Vietnam – Rediscovering the frontier

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I. Vietnam and the world

Rediscovering the frontier

The conditions that originally put Vietnam on investors' radar screens will return. Vietnam enjoyed the second-highest real growth rate in East Asia between 2000 and 2009, of 7.2% per annum – just behind China's 10%. Foreign investors are attracted by abundant resources, including cheap labour, oil and agricultural products. Political stability, an increasingly open economy and rising consumerism are all supporting the country's economic development. Capital inflows and a strong external environment have helped the country to achieve strong economic growth as well as rising asset prices.

Vietnam did go through a challenging period in early 2008. A combination of economic overheating and surging international commodity prices created the twin problems of a widening trade deficit and a spike in inflation. This weakened market confidence in the Vietnamese dong (VND) and government bonds. Between Q1-2008 and Q2-2010, the VND has depreciated by 20%, and the 2Y government bond yield has risen to 22%.

That said, many of the structural fundamentals that caught investors' attention remain intact. Vietnam has maintained positive growth throughout the global financial crisis, one of only five economies in Asia to do so (the others being China, India, Indonesia and the Philippines). The size of the economy is set to exceed USD 100bn in 2010, and in 2011, the government plans to announce a new set of economic development targets and policies for the next decade. We believe the government's target of raising per-capita GDP to USD 2,100 by 2015 – with nominal growth averaging 12% per annum – is achievable, assuming the appropriate policy reforms are in place.

A number of post-crisis developments will support Vietnam's economic development. First, global liquidity is likely to remain ample for an extended period, which means investors' search for returns will extend from emerging markets to frontier markets, including Vietnam. This is what happened in 2006 and 2007, when international capital sought opportunities in Vietnam; it is likely to happen again as global central banks maintain loose monetary policy.

Second, economic weakness in the developed world has raised public discontent over foreign imports and increased the risk of protectionist measures against large trading powers such as China. In particular, the US and Europe have targeted China over its exchange rate, and various protectionist measures have already been imposed on selected Chinese exports. Businesses are looking at ways to protect themselves and diversify their risk. Vietnam fits in nicely with this risk diversification strategy.

Third, lessons learned from the global financial crisis – including gaps in financial regulation and the dangers associated with high private-sector leverage and public-sector debt – will help the Vietnamese government to shape its economic and financial policies. The multilateralisation of the Chiang Mai Initiative (under which a USD 80bn bilateral swap facility within Asia has been expanded to USD 120bn on a multilateral basis) and support from the Asian Development Bank and the World Bank will also improve the country's resilience to external payments stress.

Few economies can go through economic transitions without some hiccups, and Vietnam's financial problems in 2008 exposed the country's Achilles' heel in the form of its external balances. Flush global liquidity should improve the country's external position, and further economic development should bring a sustainable improvement in the balance of payments by boosting the export sector and correcting the trade deficit.

II. Vietnam’s SWOT

Strengths

Economic growth. We estimate Vietnam’s trend growth over the medium term to be around 7%. Income growth, the benefits of expanding trade and infrastructure development are likely to underpin this growth momentum.

Political stability. Vietnam remains one of the most politically stable countries in Southeast Asia. The National Party Congress to be held in January 2011 is expected to see a smooth transition of party leadership. This provides comfort to investors and creates a stable backdrop for designing and implementing medium- to long-term economic strategies.

Demographics. Vietnam is poised for rapid growth in its economically active population, while many mature economies in Asia have ageing populations. We expect the country’s labour force to expand from 53mn in 2005 to 71mn in 2035. This also implies a rise in consumption power.

Weaknesses

Market confidence and policy credibility. Market confidence in the VND has been weak in recent years due to high inflation and concerns about the country’s external payments position. A low level of foreign-exchange reserve relative to the trade deficit and external debt has exacerbated this situation. Policy makers also need to be clear and consistent about their policy objectives.

Information disclosure. Provision of information regarding the economy and the financial sector has been insufficient. This can lead to ill-informed analysis and exacerbate financial market volatility, even if the country’s economic fundamentals are sound.

Bureaucracy and ease of doing business. Like many developing economies, Vietnam needs to become more business-friendly. It is necessary to reduce bureaucratic red tape and provide clear guidance on regulatory issues in order to continue to attract foreign investors.

Infrastructure. The underdeveloped state of Vietnam’s infrastructure, whether in transportation, telecommunications or power generation, represents a bottleneck to growth.

Opportunities

Consumer spending. We estimate that Vietnamese consumers’ purchasing power will rise by 10% per year, reaching three times the current level by 2025. The rise of consumerism will be particularly rapid in major cities such as Hanoi and Ho Chi Minh City.

Expanding trade. Since it signed a bilateral trade agreement with the US in 2001 and joined the WTO in 2007, Vietnam has rapidly expanded its foreign trade. Ongoing investment in manufacturing by foreign investors is likely to enhance the country’s position as an Asian manufacturing base.

Foreign investment. In addition to cheap labour, risk diversification is also persuading multinationals to consider setting up production capacity in Vietnam. Asian businesses, especially from South Korea, Japan and Taiwan, have been the biggest investors in Vietnam. Companies from China, the US and Europe are also looking at Vietnam more closely.

II. Vietnam's SWOT (con'd)

Infrastructure. Vietnam's demand for infrastructure upgrades in transportation, logistics, telecommunications and energy will be a driver of economic growth. A key question is whether the government can secure funding for these projects, either via the private sector or from multilateral organisations such as the World Bank and the Asian Development Bank (ADB).

Commodities and their derivatives. Commodities currently make up one-third of Vietnam's exports. As the country's industrial capability expands, it is likely to add more value to these raw materials instead of exporting crude products – for example, selling refined petroleum products and furniture instead of crude oil and wood.

Threats

Inflation. Vietnam is vulnerable to an aggressive pick-up in inflation, especially if global commodity prices rise. This will force the authorities to tighten monetary policy, or to implement price controls or export bans on selected products.

Financial instability. Fickle confidence and a weak market structure, combined with an information deficiency, could lead to volatility in Vietnam's financial markets, including the exchange rate, bond yields and equities.

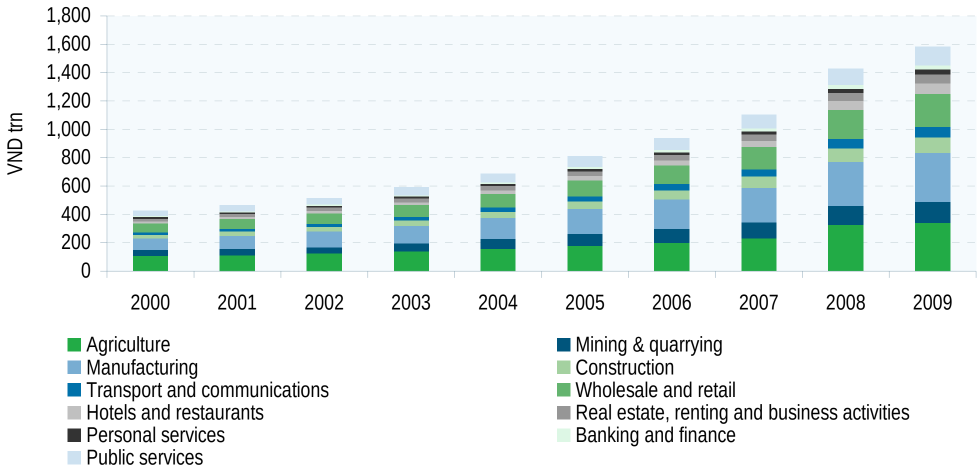
Policy mismatches. Inconsistent economic objectives, such as struggling to contain inflation while gunning for rapid economic growth, and limited policy tools could magnify volatility in Vietnam's economy and financial markets.

III. Economic structure

Expanding on all fronts

The Vietnamese economy expanded from VND 425trn in nominal terms (USD 31bn) in 2000 to VND 1,600trn (USD 97bn) in 2009. Growth has been evenly distributed across sectors. Between 2000 and 2009 (Chart III.1), the agriculture sector grew at an annualised pace of 12.1% (in nominal terms). The growth rate for manufacturing, mining and construction was 15.1%. The tertiary sector expanded by 14.2% per annum over the 10-year period.

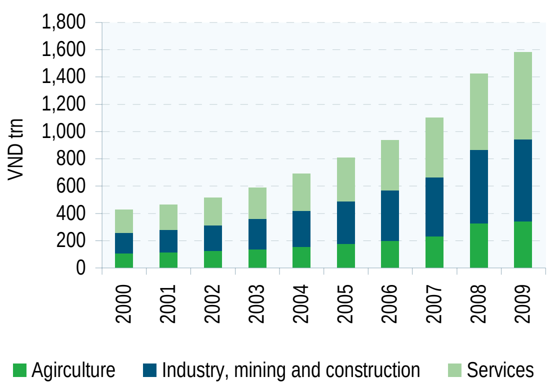
Chart III.1: GDP by sector



Sources: CEIC, Standard Chartered Research

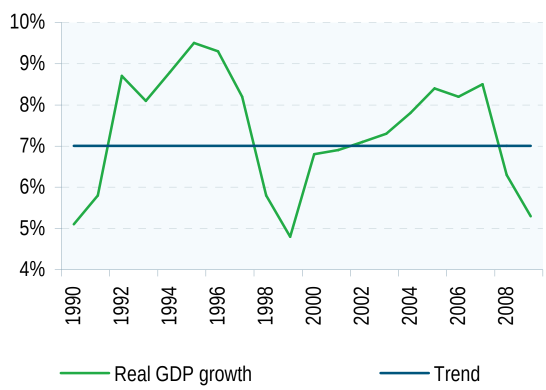
We expect comprehensive growth across Vietnam's industries in the coming years, with the economy expanding at around 7% per annum in real terms (Chart III.3). The long-term uptrend in commodity prices is likely to support Vietnam's agriculture and mining industries, although final consumption of these commodities could switch from overseas to domestic. Foreign direct investment (FDI) and domestic demand will fuel growth in manufacturing and construction activity. Meanwhile, the services sector will benefit from rising household incomes and tourism. Based on Vietnam's growth experience of the past 10 years, it is difficult to pick a clear winner from the country's economic development.

Chart III.2: GDP by broad industry



Sources: CEIC, Standard Chartered Research

Chart III.3: Real GDP growth versus trend



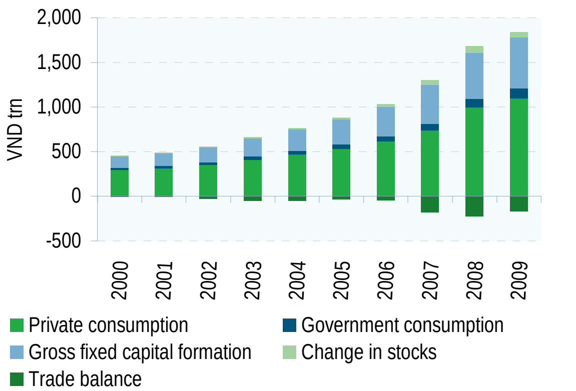
Sources: CEIC, Standard Chartered Research

III. Economic structure (cont)

In expenditure terms (Charts III.4 and III.5), consumption (both private and government) consistently makes up 65-70% of the country's GDP. Investment, in the form of gross fixed capital formation, has ranged between 30% and 35% of GDP in the past eight to nine years, with the exception of 2007, when it rose to 38%. Rapid growth in consumption and investment has led to a widening of the trade deficit. Vietnam's trade deficit reached 15% of GDP in 2007 and 2008, narrowing to 10% in 2009 following currency depreciation and austerity measures to cool the overheated economy.

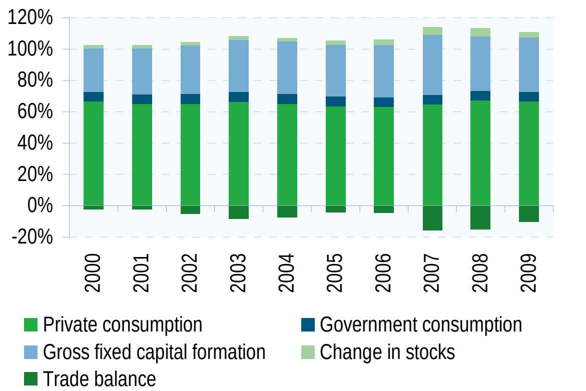
Going forward, the government wants to see a step-up in investment – particularly in transportation, energy and telecommunications – to enhance the country's infrastructure and increase its capacity for further development. The government has targeted an investment-to-GDP ratio of 40%, which implies further room to rise in the coming years if the target is reached. This could come at the cost of a return to a higher trade deficit, to be financed by capital inflows.

Chart III.4: GDP by expenditure



Sources: CEIC, Standard Chartered Research

Chart III.5: Shares of GDP by expenditure



Sources: CEIC, Standard Chartered Research

The need to enhance physical infrastructure

In modern supply chains, even the best products need efficient and reliable distribution. Therefore, foreign investors demand effective and comprehensive transport and logistics infrastructure to complement the country's competitive cost of production. While other countries have lower labour costs than China, multinationals are still buying from Chinese manufacturers because the accompanying logistics ensure timely delivery. As a result, countries with less developed logistics infrastructure have faced significant competitive pressure from Chinese producers.

Vietnam will therefore need to ensure that its infrastructure is able to meet investors' expectations. The government has set a target of raising investment as a percentage of GDP to above 40% – USD 5bn more per year from the current level of 34.5%. However, this is more than just a numbers game. How infrastructure is funded and operated has a significant impact on its future and sustainability. In addition, this drive for higher investment can also fuel inflationary pressure further.

III. Economic structure (con'd)

In terms of logistics, Vietnam's congested urban roads and a limited road network connecting cities will be bottlenecks for manufacturers, if they are not already. According to the World Bank's Logistics Performance Indicators (LPI, Table III.1), Vietnam trails behind most Asian economies in terms of its logistics set-up; logistics infrastructure and logistics competence are two areas where Vietnam is especially weak. The government is aware of the issue and plans to spend USD 4.5bn on improving seaport infrastructure in the next five years. The government has also announced the construction of various projects to improve infrastructure facilities (see Box III.1). The ADB has identified nine road projects totalling 565km, which will need USD 3bn worth of investment from the public or private sector, or both. There are also regional infrastructure projects underway which aim to improve Vietnam's connectivity with other countries in the region, especially in the Greater Mekong Region, and to take advantage of the hydropower capacity in neighbouring Laos and Cambodia to support Vietnam's economic development.

Power outages are sometimes scheduled during peak periods in the dry season as supply growth fails to keep up with surging demand. Hydro-electric plants struggle to run at full capacity when water levels are low, and power production capacity is also a constraint. According to the government's Master Plan VI of Power Generation, generation capacity will need to rise from 53bn kWh to 190bn kWh by 2015 under the base case scenario, and to 198bn kWh under the most aggressive scenario. The construction of new power plants has been approved, but their production benefits will not be realised until at least two to three years after construction. Some large-scale manufacturers have their own power generation capacity, but this tends to be costlier and is a luxury that smaller companies that cannot afford.

Table III.1: Vietnam's physical infrastructure lags behind

	LPI *	Customs	Infrastructure	International shipments	Logistics competence	Tracking and tracing	Timeliness
Singapore	4.09	4.02	4.22	3.86	4.12	4.15	4.23
China	3.49	3.16	3.54	3.31	3.49	3.55	3.91
Malaysia	3.44	3.11	3.50	3.50	3.34	3.32	3.86
Thailand	3.29	3.02	3.16	3.27	3.16	3.41	3.73
India	3.12	2.70	2.91	3.13	3.16	3.14	3.61
Vietnam	2.96	2.68	2.56	3.04	2.89	3.10	3.44
Indonesia	2.76	2.43	2.54	2.82	2.47	2.77	3.46

* *Logistics Performance Index reading;* Source: Logistics Performance Index 2010, World Bank

Box III.1: Selected infrastructure project requirements

- Hanoi – HCMC High Speed Rail link worth USD 55.8bn and spanning 1,570km
- Hanoi – Hai Phong Expressway (100km) requiring USD 410mn of investment
- Construction of two 2,000 MW nuclear power plants scheduled to start operating in 2020
- Hanoi – Lao Cai Expressway (290km) requiring USD 600mn of investment
- Hanoi Ring Road (65km) requiring USD 600mn of investment
- Van Phong Deep Sea Port (USD 200mn investment required)

Sources: Local media reports, Asian Development Bank

IV. Demographics and consumption

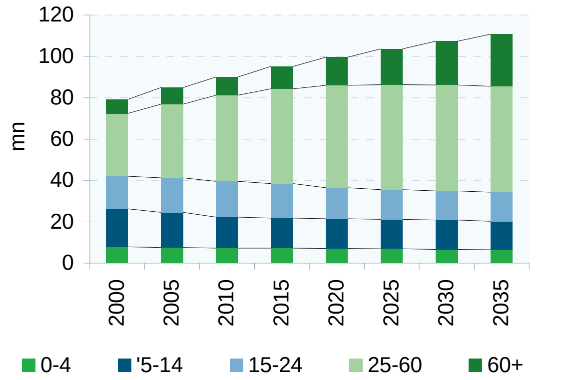
Demographic trend is Vietnam's friend

Vietnam's demographic shift over the next 20-25 years will give it an edge over many other Asian countries, whose populations are aging. According to the UN, Vietnam's population will grow from 85mn currently to more than 110mn by 2035. The economically active population, defined as those aged between 15 and 60, will rise from 58% of the total in 2000 to 66% in 2015, then ease back towards 63% by 2035. In absolute terms, Vietnam's labour force will grow from 53mn in 2005 to 64mn in 2015 and over 71mn in 2035 (Chart IV.1).

It is not just numbers that matter. Although Vietnam's income level is relatively low compared to some of its neighbours, its workforce is educated. Based on school enrolment and literacy rates (Chart IV.2), Vietnam is not at a significant disadvantage, despite its low per-capita GDP by regional standards. In our discussions with foreign businesses that have invested in the country, their feedback on the quality of labour was positive.

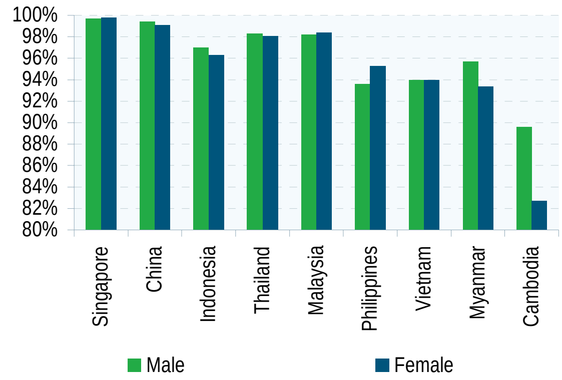
Despite high inflation in recent years, labour costs in Vietnam are still competitive. The monthly minimum wage for factory workers employed by foreign invested enterprises (FIEs) ranges from USD 55 to USD 70, depending on the location. This is still a fraction of China's average of USD 270 per month. Wages are lower for workers at local companies. However, there are two caveats. First, as in many Asian countries, employers are expected to pay for workers' insurance and social security, which can amount to 80-100% of workers' monthly salary. Secondly, and perhaps more importantly, wage inflation in Vietnam is high. To improve workers' living standards, the government has significantly raised the minimum wage in recent years, and is expected to continue to do so. According to the Ministry of Labour, War Invalids and Social Affairs, the minimum wage for domestic companies may be raised by 15-20% per annum in the coming years. Workers have also factored rising incomes into their expectations. As a result, trade union actions and protests have been reported when wage increases fail to match these expectations.

Chart IV.1: Young and active population



Source: UN World Population Prospects: The 2008 Revision

Chart IV.2: Literacy rates



Sources: UN, Standard Chartered Research

As in many developing economies, Vietnam's market for skilled workers, managers and professionals is tight. The booming equity market in 2006-07 lured finance-savvy talent from the public sector and the banking sector to stock brokerages. And while locals are learning fast, surging demand for middle and senior managers from both local and foreign companies has put upward pressure on salary and compensation. The same applies to other high-value-added services, such as legal and accounting.

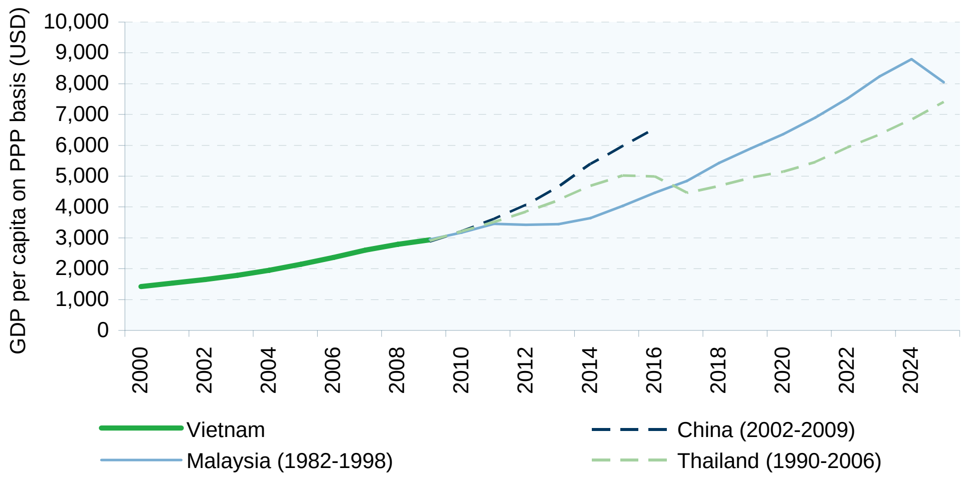
IV. Demographics and consumption (cont)

Rise of consumerism – Blossoming middle class

Although Vietnam's population of 85mn may seem small compared to China and India, it is too sizeable a market to ignore, especially if annual income growth is in the double digits in the years to come. Below, we examine the realistic pace of income growth for Vietnam in the coming years, based on the experiences of China, Malaysia and Thailand. We then consider the current spending behaviour of Vietnamese consumers.

Chart IV.3 shows the trend in Vietnam's per-capita GDP on a purchasing power parity (PPP) basis. The reason we have used this benchmark rather than per-capita GDP in current prices is to remove the impact of inflation and to allow 'apples to apples' cross-country comparisons (though we acknowledge that the calculation of PPP can be controversial). To simplify things, we have indexed the data for all countries using Vietnam's 2009 per-capita GDP on a PPP basis as the base. The solid grey line from 2000 to 2006 is Vietnam's per-capita GDP on a PPP basis for that period. We then added numbers from China, Malaysia and Thailand for a period starting when their per-capita GDP on a PPP basis was the same as Vietnam today, and observed their growth over time. The results were surprisingly consistent – all three countries saw their GDP rise by around 70% during the initial six-year period. This implies that Vietnam's purchasing power can be expected to rise by 9-10% p.a. on a PPP basis over the next five years, and could triple from today's level by 2025. If we revert back to nominal per-capita GDP in USD terms, Vietnam could reach USD 2,000-2,500 by 2015 and USD 3,000-3,500 by 2025, if the right growth conditions are met.

Chart IV.3: Vietnam – consumer purchasing power simulation



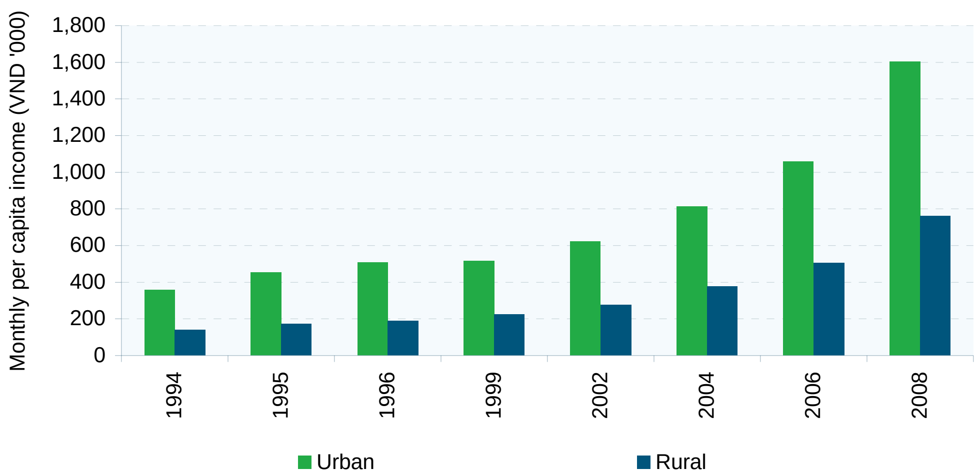
Sources: IMF, Standard Chartered Research

Consumer finance is another catalyst for unlocking consumer spending in Vietnam. Data is lacking on the extent of consumer finance penetration, which in itself reflects the low penetration. From a macroeconomic perspective, Vietnam's gross savings rate is relatively high compared with the region. While this may also translate into investment and not just consumption, it serves as a gauge of the potential spending power locked up in Vietnam.

IV. Demographics and consumption (con'd)

In summary, Vietnam's demographics represent two reasons to be bullish on the country's economic development. The current labour pool and growth trends over the coming decades will be supportive of labour-intensive manufacturing. Despite rising wages, labour costs remain competitive, except in skilled and professional areas, where the market is very tight due to short supply. On the consumption side, 85mn consumers are too many to ignore, even taking into account the wide income disparity between the cities and rural areas. According to national statistics, monthly per-capita income in urban areas rose 4.5 times between 1995 and 2008, from VND 359,000 to VND 1.6mn. Income in rural areas rose even faster during the period, surging 5.4 times to VND 762,000. With purchasing power expected to double in the next six to seven years and triple by 2025, Vietnam is likely to be a strong new source of growth for retailers in the years to come. The increased provision of personal finance services will also help to unlock spending power.

Chart IV.4: Monthly per-capita income



Source: Standard Chartered Research

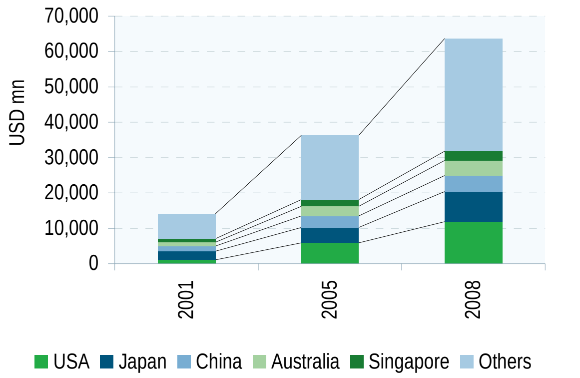
V. External trade and foreign investment

Embracing globalisation

The opening up of Vietnam to external trade was critical in putting the country on international investors' radar screen. Two landmark events marked this shift: the bilateral trade agreement signed with the US in 2001, and, more importantly, Vietnam's WTO accession in January 2007. Exposing itself to global trade brings at least three benefits. From a macroeconomic perspective, it adds another dimension to growth. Rather than relying on domestic demand alone, Vietnam now has another economic growth driver. When the global environment improves further, overall growth can be accelerated. The second benefit is increased foreign investment in the country. With external demand complementing the country's domestic demand story, multinational companies have a stronger case for investing in the country. The capital, technology and other know-how brought by FDI can further accelerate the country's economic progress.

The benefits from the US-Vietnam bilateral agreement can help to gauge what can be expected from Vietnam's WTO membership. In 2001, Vietnam exported USD 1.07bn of goods to the US. This more than doubled the next year to USD 2.4bn, despite weak US growth, and had reached USD 11.9bn by 2008 (Chart V.1). As a percentage of total Vietnamese exports, exports to the US rose from 7.1% in 2001 to 18.6% in 2008, and the US is now Vietnam's biggest export market. In addition to its trade agreement with the US, Vietnam is also looking to deepen trade relations with the EU.

Chart V.1: US is now Vietnam's top export destination



Sources: CEIC, Standard Chartered Research

Chart V.2: Vietnam is an increasingly open economy

Sources: CEIC, Standard Chartered Research

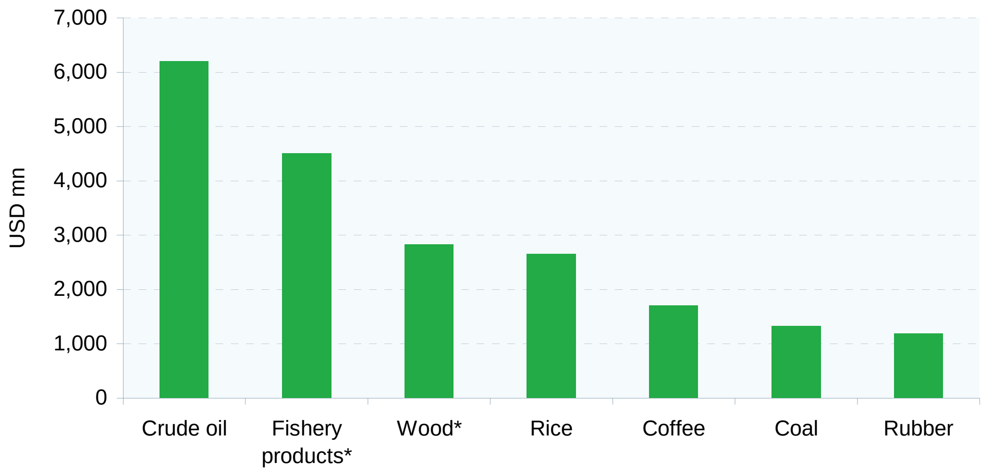
The role of commodities

Commodities make up approximately one-third of Vietnam's exports. Crude oil, fishery products and wood are the country's top three commodity exports (Chart V.3), followed by rice and coffee. There are several reasons to expect that the contribution of such raw materials to overall exports will decline over the long run, to be replaced by manufactured products.

The first reason is relatively straightforward. Rising domestic demand may absorb more of these materials, reducing exports. Second, as Vietnam upgrades its industry, it will be more able to add value to these products, selling them as manufactured or processed products rather than raw materials. For example, instead of exporting wood products, Vietnam could look to produce paper and pulp, or furniture. Crude oil is another good example of Vietnam's insufficient processing capacity. While it is a producer and exporter of crude oil, a lack of refining capacity means that Vietnam needs to export crude oil and import refined products. Hence, its oil sector is not a big earner of foreign currency. The establishment of refineries in Vietnam is likely to reduce the country's crude oil exports and its imports of refined product.

V. External trade and foreign investment (cont)

Chart V.3: Vietnam's top commodity exports



**2008 data;*
Source: Standard Chartered Research

Regional developments – China's manufacturing upgrade benefits Vietnam

The 13th ASEAN Summit in Singapore in November 2007 witnessed the signing of the ASEAN Charter and the ASEAN Economic Community Blue Print. The 10 ASEAN members agreed to work towards a single market in the coming years, promoting the free flow of goods, services, people and capital. As an ASEAN member, Vietnam will have access to this market of 560mn people with a combined GDP of USD 1.5trn. Vietnam's stable political environment relative to some of its neighbours will be a key factor in attracting foreign investors.

Looking beyond the ASEAN region, China's economic development is also moving in favour of Vietnam. While some Asian economies, such as Thailand and Malaysia, are threatened by China's rise as a manufacturing hub in recent years, China is now looking to move up the value-added ladder. As it makes this shift, the government has scaled back incentives (such as tax breaks and government assistance) to industries considered to be low-value-added. China has also implemented various policies to improve the sustainability of economic growth, at the expense of the competitiveness of its labour-intensive manufacturing. Regulations on environmental protection, labour rights and customs deposits have all added to the cost of doing business in China. Moreover, the speed and magnitude of these policy changes can create significant managerial and cash-flow challenges for manufacturers. As a result, some multinational corporations are seeking alternatives to China.

Vietnam's export structure is different from China's, as reflected in the low correlation between the compositions of the two countries' exports by product classification (shown in Table V.1). Vietnam's exports of agricultural products and commodities also help it to avoid competing head-on with China.

V. External trade and foreign investment (cont)

Table V.1: Export composition by SITC category as a percentage of total exports

SITC classification (first digit)	China	Taiwan	Korea	Singapore	Thailand	Malaysia	Indonesia	Vietnam
1. Food and live animals	2.7%	1.0%	0.9%	1.2%	14.7%	2.9%	6.1%	18.9%
2. Beverages and tobacco	0.1%	0.1%	0.2%	0.7%	0.4%	0.5%	0.6%	0.3%
3. Crude materials except fuels	0.7%	1.3%	1.1%	0.6%	4.2%	2.3%	10.2%	4.5%
4. Mineral fuels, lubricants	1.6%	5.5%	6.5%	20.4%	5.2%	14.5%	27.4%	20.7%
5. Animal and vegetable oils	0.0%	0.0%	0.0%	0.2%	0.2%	8.0%	9.6%	0.1%
6. Chemicals and related products	5.2%	12.7%	10.3%	12.2%	8.5%	6.1%	5.4%	2.1%
7. Manufactured goods	15.4%	15.8%	13.3%	4.5%	13.4%	9.2%	14.9%	8.2%
8. Machinery and transport equipment	49.0%	48.5%	56.8%	53.1%	42.1%	46.2%	14.4%	11.5%
9. Miscellaneous manufactured articles	25.1%	13.7%	10.1%	7.2%	11.3%	9.5%	10.5%	33.5%
0. Others	0.1%	1.3%	0.8%	0.0%	0.0%	0.9%	0.8%	0.0%
Correlation with China		95.5%	93.3%	82.0%	91.3%	88.0%	26.1%	39.0%

Source: Standard Chartered Research

What attracts foreign investors? Risk diversification – 'China + 1'

Risks of diseases and epidemics, terrorism, political instability, natural disasters and protectionism are among the frequently cited reasons for multinational companies to diversify their production bases. Since no one is immune to such risks (including Vietnam, given its history with avian flu), there is plenty of incentive for businesses to have contingency plans in place. This works in Vietnam's favour. The country's political environment has been very stable in recent years, and it has been free from terrorism. While there are occasional cases of avian flu, they are generally contained and have not undermined economic activity. These factors, combined with competitive labour costs and incentives to attract foreign investors, make Vietnam an attractive alternative for manufacturing.

Table V.2: Japanese manufacturers' views on China, India, Thailand and Vietnam

	Positives	Negatives
China	• Future growth potential of local market (84.8%) • Inexpensive source of labour (44.0%) • Current size of local market (32.8%)	• Rising labour costs (56.3%) • Execution of legal system unclear (55.7%) • Intense competition with other companies (50.3%)
India	• Future growth potential of local market (90.2%) • Inexpensive source of labour (38.5%) • Supply base for assemblers (19.3%)	• Under-developed infrastructure (46.9%) • Security/social instability (30.0%) • Intense competition with other companies (29.6%)
Thailand	• Future growth potential of local market (48.1%) • Inexpensive source of labour (41.7%) • Base for exports to third countries (26.9%)	• Intense competition with other companies (38.5%) • Difficult to secure management level staff (29.8%) • Security/social instability (27.9%)
Vietnam	• Future growth potential of local market (60.4%) • Inexpensive source of labour (57.7%) • Qualified human resources (21.5%) • Good for risk diversification vs. other countries (18.8%)	• Under-developed infrastructure (33.8%) • Execution of legal system unclear (30.9%) • Difficult to secure management-level staff (29.4%) • Rising labour costs (27.2%)

Note: Numbers in brackets represents percentage of respondents who consider these factors when investing;
Source: JBIC Survey Report on Overseas Business Operations by Japanese Manufacturing Companies, FY2009

V. External trade and foreign investment (cont)

Vietnam featured as one of the most promising countries for manufacturers in a recent survey of Japanese manufacturers by the Japan Bank for International Cooperation. A key reason for Japanese manufacturers' interest in Vietnam was "risk diversification" (Table V.2), a factor that was not mentioned for the other most popular countries. Deliberately or not, Vietnam has positioned itself as an alternative to China, and this 'China + 1' concept will be critical to its ability to attract investment in the coming years.

Given the still-challenging global economic environment, protectionist sentiment in the West is likely to prevail, if not intensify. Pressure on China to revalue its currency, dumping allegations against China and the potential for other non-tariff barriers to trade (on grounds such as health and safety) are prompting some global businesses to reassess their sourcing strategies and diversify their manufacturing sources. Vietnam is a likely beneficiary of this development.

Doing business in Vietnam

According to the World Bank's Doing Business Survey 2010, Vietnam ranked 93rd out of 183 countries in terms of the overall ease of doing business. In Asia, it trails China, Malaysia and Thailand, but is ahead of Indonesia and the Philippines. The World Bank survey shows that Vietnam is relatively competitive in the categories of getting credit, registering properties and enforcing contracts, while it is weak in investor protection, paying taxes and closing a business.

Table V.3 World Bank's Doing Business Survey 2010

	Ease of Doing Business ranking	Starting a business	Dealing with construction permits	Employing workers	Registering property	Getting credit	Protecting investors	Paying taxes	Trading across borders	Enforcing contracts	Closing a business
Singapore	1	4	2	1	16	4	2	5	1	13	2
Thailand	12	55	13	52	6	71	12	88	12	24	48
South Korea	19	53	23	150	71	15	73	49	8	5	12
Malaysia	23	88	109	61	86	1	4	24	35	59	57
China	89	151	180	140	32	61	93	125	44	18	65
Vietnam	93	116	69	103	40	30	172	147	74	32	127
Indonesia	122	161	61	149	95	113	41	127	45	146	142
Philippines	144	162	111	115	102	127	132	135	68	118	153

Sources: World Bank, Standard Chartered Research

While Vietnam may score well in some categories of the Doing Business Survey, businesses also face day-to-day challenges arising from public governance and policy. The World Bank's World Governance Index identifies excessive bureaucracy, lack of policy transparency and consistency, and corruption as areas where the country needs to improve. This is consistent with our observations on the ground and with the experience of some investors. While such problems are often encountered in developing economies in the region, making the governance process more efficient and transparent is essential to attracting foreign and local investment.

Balance-of-payments dynamics

Vietnam's balance of payments (BoP), shown in Table V.4, has been a challenge for the economy. Strong economic growth and structural development have encouraged imports, leading to a large trade deficit (Chart V.5). Typically, this is funded by capital inflows in the form of FDI, overseas remittance inflows and inflows from multilateral organisations such as the ADB and the World Bank. However, the global financial crisis slowed such inflows, causing the country's FX reserves to decline in 2008 and 2009 (Chart V.4).

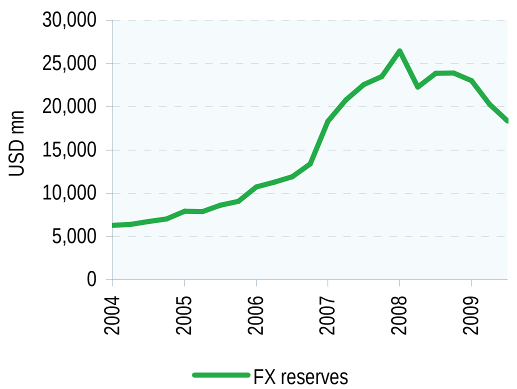
V. External trade and foreign investment (cont)

Vietnam's BoP position is likely to improve structurally in the coming years for a number of reasons.

1) **Trade balance:** Currently, Vietnam's trade balance is vulnerable on two fronts. Economic overheating has led to sizeable import bills in the past, exacerbating the trade deficit. This threat remains as long as the authorities have a bias towards pursuing growth at the cost of higher inflation. The second threat is higher commodity prices. While Vietnam excels in agriculture and mining, it is still acquiring the necessary capacity to process and refine these raw materials. This implies that higher commodity prices will increase Vietnam's import bill for refined products faster than it will boost export receipts from these raw materials. The good news is that Vietnam is gradually expanding its processing capability, for example by building oil refineries, and this will make it more resilient to an uptick in commodity prices. Meanwhile, as Vietnam's export industry continues to expand, it is expected to follow the path of other Asian economies and become a trade-surplus country in the next three to five years.
2) **FDI flows:** Despite the global financial crisis, FDI flows into Vietnam have remained resilient. Furthermore, investors from within Asia are looking to invest in Vietnam, with a keen interest in manufacturing and tourism. We also expect US and European companies to step up investment and sourcing in Vietnam. All of this suggests that Vietnam should be able to attract USD 10-15bn of FDI per year, versus USD 7-9bn in the past two years.
3) **Remittance flows:** Remittances from overseas Vietnamese workers are likely to remain stable. The strong local stock-market performance may increase such inflows, as seen in 2006 and 2007.
4) **Portfolio flows:** Foreign interest in Vietnam's financial markets is relatively low after the balance-of-payments stress, USD liquidity squeeze and VND devaluation of 2008. However, amid ample liquidity and low yields in the developed world, the search for yield may cause funds to return to these 'frontier' markets over the medium term. Hence, the risk of portfolio flows over the next three to five years should be skewed towards inflows.

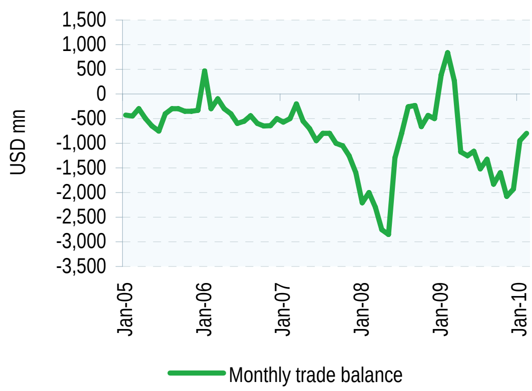
Overall, while we believe that the BoP will remain in a delicate balance in 2010 and 2011, structural improvements – including the acceleration of export growth, the enhancement of Vietnam's capacity for import substitution, and continuing capital inflows – should transform Vietnam into a BoP-surplus country. This will in turn be supportive of the Vietnamese dong (VND).

Chart V.4: Vietnam's FX reserves



Source: Standard Chartered Research

Chart V.5: Monthly trade balance



Source: Standard Chartered Research

V. External trade and foreign investment (con'd)

Table V.4: Vietnam's balance of payments, 2005-08

USD bn	2005	2006	2007	2008
Current account	**-560**	**-164**	**-6,953**	**-10,706**
Goods	-2,439	-2,776	-10,438	-12,782
Services	-296	-8	-755	-835
Income	-1,205	-1,429	-2,190	-4,400
Transfers	3,380	4,049	6,430	7,311
Financial account	**957**	**-1,236**	**7,518**	**11,868**
Fixed investment	1,889	2,315	6,516	9,279
Securities investment	865	1,313	6,243	-578
Other	279	-573	4,945	3,602
Errors and omissions	**-397**	**1,400**	**-565**	**-1,162**

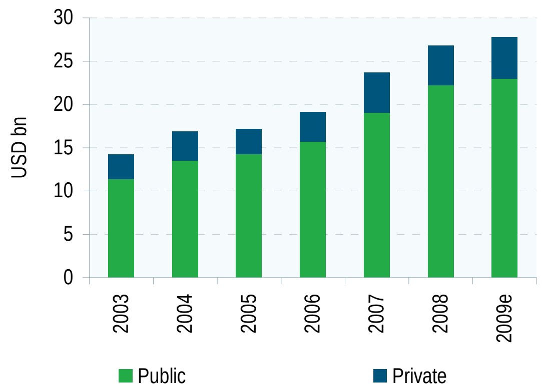
Sources: CEIC, Standard Chartered Research

External debt – Vulnerability has been overstated

Like its external payments position, Vietnam's external debt position is a potential weak link in the economy. As Chart VI.7 shows, the country's ratio of external debt to FX reserves has exceeded 100% in recent years. The drop in FX reserves since 2008 has further widened the gap. This has raised concerns that the country may struggle to meet its external debt obligations, especially if the VND depreciates further.

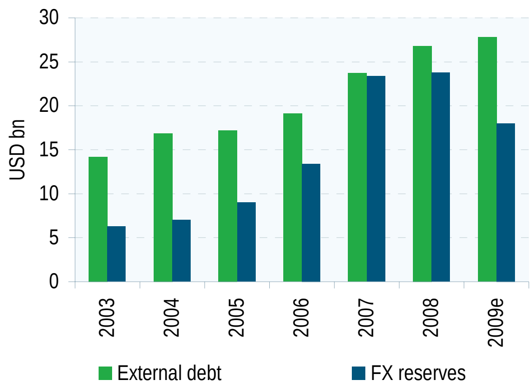
However, we believe such concerns are overstated for a number of reasons. First, the level of Vietnam's external debt relative to the size of its economy is in line with the rest of the region, at 30%. Second, over 80% of this external debt is held by the public sector (Chart V.6), and much of it is to official creditors (governments) and international organisations such as the World Bank and the ADB. For example, the Japanese government, the International Development Association (an arm of the World Bank) and the ADB account for 30.8%, 22% and 12% of Vietnam's external debt, respectively. This implies less volatility in sources of funding, even during financial-market turbulence. Furthermore, the short-term portion (less than 1Y) of external debt is very low, which mitigates the problem of low FX reserves.

Chart V.6: Public sector makes up 80% of external debt



Sources: IMF, Standard Chartered Research

Chart V.7: External debt vs. FX reserves



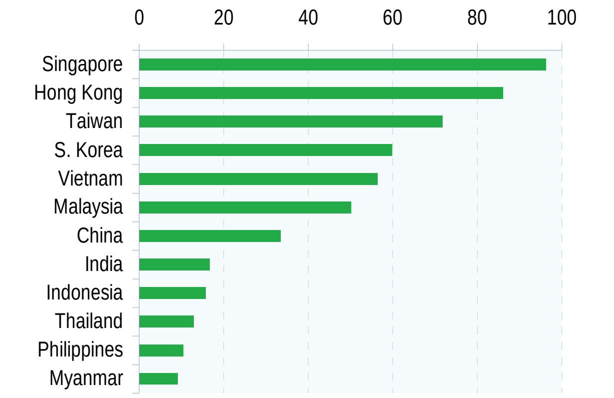
Sources: IMF, Standard Chartered Research

VI. Politics and policy making

Stable political environment

According to the World Bank's World Governance Index, Vietnam scores well in the 'political stability' category, with one of the highest rankings in ASEAN (Chart VI.1). In addition to the country's stable political structure, relative income equality and improving living standards have bolstered public support for the government and its reforms. The income ratio between the highest 20% of the population and the lowest 20% was 6.4 times in 2006, among the lowest in Southeast Asia (Table VI.1). It will be a challenge for the government to maintain this balance in the coming years amid rapid economic development. The experiences of other countries in the region suggest that income equality is often a victim of rapid growth. While we believe Vietnam can realistically achieve USD 2,100 per-capita GDP by 2015, the bigger challenge will be to manage the distribution of income and maintain public support for the government, especially against the backdrop of rapid economic growth and high inflation.

Chart VI.1: Political stability index, World Bank World Governance Index (2008)



Source: World Bank

Table VI.1: Vietnam's income equality is high among Asian neighbours

	Income ratio of highest 20% vs. lowest 20%	Last data point
China	8.30	2002
Singapore	9.80	1998
Philippines	9.00	2006
Malaysia	6.90	2004
Thailand	8.00	2004
Cambodia	6.90	2007
Indonesia	6.70	2005
Vietnam	6.40	2006
Laos	4.90	2002

Sources: IMF, Standard Chartered Research

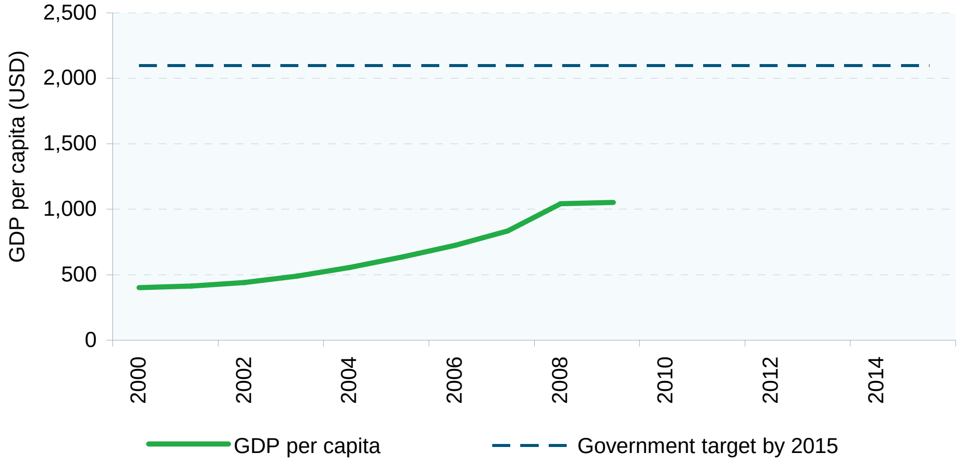
A stable political backdrop cannot be taken for granted in Southeast Asia. In addition to its stable politics, racial and religious issues are much less complex in Vietnam than in some neighbouring countries, thanks to a relatively homogenous population. While there are over 50 different cultural minority groups, as much as 85% of the population are Vietnamese, who speak an Annamese-Muong language and have dominated the two major river deltas of the Mekong and Red River for the past millennium. A tolerant culture supported by the wide practice of Buddhism and Confucianism has contributed to the absence of terrorism – an important consideration when businesses are looking to diversify risks.

Upcoming Party Congress to set national development strategy

The National Congress of the Communist Party of Vietnam will be held in 2011. In March 2010, the Communist Party held its annual plenary session, providing a glimpse of what can be expected at next year's Party Congress and in terms of national development over the next decade. A key theme was "rapid but sustainable" economic development. The government aims to transform Vietnam into an industrialised nation by 2020, with an interim target of raising per-capita GDP to USD 2,100 by 2015. As noted above, we believe this target is achievable if the global economic environment is accommodative and the necessary reforms are implemented. The government's economic strategy for 2011-20 economic strategy should set out details on how this will be achieved.

VI. Politics and policy making (cont)

Chart VI.2: Policy makers aim to increase per-capita GDP to USD 2,100 by 2015

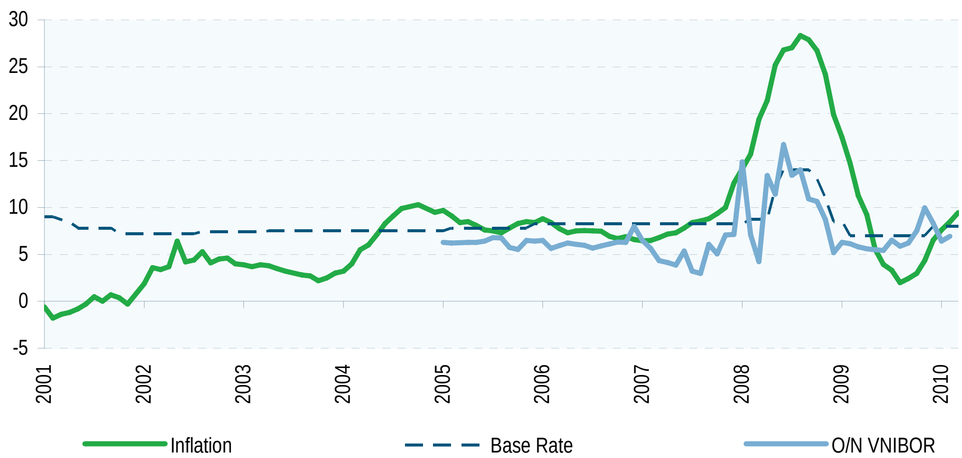


Source: Standard Chartered Research

Monetary policy and controlling inflation

Considerable reforms of Vietnam's monetary policy mechanism are underway. In the past, commercial lending rates were dictated by the Base Rate, set by the State Bank of Vietnam (SBV), the central bank. A ceiling for commercial lending rates was set at 150% of the Base Rate. Hence, with the Base Rate at 8%, commercial banks were able to charge borrowers a maximum of 12%. This changed in H1-2010, when the central bank liberalised the setting of lending rates in steps. First, in February 2010, the SBV permitted commercial banks to negotiate interest rates with borrowers for medium- and long-term loans (1Y or more). This was extended to short-term borrowing in April 2010. These measures make the Base Rate much less relevant as policy guidance. We may see further reform of the policy rate, perhaps switching to a more market-oriented benchmark such as the overnight interbank market rate.

Chart VI.3: Inflation, Base Rate and market rate



Sources: Bloomberg, Standard Chartered Research

VI. Politics and policy making (con'd)

There is a need for the SBV to further refine monetary policy implementation in order to maintain price stability. Volatile inflation has been a signature of the Vietnamese economy. A clear objective, such as an explicit inflation target, would help to anchor inflation expectations in the economy. In H1-2010, with inflation gathering momentum, the central bank has remained cautious towards hiking rates. The liberalisation of lending rates in early 2010 is a de facto rate hike, as it has caused commercial interest rates to rise by 200-300bps. Nonetheless, given the likely uptrend in inflation, the central bank will need to be ready to tighten further.

Reinforcing confidence in the VND

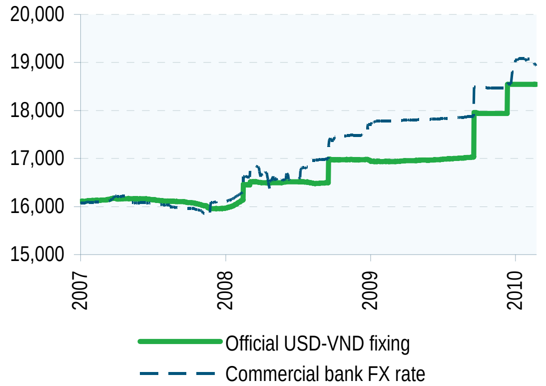
Another signature of the Vietnamese economy is the depreciation trend of the Vietnamese dong (VND). Before 2007, the VND followed a crawling peg against the USD, with a 1% per annum depreciation against the US dollar (USD). As Chart VI.4 shows, this depreciation path was reversed in 2007 due to large inflows, especially into the stock market. But as inflation took off and the overheated economy ran a sizeable trade deficit in 2008, the currency began a depreciation trend, from 16,000 to the USD at the start of 2008 to the current level of 19,000.

While the initial phase of depreciation of the VND was caused by foreign portfolio investors pulling their money out of the local market, the subsequent depreciation in 2009 and early 2010 was primarily driven by local investors, in our view. Against the backdrop of a highly dollarised economy and local investors' affection for gold, the VND is arguably only the third-most preferred currency in the country. Any decline in confidence in the outlook for the trade balance and for VND purchasing power triggered by high inflation can prompt investors to shun the VND and move to the USD and gold.

This typically results in a hoarding of USD, and hence a shortage of USD liquidity in the market, even though the economy as a whole is likely to be holding significant amounts of USD. The government in late 2009 ordered the closure of gold exchanges to protect investors. The authorities also instructed seven state-owned enterprises with large foreign-currency holdings to release their surplus USD to the market to ease the USD shortage.

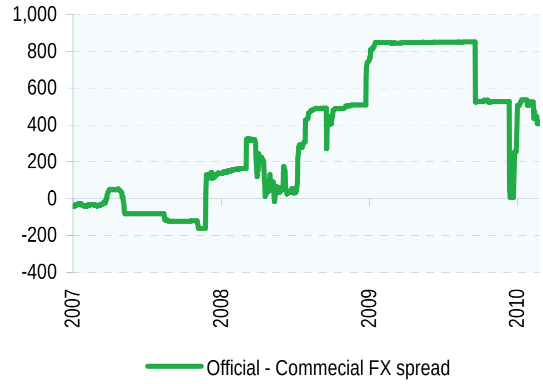
As Chart VI.5 shows, the spread between the official USD-VND daily fixing and the commercial FX rate (within the legal trading band) has narrowed, indicating that measures to ease USD liquidity and reduce VND depreciation pressure have had some positive effect. Nonetheless, the VND is still vulnerable to the trade deficit and to spikes in inflation. The SBV will need to communicate with the market more frequently and effectively in order to establish credibility with investors and the general public, and to reinforce confidence in the VND.

Chart VI.4: USD-VND exchange rate



Sources: CEIC, Standard Chartered Research

Chart VI.5: Spread between USD-VND official and commercial FX rates



Sources: CEIC, Standard Chartered Research

VII. Bond market development

Types of government debt

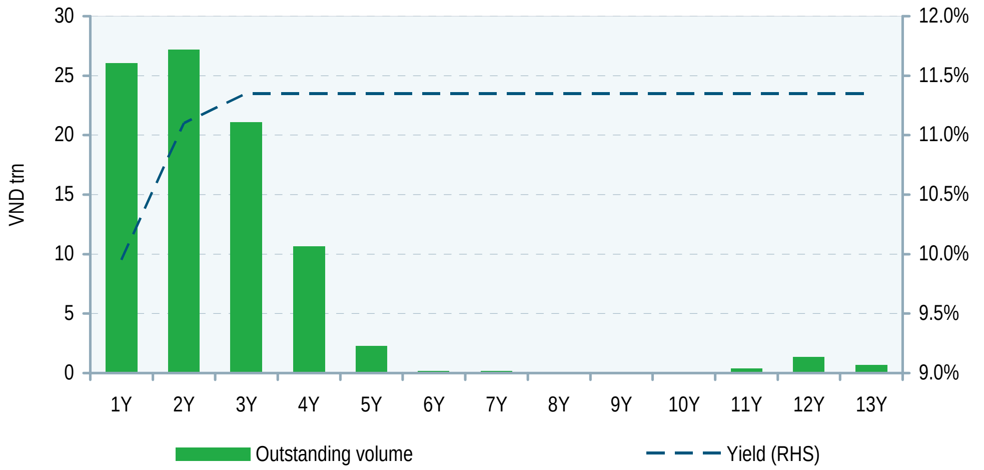
There are three main issuer classes of government securities in Vietnam: the State Treasury, government agencies (including the Vietnam Development Bank and the Vietnam Expressway Corporation), and the State Bank of Vietnam.

The State Treasury is responsible for issuing T-bills, T-bonds, and Central Project bonds, of which the proceeds are used for the state budget. **The State Bank of Vietnam (SBV)**, the central bank, issues bills as a tool for monetary liquidity management.

Primary market

There are three main primary-market issuance methods in Vietnam: direct auction and underwriting (for State Treasury bonds) and direct auction through the SBV (for T-bills and SBV bills). The government usually alternates between auctions and underwriting for government bond issues, with an even split between the use of these two methods. Another issuance method is via retailing, although this is less common for government bonds.

Chart VII.1: Treasury bonds outstanding



Sources: Bloomberg, Standard Chartered Research

Types of debt instruments

Government debt issues:

State Treasury bills (T-bills) – The State Treasury issues 1Y T-bills and uses the proceeds for state budget funding, while the central bank acts as the facilitator of the issuance. Note that the State Treasury issued a number of 6M and 9M T-bills in 2009 to address the market's apparent interest in shorter-tenor paper. Issuance frequency is typically weekly, with an average size of around VND 1trn. Demand at T-bill auctions has traditionally been strong, since banks can use T-bills to obtain funding from the SBV via repo. Recently, however, T-bill auctions have frequently failed, with the State Treasury aggressively capping yields considerably below secondary-market levels. The total outstanding amount of State Treasury T-bills is VND 12.3trn (as of November 2009). T-bills are issued at a discount, as interest payment is made on the issue date.

VII. Bond market development (cont)

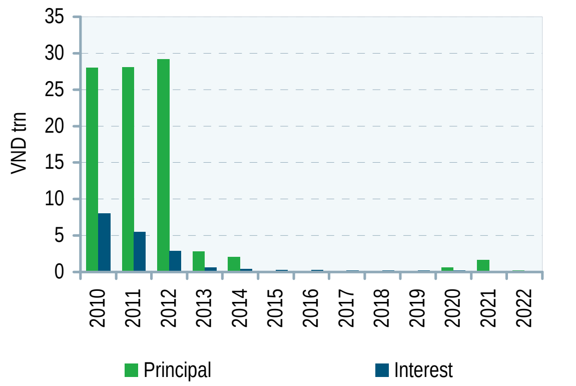
SBV bills – The State Bank of Vietnam auctions bills for liquidity management purposes. Tenors include 1-week, 2-week, 1M, and 2M through to 1Y, although the most common tenors have traditionally been 1-2M. The use of SBV bills decreased significantly in 2009 due to the need for increased liquidity to tackle the global economic downturn. Issuance of these monetary tools is as frequent as three times a week, while the issuance amount varies widely depending on liquidity management needs. These bills usually receive strong demand from banks, which can use them as collateral in repos with the central bank for funding. Their popularity, however, decreased markedly in 2009, and the uptake at recent auctions (once a week) has been zero due to tight market liquidity. The total amount of SBV bills outstanding is around VND 1.7trn 3trn (as of November 2009).

Treasury bonds (T-bonds) – These are issued by the State Treasury and comprise 2Y, 3Y, 5Y, 7Y, 10Y, and 15Y tenors at issuance. The 5Y has traditionally been the most liquid tenor, as structural demand for this maturity bucket is highest (see ‘Investors and demand structure’ section below). Thus, most supply has been in the 5Y sector to cater to this demand. However, given the liquidity squeeze in 2009 and market concerns about inflation, investor preference shifted to the shorter tenors. As such, liquidity has been seen mostly in tenors of 2Y and below. The State Treasury announces a quarterly supply schedule and typically holds two to five auctions per month. Auction sizes vary from around VND 200bn-1trn. There is usually only one tranche issued per week. Buyers of T-bonds are usually banks and state-owned enterprises, while the proceeds of T-bonds are used for state budget funding. The total outstanding amount of T-bonds is VND 91.7trn (as of November 2009).

Vietnam Development Bank (VDB) bonds – Bonds issued by the Vietnam Development Bank, are fully government-guaranteed and thus carry the same credit risk as T-bonds issued by the State Treasury. Issuance is via a direct auction or underwriting, similar to T-bonds. There is no pre-announced schedule for VDB bonds, and they are issued on an ad hoc basis. However, VDB bonds usually trade at a modest spread (of around 10-50bps) over T-bonds, since there is no haircut charge for a repo on a State Treasury bond, while the haircut charge for a repo on VDB bond is 20%.

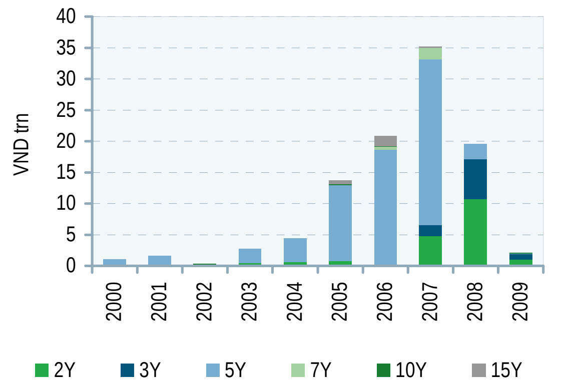
Sovereign USD bonds – In October 2005, the Socialist Republic of Vietnam issued a sovereign USD 750mn 10Y bond at a relatively tight spread of 256bps over US Treasuries. This was the first time Vietnam had issued USD paper since March 1998. The bond was popular, with book-building suggesting that it was six times oversubscribed. In 2007, Vietnam was said to be planning issuance of a USD 1bn sovereign bond. The 2008-09 financial crisis repeatedly delayed this issuance and led to onshore USD issuance instead. A USD 1bn offshore issuance was finally executed in Q1-2010.

Chart VII.2: Government debt profile



Sources: Bloomberg, Standard Chartered Research

Chart VII.3: VGB issuance



Sources: Bloomberg, Standard Chartered Research

VII. Bond market development (cont)

Market liquidity and yield curve development

Secondary market – While it has shown signs of improvement in recent years, secondary-market trading is still very illiquid in Vietnam. One factor that hindered trading activity in 2009 was tight market liquidity, mainly due to strong pressure exerted by loan growth driven by the interest rate support programme.

Benchmark yield curve and issuance – The Vietnamese government bond yield curve extends from 2-15Y. However, in terms of liquidity, the actual yield curve does not currently extend beyond the 5Y segment. The development of a proper government bond yield curve has been hampered by the systematic issuance of new bonds as opposed to reopenings of outstanding ones. The government is looking into addressing this issue by introducing bond issuance through reopenings. Going forward, the State Treasury may follow in the footsteps of other bond markets in the region, such as the Philippines, and conduct buybacks of illiquid bonds in order to improve the efficacy of the benchmark yield curve.

Investors and demand structure

Demand – Traditionally, the 5Y has been the most actively traded tenor, with most of the demand coming from banks. However, given recent market dynamics (tight liquidity and inflation concerns), most market trading has been focused on tenors of 2Y and below.

Banks – Both local and foreign names are active in the secondary market, although the state-owned banks have traditionally been the dominant players in the domestic bond market. However, the local joint-stock banks have gained importance in recent years, becoming the main investor class in government bonds. Banks in general are by far the most active players in the 1Y T-bill sector, investing for liquidity management purposes. Banks have also traditionally been very active in the short and intermediate tenors of the bond market. However, tight liquidity conditions in 2009 drastically reduced banks' appetite for government bonds. Around eight local banks and five foreign banks are active in the domestic bond market.

Insurance firms (life and non-life) – Although there are 39 insurance companies (27 non-life and 12 life insurance companies) in Vietnam, only about three are active in the domestic bond market. Due to the need to match assets and liabilities, life insurance firms tend to invest in the longer tenors, namely the 10Y and 15Y sectors of the curve. The relatively small (albeit growing) size of the local insurance industry has been one factor hampering the government's ability to continuously issue long-dated bonds.

Fund management companies – The number of investment funds focusing on Vietnam has grown substantially in recent years. However, funds have focused mostly on the stock market (Ho Chi Minh Stock Index), with local equities registering a strong performance in 2009 (up 58%). These funds have limited investments in local government bonds, mostly for diversification purposes. Fund management companies tend to follow market liquidity in terms of local government bond interest, which means they are active in the more liquid bills and bonds.

Securities companies – There are almost 100 securities companies in Vietnam. They can act as brokers of bond purchases by other end investors or they can trade for their own books. When trading for their own books, securities companies sometimes participate in the longer end of the curve, but brokerage remains their main activity.

Finance companies – Finance companies are still small players in the domestic bond market, although their participation is expected to increase going forward.

VII. Bond market development (cont)

Supply structure

Government bond supply profile

The supply profile is fairly front-loaded, with over 96% of outstanding VGBs maturing in five years or less. Given the lack of appetite for long-dated government paper among market participants, the limited amount of government bonds issued in 2009 were mostly in the 2Y and below segment. The lack of issuance of long-dated government bonds and the passage of time have resulted in outstanding government debt being clustered at the short end of the curve.

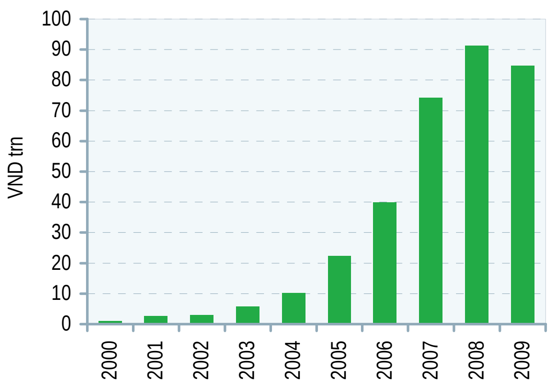
Funding, repos and hedging

The money market curve is depicted by VNIBOR, which is a clean borrowing/lending rate. It is similar in nature to LIBOR. VNIBOR is derived via a compilation of interest rates from 17 contributing banks, including Standard Chartered Bank (Vietnam) Ltd. The fixing for the day is done by eliminating the four highest and four lowest rates and averaging the remaining rates before 11:00. However, this rate is only indicative, and for actual trades, quotes must be obtained over the counter (OTC). The most common tenors used for borrowing/lending are overnight, 2-week, 1M, 2M, and 3M. Note that due to tight liquidity conditions in 2009, most interbank funding was done on the shorter tenors.

An alternative way to borrow money in Vietnam is via the repo market. The repo rate is typically lower than money market rates for a similar tenor, which is intuitive since the repo rate involves underlying collateral. However, total costs (including related transaction costs) sometimes make it more expensive to borrow money via the repo market than the money market. For interbank repo, given tight liquidity, the preferred tenors are currently 1M and below (traditionally, the 3M has also been commonly used). The SBV can also conduct repos through the open market, and the most common tenors for this exercise have traditionally been 7-14-day (with a recent preference for the 7-day tenor). Note that a minimum of two-thirds of the awarded amount for repos with the central bank must be backed by State Treasury- or SBV-issued paper, while the balance can be in the form of VDB bonds, government-guaranteed bonds, and municipal bonds.

As mentioned above, there is no haircut charge on T-bonds, while the haircut charge on VDB bonds is 20%. There are no indicative repo rates displayed on Reuters, and quotes must be obtained OTC. The derivatives market is still very underdeveloped, with only a few trades done in Vietnam's financial-market history. Thus, hedging capabilities are limited in Vietnam.

Chart VII.4: Historical outstanding VGBs



Sources: Bloomberg, Standard Chartered Research

Table VII.1: Reserve requirement

Reserve requirement	Requirement ratio
VND deposits of up to 12 months	5%
VND deposits of 12-24 months	1%
FCY deposits of up to 12 months	7%
FCY deposits of up 12-24 months	3%

Sources: Bloomberg, Standard Chartered Research

VII. Bond market development (con'd)

Market drivers

Since the exodus of foreign investors in 2008, the local bond market has been mainly driven by domestic factors. Strong loan growth in 2009 came at the expense of local government bonds, with market activity remaining relatively quiet throughout the year. Concerns about a potential surge in inflation and the lack of successful primary issuance have also hindered the performance of local government bonds. This is in contrast to the previous boom years in the local bond market, when foreign investors were attracted by appealing carry returns and a stable VND outlook. Flush market liquidity ensured that sellers looking to take profit on their government bondholdings could easily find willing buyers.

The appeal of holding government bonds declined sharply in 2009, due in part to the low yields offered (compared with commercial lending rates) and the bearish market view on the VND. Note that economic data tends to have a limited effect on the local bond market, which remains mostly flow-driven. Bond yields are primarily a function of demand (liquidity) and supply.

Reserve requirements

Table VII.1 summarises the reserve requirements that most banks operating in Vietnam must adhere to. These requirements have been slashed aggressively since November 2008 in order to boost market liquidity amid the global economic slowdown. Note that all reserve requirements must be held in cash with the central bank, and government bonds are currently not eligible for this purpose.

VIII. FX market development

Vietnam's exchange rate regime

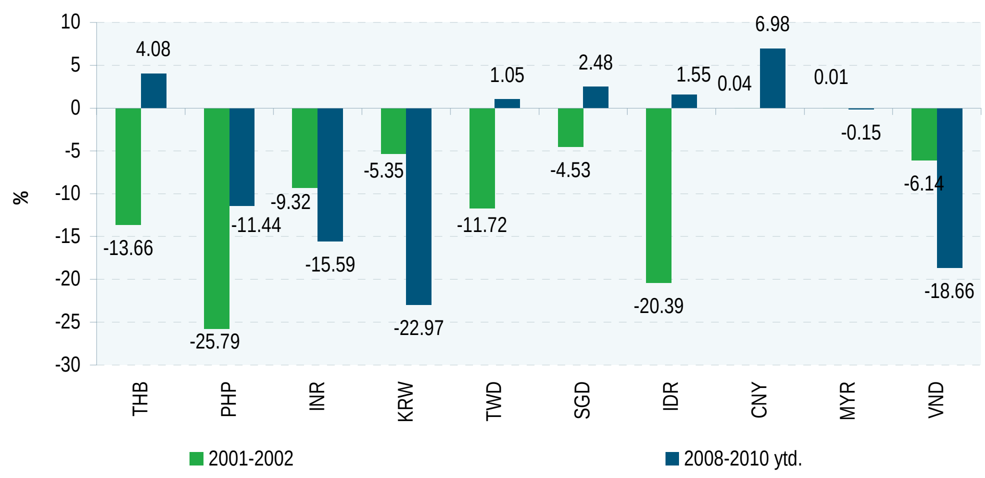
According to the IMF's classification of exchange rate regimes and monetary policy frameworks, Vietnam operates an exchange rate anchor relative to the US dollar (USD). By definition, this implies that the monetary authority stands ready to buy or sell USD at given quoted exchange rates to maintain USD-VND at its pre-determined level or within a range. From 2002 until Q4-2007, Vietnam operated a crawling peg versus the USD, under which it adjusted USD-VND higher by around 1% per annum. Since March 2008, the Vietnamese authorities have resumed a crawling USD peg, although repeated one-off devaluations and widening of the daily USD-VND trading band have accelerated the depreciation of the Vietnamese dong (VND). Currently, the daily trading band for USD-VND is +/- 3%, and USD-VND has consistently traded in the top end of the band since March 2008.

VND currency performance since the Asian financial crisis

Since January 1996, the VND has weakened by 72.59% versus the USD. By comparison, over the same period, the Hong Kong dollar (HKD) has weakened by 0.90%, the Taiwan dollar (TWD) by 17.36%, the Thai baht (THB) by 28.09%, the Malaysian ringgit (MYR) by 30.80%, the Indian rupee (INR) by 31.38%, the Korean won (KRW) by 57.51%, the Philippine peso (PHP) by 77.47% and the Indonesian rupiah (IDR) by 305.60%. On the other hand, the Chinese yuan (CNY) and the Singapore dollar (SGD) have appreciated by 17.94% and 0.62%, respectively, versus the USD since January 1996. As such, the VND is the third-worst AXJ performer since January 1996 after the PHP and the IDR.

Since January 1996, headline CPI inflation has averaged 9.8% in China, 1.3% in Singapore, 1.54% in Hong Kong, 1.12% in Taiwan, 2.48% in Thailand, 2.8% in Malaysia, 5.10% in India, 3.47% in Korea, 5.7% in the Philippines and 13.42% in Indonesia. This compares with Vietnam's average headline CPI inflation of 6.26% since January 1996. As such, Vietnamese exporters appear to have gained competitiveness versus Chinese exporters, although their performance versus other Asia ex-Japan (AXJ) competitors is more mixed. Since the AXJ currency correction began in January 2008, the VND has been the second-worst performer after the KRW. While most AXJ currencies weakened sharply from July 2008 to March 2009, they had rallied until recently. In contrast, since March 2008, the VND has continuously weakened versus the USD.

Chart VIII.1: AXJ FX losses vs. the USD in 2000-01, 2008-10*



** Data as of 24 May 2010;*
Sources: Bloomberg, Standard Chartered Research

VIII. FX market development (cont)

FX economics

FX economics – Growth: accelerating

In this section, we assess the outlook for the VND over the next three to 2 months based on FX economics, which includes (1) growth, (2) inflation and monetary policy, (3) external balances, and (4) fiscal developments. The global industrial cycle is an important leading indicator of AXJ export growth (see Chart VIII.2). The global industrial cycle is likely to slow in H2-2010 as the inventory cycle becomes less favourable, the effects of fiscal stimulus fade, and domestic demand – especially in the West – remains relatively sluggish. This could lead to a softening of the ISM index in H2. That being said, the index is likely to stay in expansionary territory, above 50, as the global recovery remains on track.

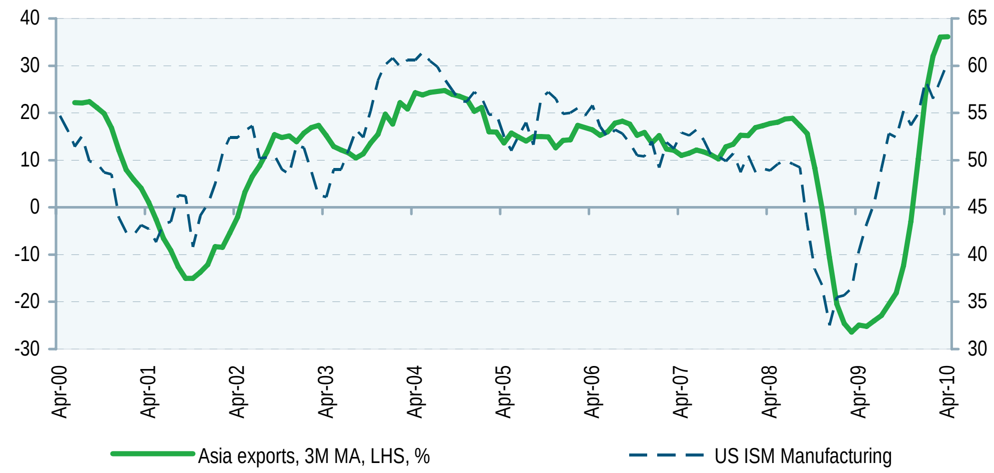
We forecast Vietnam's 2010 GDP growth at 6.7%, versus 5.3% in 2009. As such, Vietnam should be the third-strongest growth performer in Asia in 2010, after China and India. We view current growth dynamics as a positive for Vietnam, as accelerating growth should stimulate capital inflows. However, there is a risk that strong domestic demand may trigger a widening of the trade deficit again.

FX economics – Inflation and monetary policy: inflationary pressures should prompt action

April CPI rose by 0.14% m/m and 9.23% y/y, compared with 0.75% m/m and 9.46% y/y in March. Inflationary pressures are rising again, supported by the sharp rebound in domestic activity; m/m CPI inflation has averaged 1.02% over the past six months. In line with this, we expect the SBV to tighten monetary policy in the coming months, taking the Base Rate to 12% by end-2010 from 8.0% currently. However, there is a risk that the central bank will raise interest rates less than we expect given the government's pro-growth bias. We see low market interest rates – especially low borrowing rates – as a modest negative for the VND, as they raise the incentive for onshore market players to borrow in VND, thereby increasing supply of the local currency relative to USD. In this regard, it is important to recall that one of the key triggers of the sell-off in the VND in 2008 was that the SBV fell behind the curve in terms of raising interest rates.

Chart VIII.2: US ISM Manufacturing Index and AXJ exports

A V-shaped rebound



Sources: Bloomberg, Standard Chartered Research

VIII. FX market development (cont)

FX economics – External balances: modest improvement

We expect Vietnam's current account (C/A) deficit to narrow to 8.7% of GDP in 2010 from 10.8% in 2009 as stronger inward remittances and an improvement in the services balance offset a widening of the trade deficit. In addition, we expect FDI to improve to USD 11-12bn in 2010 from USD 8-9bn in 2009, supported by the global recovery. Although balance-of-payments (BoP) dynamics remain challenging for the VND, we expect them to improve this year. As such, we see developments in Vietnam's BoP as a modest short-term positive for the VND.

FX economics – Fiscal balances: set to improve, but risks remain

We expect Vietnam's fiscal deficit to narrow to 6.2% of GDP in 2010 from 11.8% in 2009. Vietnam currently has foreign-currency credit ratings of Ba3 from Moody's and BB from S&P, both with a negative outlook; Fitch rates Vietnam BB- with a stable outlook. Given the sovereign debt crisis in the euro area, countries with relatively weak fiscal positions are naturally perceived by investors as more vulnerable. Vietnam's large fiscal deficit in 2009 and relatively large C/A deficit are cause for concern. As such, the expected sharp narrowing of the fiscal deficit in 2010 and Vietnam's relatively low level of government debt (at 36.2% of GDP) should be seen as positives. In sum, from a fiscal perspective, we see Vietnam as one of the more vulnerable AXJ economies given its large fiscal deficit in 2009, which raises the risk of foreign-currency credit rating downgrades. However, we expect significant fiscal consolidation in 2010, which should be seen as a medium-term positive.

FX outlook (3-12 months): USD-VND to edge higher

We have *Neutral* short- and medium-term FX ratings on the VND. This implies that we expect the VND to trade broadly in line with trading-partner currencies relative to forwards over the coming three to 12 months. Note that USD-VND forwards and NDFs are pricing in further VND depreciation. Below, we list the key factors behind our FX ratings on the VND.

- **Exchange rate policy:** Since March 2008, the SBV has initiated a series of one-off devaluations and has widened the daily trading band on several occasions. This has created incentives for onshore market players to hoard USD in anticipation of further devaluations. We believe the risk remains of further one-off VND devaluations given the government's pro-growth bias and ongoing USD funding issues.

- **Balance of payments:** We expect the C/A deficit to narrow to 8.7% in 2010 from 10.8% in 2009 as improvements in the services balance and a pick-up in inward remittances outweigh a likely deterioration in the trade balance. In addition, we expect FDI to rise to USD 11-12bn in 2010 from USD 8-9bn in 2009, supported by the global recovery. While BoP dynamics will continue to put upward pressure on USD-VND, we see them as less of a negative than in 2008-09.

FX outlook (12+ months): USD-VND to stabilise

We expect USD-VND to stabilise over the longer-term. The VND has depreciated by 20.08% versus the USD since its low on 21 March 2008. As such, we believe that the VND is now more fairly priced than it was in Q1-2008. This should support Vietnam's external position over the long term. From a structural perspective, long-term prospects look relatively bright. Political stability, a sizeable population, and the fact that many global corporates are considering using Vietnam as a manufacturing base result in a promising outlook.

VIII. FX market development (con'd)

Table VIII.1: Key macroeconomic indicators

	GDP	2005	2006	2007	2008	2009	2010F	2011F
1)	Real GDP growth (%)	8.4	8.2	8.5	6.2	5.3	6.7	7.2
2)	Nominal GDP (USD bn)	52.9	60.9	71.1	89.8	92.4	109.0	120.0
3)	GDP per capita (USD)	636	724	835	1,042	1,059	1,143	1,250
	Inflation, FX, and interest rates	**2005**	**2006**	**2007**	**2008**	**2009**	**2010F**	**2011F**
1)	Inflation (average CPI change, %)	8.4	7.5	8.3	23.1	6.7	11.5	8.5
2)	USD-VND exchange rate (year-end)	15,918	16,043	16,003	17,486	18,479	20,000	19,800
3)	5Y VND government bond yield (%, year-end)	-	8.29	8.73	10.00	11.68	14.0	-
	Balance of payments (USD bn)	**2005**	**2006**	**2007**	**2008**	**2009E**	**2010F**	**2011F**
1)	Exports	32.4	39.8	48.6	62.4	56.4	63.2	75.8
2)	Imports	34.9	42.6	58.9	75.2	68.9	76.2	90.8
3)	Trade balance = 1 + 2	-2.4	-2.8	-10.4	-12.8	-12.5	-13	-15
4)	Services, income and transfers	1.9	2.6	3.4	2.1	2.5	3.5	4.5
5)	Current account balance = 3 + 4	-0.6	-0.2	-7.0	-10.7	-10.0	-9.5	-10.5
	as % of GDP	-1.1	-0.3	-9.8	-11.9	-10.8	-8.7	-8.8
6)	FX reserves	8.6	11.5	21.0	23.0	15.0	18.0	22.0
7)	FX reserves in months of imports	2.2	2.1	3.0	4.1	2.6	2.8	2.9
	Country risk indicators	**2005**	**2006**	**2007**	**2008**	**2009**	**2010F**	**2011F**
1)	Standard & Poor's long-term FX debt	BB-	BB	BB	BB	BB	BB	-
2)	Moody's long-term FX debt	Ba3	Ba3	Ba3	Ba3	Ba3	Ba3	-
3)	Fitch's long-term FX debt	BB-	BB-	BB-	BB-	BB-	BB-	-
4)	Budget deficit as % of GDP	-4.5	-1.1	-5.3	-4.7	-11.8	-6.2	-
5)	Government debt as % of GDP	-	-	33.8	36.2	44.6	-	-
6)	Foreign debt as % of GDP	36.1	33.0	33.6	29.8	38.9	-	-

Sources: ADB, IMF, Standard Chartered Research

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