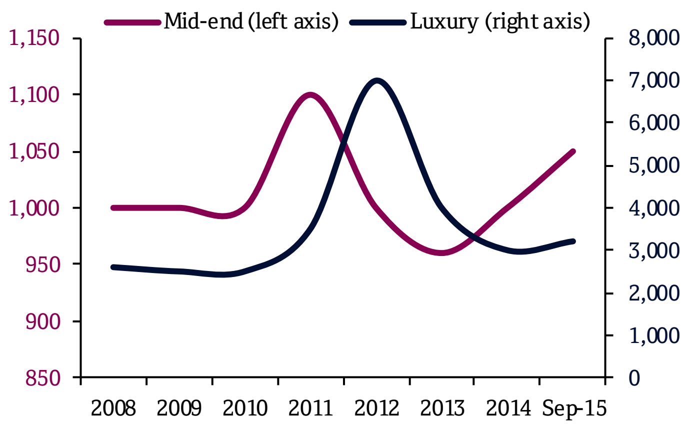
Sources: Bankscope and QNB Economics; *As of 2013

A property crash led to high NPLs, but real estate prices have begun to recover

The banking sector is recovering from a 2011-12 real estate crash when prices fell sharply, leading to high NPLs. Official NPLs rose to 4.5% of total loans by the end of 2013, then fell to 3.7% by mid-2015. But problem loans are actually higher. Vietnam's accounting standards enabled banks to restructure problem loans as other assets, like special mention loans (SMLs, about 3% of total loans). Also, a bad bank, the Vietnam Asset Management Company (VAMC), was set up in 2013 to take NPLs off banks' balance sheets. But, this debt still needs to be written off by banks over the next 10 years. VAMC loans are about 3.4% of total loans, so total problem loans are high at ~10% of loans in mid-2015 (adding NPLs, SMLs and VAMC loans), although they are falling gradually.

Hanoi residential new property prices

(USD per square metre)



Sources: Colliers International and QNB Economics

The banking sector is undergoing consolidation

SBV is supporting mergers, acquisitions and strategic partnerships to restructure and recapitalise the sector and plans for only 15 banks by 2017. Banks heavily impacted by the real estate crash are being merged with stronger banks, SBV has acquired three weak banks in 2015 and there are opportunities for foreign banks. For example, Bank of Tokyo Mitsubishi acquired a 20% stake in Vietinbank. In February, a law came into effect prohibiting local banks from: (a) owning more than a 5% stake in other banks, and (b) owning stakes in more than two other banks. This should encourage mergers and strategic partnerships. There are currently four mergers in the pipeline (Vietinbank-PGBank, Sacombank-Southern Bank, Maritimebank-Mekong Development Bank, and Vietcombank is said to be looking for a suitable target).

Banking sector consolidation

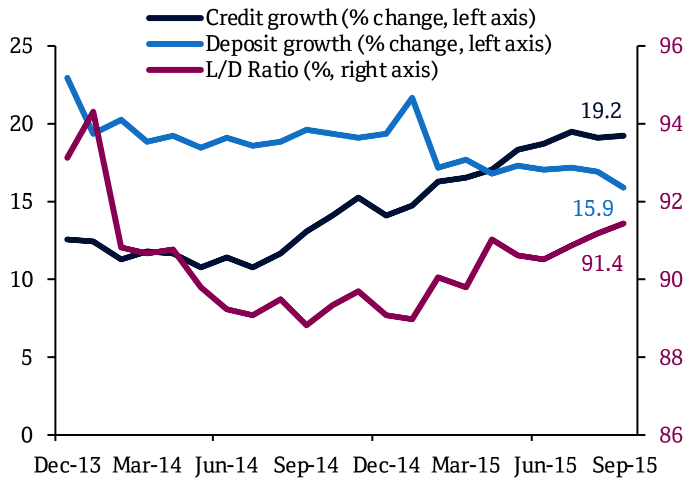
2011	Merger of Ficombank, TinNghiaBank, and Saigon Bank
2011	Mizuho Bank acquired 15% stake in Vietcombank
2011	Macquarie Capital acquired 14% stake in Saigon Commercial Bank
2012	ANZ divested 9.6% of Sacombank
2012	Saigon Hanoi Bank acquired Habubank
2012	Bank of Tokyo Mitsubishi acquired 20% stake in Vietinbank
2013	Merger of WesternBank and PVFC to form PVcomBank
2013	Merger of DaiA Bank and HD Bank
2013	OCBC Singapore divested 15% of VPBank
Feb-15	SBV acquires VNCB for zero and Vietcombank takes over management
Apr-15	SBV acquires Oceanbank for zero and Vietinbank takes over management
May-15	Merger of BIDV and Mekong Housing Bank
Jul-15	SBV acquires GPBank for zero and Vietinbank takes over management
Aug-15	Merger of Maritime Bank and Mekong Development Bank
Oct-15	Merger of Sacombank and Southern Bank

Sources: S&P, Reuters and QNB Economics

The real estate recovery and improving liquidity have boosted credit growth

Credit growth picked up to 19.2% year on year in September 2015 from of 14.2% in 2014. After the real estate bust, banks deleveraged and credit growth slowed, while deposit growth remained robust in comparison. The loan to deposit ratio fell from 110% in 2011 to 89% in 2014. However, the deleveraging process has now ended, credit growth has begun to pick up and the loan to deposit ratio is rising, although it remains low (91% in September). Deposit growth is now lagging credit growth for two main reasons. First, SBV policy rates have been cut as inflation has eased, leading to lower deposit rates. Second, some savings are being invested in real estate. Return on equity at the nine listed banks was 10.9% in Q3 2015, broadly unchanged since 2014, as higher provisioning for bad loans offset the positive effects of higher credit growth and falling NPLs. The capital adequacy ratio was 11.8% in 2012, but bank disclosures on capital and risk weighted assets have been limited since then.

Loans and deposits

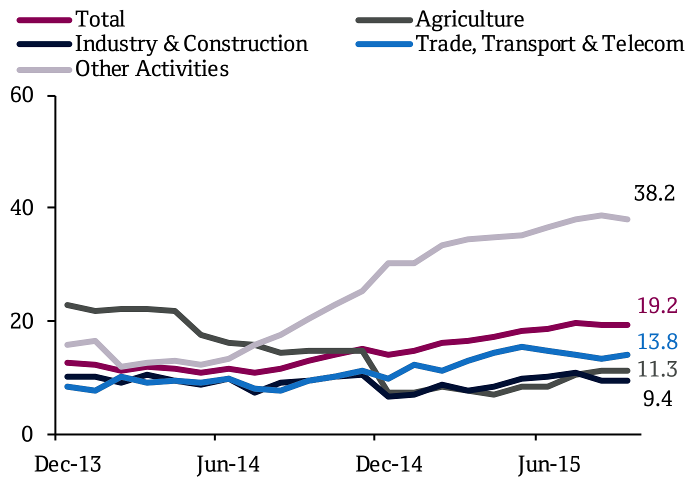


Sources: SBV and QNB Economics

Loan growth has picked up across most sectors over the last year, except agriculture

The main driver of rising credit growth in the first nine months of 2015 was “Other Activities”, which accounts for 35% of total credit and contributed 11.4% to overall credit growth of 19.2%. Other Activities mainly include personal loans and loans to real estate and financial services sectors, which have been accelerating on accelerating economic growth and rising incomes. The next largest contributors to credit growth were trade (2.4%) on the back of the strong retail sector and construction (1.9%) with the recovery in real estate and industry (1.6%). While lending to agriculture contributed 1.2%, credit growth to the sector has slowed over the last year.

Lending growth by sector
(% year on year)

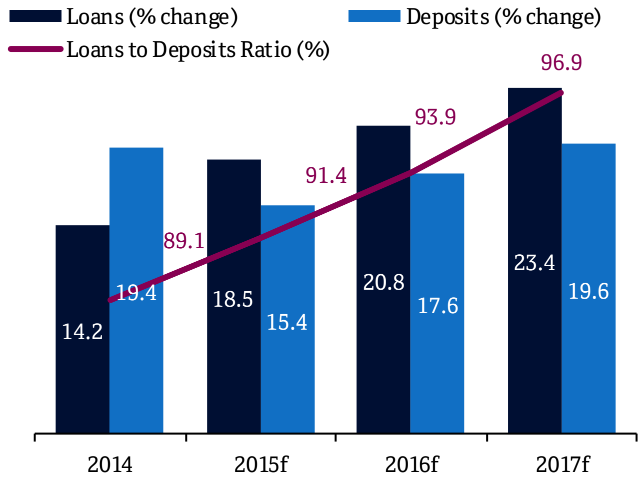


Sources: SBV and QNB Economics

The banking sector should continue to recover with credit growth outpacing deposits

We expect loan growth to continue to accelerate with strong demand for credit supported by accelerating economic growth and rising incomes. We expect deposit growth at a slightly slower rate than credit growth as low deposit rates continue to encourage savers to invest in alternatives to bank deposits. As a result, we expect the loan to deposit ratio to rise steadily, although it should remain under 100%. NPLs should continue to fall as the economy recovers, but profitability is unlikely to improve with banks continuing to increase provisions for bad loans as they are currently under-provisioned.

Loans and deposits outlook



Sources: SBV and QNB Economics forecasts

Macroeconomic Indicators

	2010	2011	2012	2013	2014	2015f	2016f	2017f
Real sector indicators								
Real GDP growth (%)	6.4	6.2	5.2	5.4	6.0	6.4	7.0	7.5
Nominal GDP (bn USD)	112.8	134.6	155.6	170.5	185.8	192.3	202.8	222.8
Growth (%)	11.0	19.4	15.6	9.6	9.0	3.5	5.5	9.9
GDP per capita (k USD)	4.4	4.7	5.0	5.3	5.7	5.9	6.2	6.7
Consumer price inflation (%)	9.2	18.7	9.1	6.6	4.1	0.5	1.5	3.3
Budget balance (% of GDP)	-2.8	-1.1	-6.8	-7.4	-6.1	-6.9	-6.7	-5.9
Revenue	27.3	25.9	22.6	23.1	21.9	20.9	20.8	21.3
Expenditure	30.0	26.9	29.4	30.5	28.0	27.8	27.5	27.1
Public debt	48.1	46.5	48.6	52.6	57.2	61.2	63.7	66.1
External sector (% of GDP)								
Current account balance	-3.8	0.2	6.0	4.7	4.9	-0.4	1.7	6.4
Goods and services balance	-10.8	-6.3	0.7	-1.0	-0.2	-5.3	-2.8	2.4
Exports	71.1	78.7	80.0	83.9	86.9	90.8	99.1	112.7
Imports	81.8	85.0	79.3	84.9	87.2	96.1	102.0	110.3
Other current balances	7.0	6.5	5.3	5.7	5.2	4.9	4.5	4.0
Capital and Financial account balance	5.5	4.8	5.6	-0.4	3.0	5.5	5.7	5.8
Errors and Omissions	-3.3	-4.1	-3.9	-4.0	-3.4	-3.6	-3.1	-2.8
International reserves (prospective import cover)	1.3	1.3	2.1	1.9	2.2	2.1	2.2	2.8
External debt	39.8	39.4	38.0	38.4	38.8	40.1	39.5	35.9
Monetary indicators								
M2 growth	33.3	12.1	18.5	18.8	17.7	4.2	8.7	8.9
Interbank interest (%, 3 months)	13.4	14.0	9.0	6.8	5.1	n.a.	n.a.	n.a.
Exchange rate USD:VND (avg)	19,131	20,649	20,859	21,017	21,189	21,892	22,548	22,774
Banking indicators (%)								
Return on equity	17.7	16.4	8.2	n.a.	n.a.	n.a.	n.a.	n.a.
NPL ratio	2.1	2.8	4.1	3.6	3.3	n.a.	n.a.	n.a.
Capital adequacy ratio	11.3	12.9	11.8	n.a.	n.a.	n.a.	n.a.	n.a.
Deposit growth	36.3	12.4	17.9	23.0	19.4	15.4	17.6	19.6
Credit growth	32.5	14.3	9.2	12.5	14.2	18.5	20.8	23.4
Loan to deposit ratio	108.0	109.9	101.8	93.1	89.1	91.4	93.9	96.9
Memorandum items								
Population (m)	86.9	87.8	88.8	89.7	90.7	91.6	92.5	93.5
Growth (%)	1.1	1.0	1.1	1.1	1.1	0.9	1.0	1.0
Unemployment (%)	4.3	3.6	3.2	3.6	3.4	2.5	2.5	2.5

Sources: Asian Development Bank, Bank for Investment and Development of Vietnam, Bloomberg, GSOV, IMF, SBV, The Ministry of Finance, World Bank, Vietcombank and QNB Economics forecasts

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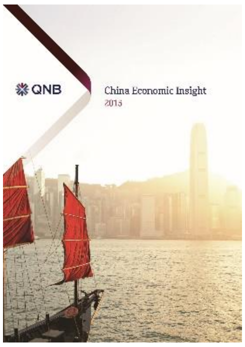

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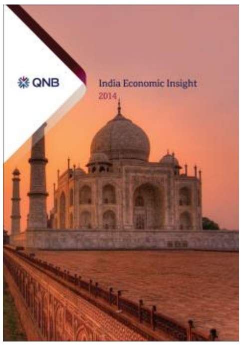

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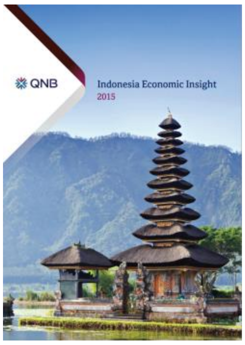

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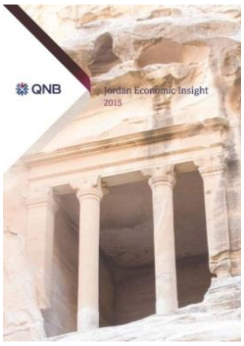

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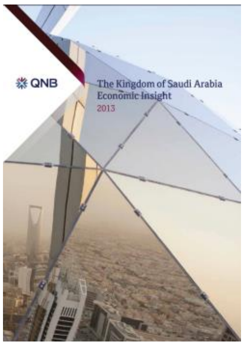

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