Deutsche Bank Research

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Understanding Vietnam

A look beyond the facts and figures

Vietnam's (re)discovery in recent years by the international investor community gives the country a second chance to become an Asian tiger. With the end of the US embargo in 1994, Vietnam was tipped to become the next Asian tiger, but did not live up to its potential. Now, investors have again become aware of Vietnam as resource-rich nation hungry for capital imports to industrialise its economy and as a potential marketplace with a budding financial sector market. For some it is also an attractive diversification alternative to China.

According to the DB Research growth forecast model, Vietnam will remain in the same growth league as China and India until 2020 since fundamental drivers are strong. It has a young and literate population. Highly skilled workers are scarce today but we expect significant improvements in education levels. Ever closer ties with the US and China will continue to support booming trade performance. Investment is likely to remain high. Sectors which already have attracted foreign investor interest include light manufacturing, IT outsourcing, tourism, infrastructure and the banking sector.

Banking sector reforms and deepening capital markets provide new opportunities. The banking sector's growth potential is significant. But problems like undercapitalisation, an unknown amount of non-performing loans, inadequate risk management and weak supervision need to be tackled faster. Capital markets are still maturing, but have delivered substantial returns. Investor-friendly regulation and an expected increase in the equity market's size have attracted significant investor interest. A corporate bond market is slowly emerging as well.

Plenty of challenges remain. There is an urgent need to improve Vietnam's legal system and general governance framework. Although the macroeconomic environment is fairly stable, high inflation, a rising fiscal burden and a tightly managed exchange rate need to be monitored carefully. There is also potential for social unrest stemming from rising income inequality.

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Vietnam: Historical milestones

Until mid 19th century:	Chinese influence in the North, Indian influence in the South (via Champa, Khmer culture)
1858:	Beginning of French colonial rule
1954:	Victory of communist forces at Dien Bien Phu, end of French rule in Indochina; partition of the country along the 17th latitude
1975:	End of the Vietnam war
1976:	Reunification under the name "Socialist Republic of Vietnam"
1979:	Border skirmish with China
1986:	Introduction of the Doi Moi policy of Renovation
1991:	Resumption of diplomatic relations with China
1994:	Ending of US embargo, Vietnam can join World Bank, IMF
1995:	Resumption of diplomatic relations with the US; Vietnam joins ASEAN
2000:	US President Clinton visits Vietnam
2001:	Ratification of the bilateral trade agreement with the US
2005:	Prime Minister Phan Van Khai visits the US
2006:	Vietnam hosts the APEC summit with leaders from 21 nations
2007:	Vietnam joins WTO

Source: various news articles 1

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A few basic facts

Name:	Socialist Republic of Vietnam
Ruled by:	Communist Party of Vietnam (CPV)
Secretary General:	Nong Duc Manh
Head of govt:	Nguyen Tan Dung
Head of state:	Nguyen Minh Triet
Capital:	Hanoi
Currency:	Vietnamese dong (VND)
Area:	329,560 sq km (similar to Germany)
Population:	85 m
Ethnic groups:	Kinh (Viet): 86%, 54 ethnic minorities: 14%
Religions:	None: 81%, Buddhist: 9%, Catholic: 8%

Sources: CIA factbook, DB Research 2

1. (Re-)Discovering a forgotten tiger

15 years ago when the Asian miracle was happening and the tiger states of East Asia bared their economic "claws" for the world to see, many observers started to predict that Vietnam would soon join the ranks of these rapidly growing East Asian tigers. After all, it had announced its re-entrance onto the world stage – this time not as a country fighting one of the world's major powers, but as a reformist communist country introducing market economy concepts following the Chinese example. Its "Doi Moi" (roughly translates as "change to something new") or "Renovation" policy was instituted in 1986, 8 years after China's "Open Door" policy. The Asian crisis hit Vietnam's economy hard, as risk aversion towards Asia compounded investor disillusionment with Vietnam's snail-like reform process. Hence, many investors pulled out of the country in search of other opportunities. Yet those who stayed may be finally starting to reap the benefits.

Why is this the case? Are we seeing a fundamental change in how things are being done in Vietnam – a sort of "Doi Moi 2.0" – or is Vietnam just flavour of the year? Will Vietnam be able to continue to rise and establish itself as an Asian tiger at a time when two huge markets – China and India – completely occupy the spotlight on the world stage? We will argue that several factors underpin a very favourable growth story for Vietnam provided that the right policy choices are made.

2. Why the spotlight has now turned onto Vietnam

Growth rate second only to China
Real GDP growth, CAGR 2000-2006, %

Source: DB Research 3

Vietnam's growth rate in recent years has been second only to China in Asia (see chart 3). But Vietnam's attractiveness has also been helped along by other factors, not all of its own making:

— The ***US-Vietnam bilateral trade agreement*** in 2001 opened the door to the US market for Vietnamese exports which have since skyrocketed.

— The current ***commodity boom*** is a big opportunity for a country which has oil and gas reserves and has become the world's largest exporter of pepper and the second-largest of rice and coffee.

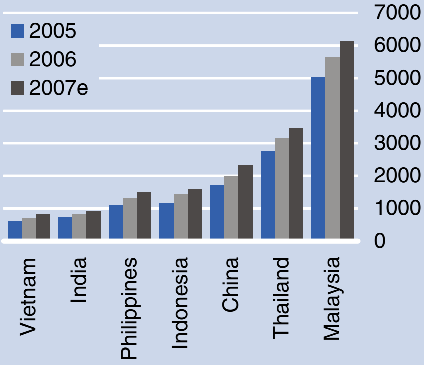
— ***Strong demand for capital goods*** like machinery and equipment attracted the attention of infrastructure suppliers and exporters in industrial countries as ongoing industrialisation of the economy has triggered a domestic investment boom (investment as a share of GDP has increased by 7 percentage points to currently 33% since the late 1990s).

— Preparation for ***WTO accession*** (in January 2007) led to reforms and liberalisation measures and fostered a domestic entrepreneurial spirit.

— As Vietnamese culture, its political system and economic reform process are perceived to be very similar to China's, Vietnam is increasingly seen as an ***alternative or "second leg" to a China engagement*** by many investors looking for a location with low labour costs and a stable political environment.

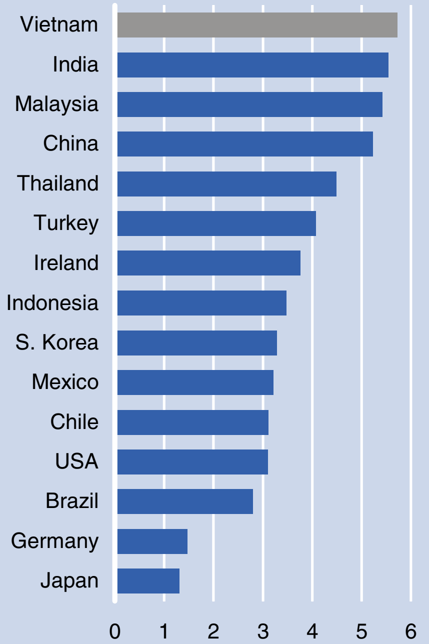
— Vietnamese ***companies are becoming more competitive,*** which is being noticed in the region. Reportedly, Thai businesses

Same development level as India
Per-capita GDP, nominal, USD



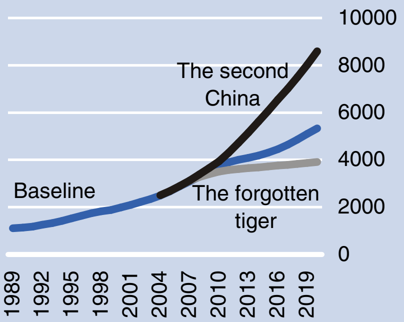
Source: DB Research 4

Vietnam - Growing in the same league as India and China
Ranking of GDP growth 2006-20, % p.a.



Source: Deutsche Bank Research, *Formel-G* 5

Possible growth paths until 2020
Real GDP per capita, USD PPP



Source: Deutsche Bank Research 6

have voiced concern about increased competition from Vietnam. Some Vietnamese companies are viewing their country as a gateway into Indochina and plan to branch out into Cambodia and Laos. However, Southern China is also an option.

— For the tourism industry, the country is a ***"fresh face", a safe destination, with an interesting history.*** The country is not troubled by threats of domestic terrorism or radical Islamist groupings; it is an exotic and still relatively cheap place for travelling. The fact that it won a war against the United States makes many curious enough to want to visit.

— ***Domestic financial market development*** has finally progressed to a point where it has attracted the interest of the international financial community. Portfolio diversification strategies and the "search for yield" have been supporting factors in Vietnam's "discovery" as well.

— ***Political stability, broad social consensus and a relatively favourable macroeconomic environment*** make for a favourable business environment. Ample capital inflows reduce the need for borrowing and are keeping debt servicing low.

While this is an impressive list of attractive factors, some of these will fade over time and some will need active policy support to be maintained. Let's take a closer look at a few of them.

3. In the same growth league as India and China

Vietnam's economic growth rate has in the recent past been second only to China in Asia, averaging 7.4% for the period 2000-2006 compared to China's 9.5% and India's 6.7% (see chart 3). On the other hand, its development level is more like India's with nominal GDP per capita for 2006 estimated at USD 715, close to India's USD 765 and less than half of China's nearly USD 2,000 (see chart 4). In a nutshell, Vietnam is as poor as India, but is growing at almost the same speed as China (India's growth has accelerated, though).

According to Deutsche Bank Research's *Formel-G* model, which forecasts real GDP growth for more than 30 industrial countries and emerging markets until 2020, Vietnam is likely to grow at about the same speed as India and China in the next one and a half decades – at an estimated 5.7% p.a[1] (see chart 5). Hence, in 2020, Vietnam's GDP per capita will have reached approximately the same level as China's today.

Upside scenario: The second China

It is not unthinkable that with the right policies in place Vietnam's growth performance could come closer to 8-10% p.a. Some indicators are pointing this way: WTO and AFTA membership are providing policy anchors. Substantial economic and structural reforms have significantly alleviated poverty in the country, garnering kudos and support from multilateral agencies. Under this scenario, the highly dynamic economy seen so far will continue into the

[1] See Bergheim (2005). Please note: Vietnam was not included in the original estimation of the *Formel-G* model due to data difficulties. As the 5.7% growth forecast is based on estimated data, the statistical margin of error is wider than for the original estimation which included China and India.

medium term and the government's goal of graduating from low income status[2] by 2010 looks easily achievable.

Downside scenario: The forgotten tiger

A reversal of the reform drive and rising protectionism, however, could lead to rapidly deteriorating growth, which would likely go hand in hand with waning FDI, similar perhaps to the aftermath of the Asian crisis when Vietnam's growth dropped to 4.8% in 1999. In an environment of stalled reforms and resulting decrease in foreign investment inflows, Vietnam's growth performance could get stuck at 4-5%.

Currently, it looks as if Vietnam has chosen the right policy mix. Policy makers have been looking at neighbours for guidance. The country generally emulates China's transition process from planned to market economy. It looks at Thailand's success at becoming a major Southeast Asian tourist destination and air hub. And it wants to create national champions out of its large state enterprises, perhaps along the lines of South Korea's chaebols. But all these goals need to be integrated into an overall, coherent policy framework. In this context it is positive to note that the government has an increasingly open attitude towards foreign consultation, i.e. discussion of policy matters with international organisations like the IMF or World Bank as well as private businesses.

4. The people

Young and ambitious

With 85 m people (roughly the same as the population of Germany), Vietnam is the third largest country after Indonesia (245 m) and the Philippines (90 m) in Emerging Asia ex China & India. Other emerging markets of similar population size include Mexico (108 m) or Egypt and Turkey (both about 75 m). Vietnam's population is very young, with a median age of just 25, which is about the same as India's and compares very favourably to China's 33. As the Vietnamese government has been promoting the 2-child family, Vietnam's society will likely age somewhat faster than India's, but will not face the demographic problems of China's one-child policy. The economy is enjoying a demographic dividend and working age population in Vietnam will continue to grow in the same vein as India's at 1-2% p.a. and not decrease as in China (see chart 7), providing one key driver for future economic growth. The current labour force is estimated at 40 m people and growing.

This young society is open to change and often quite entrepreneurially minded. Moreover, this post-war generation is positively inclined towards the US, and waves of emigration have generated strong ties with North America, France, Germany and Australia. It is not unusual to encounter families who have at least one family member living abroad.

Tapping the diaspora

It is officially estimated that about 3m Vietnamese live abroad, mostly in North America and Western Europe (informal estimates put the figure somewhat higher at roughly 5m). This is tiny

1000 years Chinese rule, 100 years French rule, 10 years American rule

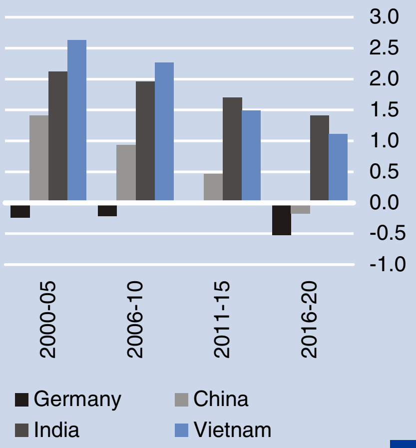
This is a rough rule of thumb for Vietnam's history. This foreign rule has left its imprint in various parts of Vietnamese culture and society as well as in its legal system (which is a patchwork of different elements of former colonial systems). It may also have given the people the ability to assimilate outside influences in a constructive way.

The North-South divide

The North with the capital Hanoi as the seat of politics is generally seen as more conservative while the South with Ho-Chi-Minh City (HCMC) as the centre of commerce and business is seen as more open to capitalism and faster reforms. With increased inner-country migration and improved economic development in the North, this (perceived) division is dwindling. In fact, today the focus is shifting to the economic gap between the majority "Kinh" people and the 54 ethnic minorities which have been left behind.

Working-age population to increase further

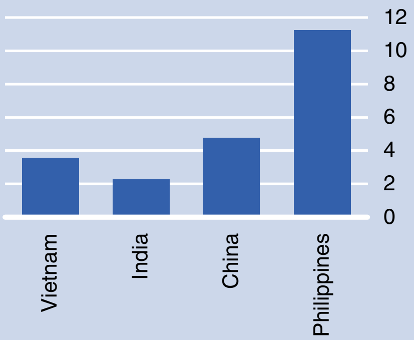
% change p.a. in population aged 15-64



Source: UN 7

Relative size of diaspora larger than India's

Diaspora, % of home country population



Source: Various news articles 8

[2] The current five year plan foresees GDP per capita at USD 1,050-1,100 by 2010 and annual average GDP growth rates at 7.5-8%. See MPI, Socio-Economic Development 2006-2010.

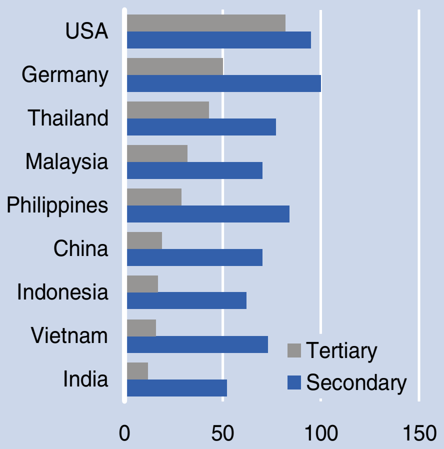
Remittances are important

Estimated 2006 remittances as a share of 2005 GDP, %

* DB Research estimate.
Source: The Economist, Nov 25, 2006 9

Good secondary, poor tertiary education

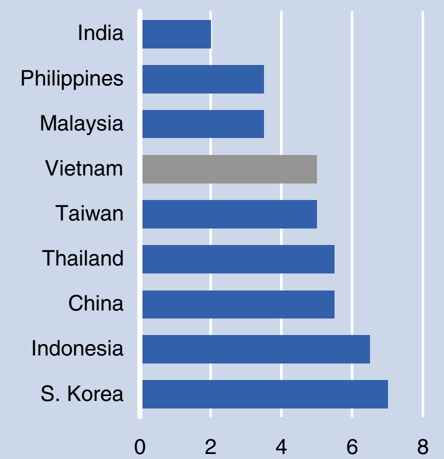
Gross enrolment ratio, %



Source: WDI 10

English proficiency better than many neighbours'

English proficiency (0: best - 10: worst)



Source: PERC survey Aug 2005 11

compared to the 20-25 m members of the Indian or the 55-60 m members[3] of the Chinese diaspora. However, the relative size of the Vietnamese diaspora is large, amounting to roughly 3.6% of the domestic population, bigger than the Indian diaspora at 2.3%, although smaller than the Chinese at almost 5% (see chart 8). Remittances from this group help to spur consumption and reached an estimated 9.5% of GDP in 2006, only second to the Philippines (see chart 9).

It has been acknowledged that non-resident Indians have played a pivotal role in advancing certain sectors of the Indian economy, and returning overseas Chinese have been important in improving the talent pool and providing input into policy-making. Hence, although the Vietnamese government has long been reluctant to tap the potential of overseas Vietnamese or "Viet Kieu", their ability to access a network of international business contacts and facilitate knowledge transfer has started to become acknowledged and the government has been working hard to tap the potential of Viet Kieu in recent years.

A small, but emerging middle class

The middle class is still small, estimated at about 10% of the population. These people are becoming increasingly open about showing their status symbols and have started to spend some of their income on non-essential consumption. Currently about 1.5-2 m Vietnamese travel abroad each year[4], mostly to other destinations in Asia (Thailand, Singapore, Malaysia, China) but also to the US and Europe. Car ownership has increased (about 5% of the population is estimated to own a car) and seems to be mainly concentrated in the luxury sector (limousines and SUVs). Further growth in car ownership could be constrained by poor roads, though.

5. Education, education, education!!!

Widespread basic education

One factor which contributes to Vietnam's high growth potential is the country's emphasis on education. Its literacy rate of roughly 90% is similar to China's and significantly higher than India's 60% or Pakistan's 50% which are countries at a similar level of development. The country also scores well in terms of its secondary school gross enrolment ratio of 73%, which is higher than the ratio of some of its neighbours (see chart 10). Due to Vietnam's openness to foreign influence and reliance on trade, the workforce's English language proficiency compares favourably with many of its neighbours, notably China (see chart 11). Moreover, there are many German-speaking Vietnamese (about 100,000, among them about 10,000 academics who were educated and worked in the former East Germany[5]). It should also be mentioned that Vietnam scores relatively well in terms of female labour force participation, meaning that the country is tapping a broad range of human resources.

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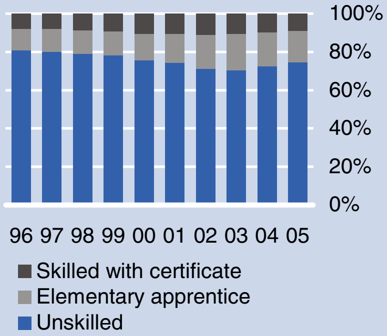
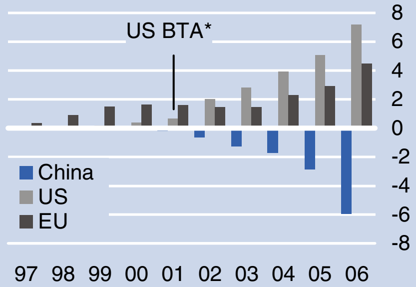
[3] Estimates for the size of the different diasporas are based on various news articles.
[4] EIU (2006b).
[5] Auswärtiges Amt (2007).

Highly skilled people are still a rarity
% of all economically active persons



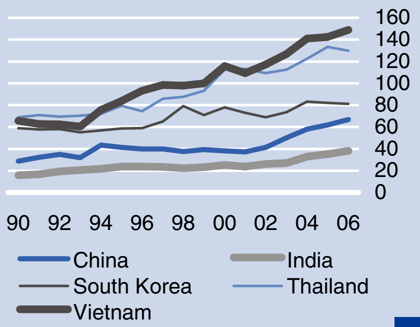
Source: CEIC **12**

Exporting to the US, importing from China
Bilateral trade balance, USD bn



*Bilateral trade agreement.
Source: IMF Direction of Trade statistics **13**

Already a very open economy
Exports + imports (g&s), % of GDP



Source: DB Research **14**

Welcoming the US – wary of China

There are interesting political dynamics in Vietnam's relationship with its former war enemies. Attitudes towards the US in the general population are mostly positive, fostering closer trade and investment ties. On the other hand, the US is keen to court Vietnam as an ally in its dealings with China. Tentative military-to-military cooperation has started. Nevertheless, trade disputes have complicated bilateral relations. China and Vietnam on the other hand, appear to be natural allies due to their similar political systems and economic transition paths. There are reportedly regular mid-level staff exchanges between both countries' central banks. However, China's rise is also viewed with suspicion in Vietnam.

Highly skilled people are scarce and becoming expensive

Access to tertiary education, however, remains relatively poor. Vietnam's gross enrolment ratio of just 16% is close to the bottom of the regional ranking (see chart 10), as there are too few university places with too few teachers in the country. Hence, highly skilled professionals with a university degree or vocational qualification are very rare (see chart 12). This skill shortage means that salaries for some professions have seen annual increases as high as 30-50%[6], especially for personnel with banking, financial, accounting, HR, and (middle) management skills. Reportedly, firms are trying to fill this gap with Indians, Filipinos and staff from other Asian subsidiaries. English language proficiency, although deemed favourable compared with neighbouring countries, still needs improvement in absolute terms. The same applies to the quality of service provided by personnel in the hospitality sector. Moreover, regulatory oversight and policy-making could benefit from better trained personnel. Vietnamese experts who are savvy in international economic and political issues and who can represent Vietnam's economic interests on the global stage are still relatively rare.

Significant improvements in the education level of the population are desirable. Considering society's emphasis on giving children a good education and recent government policy focus on this area, tangible progress looks also achievable.

6. Booming trade

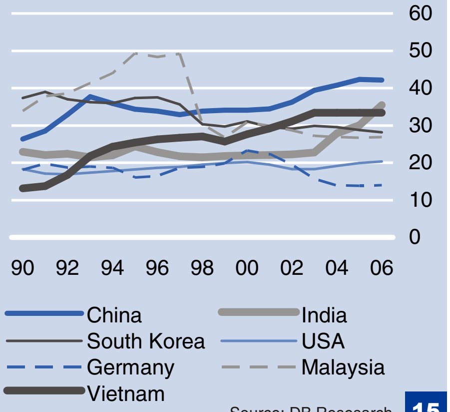
From old enemies to main trading partners

Until the mid-1990s Vietnam was relatively isolated due to its chosen policies and the US embargo. With reforms of the Doi Moi policy instituted in 1986 slowly bearing fruit and the normalisation of US-Vietnamese relations during the Clinton administration, trade with the rest of the world slowly took off. The bilateral trade agreement with the US which came into force in 2001 granted Vietnam's exporters access to the world's biggest market. Soon the US became Vietnam's main export market and bilateral trade with the US surpassed that with the EU (Vietnam's biggest trading partner for a long time). Moreover, Vietnam was also affected by China's emergence as an economic powerhouse and in 2005 the Middle Kingdom became Vietnam's largest trading partner. Interestingly, Vietnam's trade relations with China are a mirror image of those with the US and EU as it has a trade deficit with China (see chart 13): it imports textiles, toys, motorbikes, TVs, and radios, while it exports mainly agricultural products, rubber, and seafood.

Thus, Vietnam became one of the last to join Asia's "flying geese formation" of small open economies driven by high export growth and investments. When it joined the WTO in January 2007 the sum of Vietnam's exports and imports stood at 150% of GDP (see chart 14), much higher than China and India and even Thailand. Vietnam is likely to continue becoming more closely integrated into world trade and exports are expected to remain one of the main drivers of growth. The catch here, though, is that most of the country's exports today are still very commodity-based or of low value-added. Although the share of manufacturing goods has risen over time to

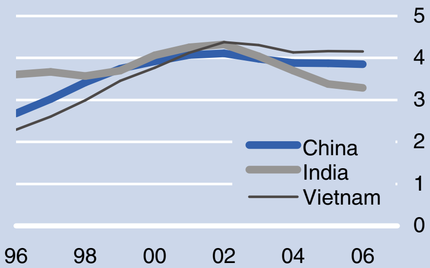
[6] Bradsher (2006).

Level of investment expected to rise to 40%
Investment, % of GDP



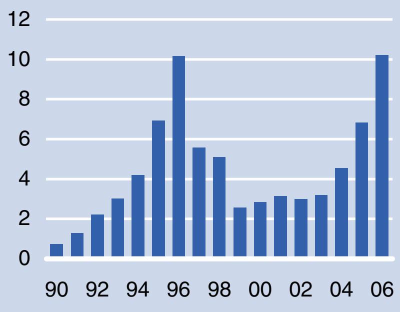
Source: DB Resesarch 15

Vietnam's investment efficiency is worse than its neighbours'
ICOR (incremental capital output ratio)*



*Units of investment needed for another unit of output. Source: DB Research 16

FDI has recovered due to WTO accession
Total FDI (registered capital), USD bn



Source: CEIC 17

over 50% of all merchandise exports, these consist mainly of garments and textiles, footwear and furniture. The question therefore is whether Vietnam will be able to build up higher value-added manufacturing industry as well, in order to diversify its export base and not to be too dependent on the vagaries of international commodity prices.

7. More investments are needed

Similar to China, investment plays a crucial role in driving Vietnam's economic growth performance. At 33% of GDP (see chart 15) Vietnam's investment ratio is not as high as China's (above 40%), but higher than most of its neighbours'. Still, Vietnam's investment needs remain huge, especially regarding infrastructure. Bottlenecks are manifold, ranging from insufficient power plants, to choked ports and poor roads[7]. Electricity supply is significantly below demand leading to frequent power outages. If these bottlenecks are not alleviated soon, they could drag down the economy's growth performance. Hence, the government is planning to raise investments to about 40% of GDP by 2010[8] or by a cumulative USD 140 bn[9].

Unfortunately, the efficiency of investment as measured by the incremental capital output ratio (ICOR)[10] has been decreasing over the years and at 4.2 is now even worse than China's 3.7 or India's 3.3 (see chart 16). Part of the reason might be corruption[11], but inefficient capital allocation likely also plays a role, due to the still immature financial system.

Foreign direct investment (FDI) is surging

FDI into Vietnam was relatively tiny at the beginning of this decade at around USD 3 bn (on a commitment basis) per year. In the last couple of years, however, as investor interest resumed so did FDI (see chart 17), It reached over USD 10 bn (16% of GDP) on a commitment basis in 2006 (USD 4.4 bn were disbursed[12]). According to local estimates, FDI commitments could triple in 2007 to USD 30 bn. Although the government is a recipient of generous overseas development aid (ODA) (see box p. 9) and has started to tap international financial markets[13], it hopes that FDI will play a major role[14] in increasing investment. The trend looks supportive: The foreign-invested sector has been playing an increasingly bigger

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[7] But one should also give credit to the large improvements in infrastructure in the past few years. For example, in 2001 only 3 ATMs existed in the whole country and mobile phone providers did not even know that Vietnam existed. Today, there are ATMs around every corner at the centre of the big cities and international mobile phone access is not a problem at all.
[8] See MPI, Socio-Economic Development 2006-2010.
[9] See IMF article IV consultation (Nov 2006).
[10] ICOR: units of investment needed to create one more unit of output; a higher value signals a decrease in efficiency, i.e. one needs to invest more for a one-unit increase in output.
[11] The Central Institute for Economic Management (CIEM) estimated that 20-40% of all state investment in construction projects is lost in "leakage and waste" (See IMF article IV consultation (Nov 2006) or Kazmin (Jan 13, 2007)).
[12] World Bank estimate.
[13] It is said for example that Vietnam issued its first sovereign Eurobond in October 2005 not because of financial needs, but to raise its profile in financial markets, to signal its existence to investors and to incite more research about the country so that more investors might become interested in investing in the country. The issue has been well received and has been trading at spreads below its regional peers.
[14] The five-year plan foresees investment relative to GDP reaching 40% in 2010 with domestic capital accounting for 65% and external capital for 35%. See MPI, Socio-Economic Development 2006-2010.

Plenty of overseas development aid (ODA)

ODA has played a strong role in financing investment in public infrastructure. As Vietnam has been a showcase of poverty alleviation, the donor community has been relatively generous (annual commitments have totalled USD 2-3.5 bn or up to 5% of GDP since the beginning of the decade, actual inflows were USD 1.8 bn in 2005). It is expected that these flows will continue with commitments in a similar range to in the past.

Vietnam's top foreign investors

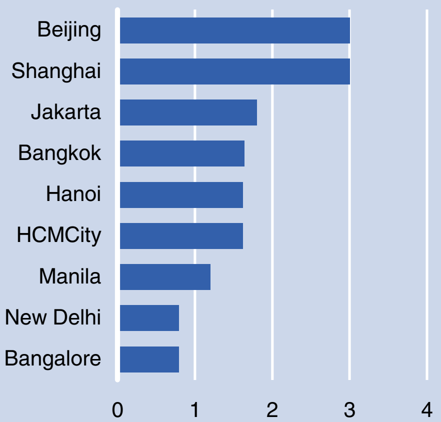
FDI stock as of end-March 2007, USD m

	Disbursed capital	Registered capital
Japan	5,171	7,780
Singapore	4,047	8,767
Taiwan	3,127	8,352
South Korea	2,893	8,420
Hong Kong	2,328	5,409
Netherlands	2,242	2,361
B.V. Islands	1,439	3,405
France	1,152	2,203
Malaysia	1,132	1,643
Mauritius	903	192
Thailand	833	1,608
US	718	2,302
India	683	134
UK	655	1,376
Cayman Islands	641	1,680

Source: Vietnam Investment Review, April 16-22, 2007 **18**

Telephone charges no longer out of line

International call (3 min), USD



Source: JETRO survey for 2006 **19**

role in the economy, accounting for 17% of output in 2006 compared to only 6% a decade ago.

Japan is Vietnam's main foreign direct investor. Reportedly, Vietnam has become the first choice for Japanese firms that have an operation in China and want to shift their investment to a third country.[15] Other big investors are Singapore, Taiwan, South Korea, and Hong Kong. Big non-Asian investors include the Netherlands, France, the US, and the UK (see table 18). Germany is still a very small investor with disbursed capital of only USD 161 m as of Q1 2007.[16] Chinese investments in Vietnam have also taken off, with (disbursed) investment as of Q1 2007 at over USD 245 m[17]; the true figure might be larger as there appears to be quite a bit of unofficial investment, especially in the border regions. China's investments have been mostly in raw materials like coal and bauxite and in building the transportation infrastructure to connect Vietnam to southern China.

Early foreign direct investors have complained that one of the main obstacles to setting up shop in Vietnam is a missing supplier base and high operating costs. With improvements in the infrastructure the latter, like e.g. telephone charges, have come down quite significantly (see chart 19), and the former is likely to slowly build up with further development of the economy.

8. Sectors of foreign investor interest

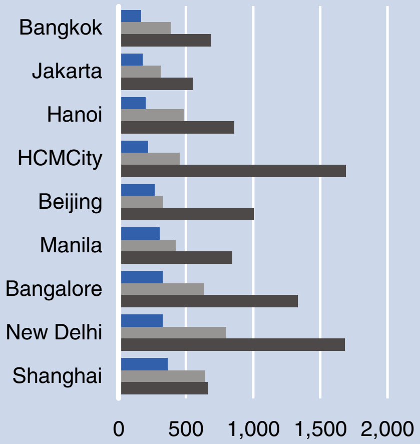
Light manufacturing: Driven by diversification

Vietnam's advantage as a manufacturing site lies in its still comparatively cheap labour costs (see chart 20), although higher-skilled workers such as managers are becoming expensive due to a scarcity of qualified personnel, as discussed above. Also, the industriousness of its labour force combined with political stability in a relatively investor-friendly economic environment are attractive features. As costs and staff turnover have been rising in China and in India, investors have started to look for alternatives. The desire for diversification of locations has played a role as well. Vietnam has gained attractiveness with small and medium-sized enterprises (SMEs).

The **footwear and garment industry** was one of the first sectors to discover the potential of Vietnam as manufacturing site. The main market of Vietnam's garment exports is the US (56%), followed by the EU (19%) and Japan (11%).[18] Garment exports surged by almost 30% in 2006 in anticipation of WTO accession.[19] The shoe industry's export performance has been so good that it was included in the anti-dumping measures the EU raised in 2006 against Asian shoe imports. Nevertheless, footwear exports rose by roughly 20%[20] yoy last year. Often China is the location for mass market production, while specialised, high-quality orders are routed to Vietnam. There is also a budding **electronics / ITC equipment manufacturing** sector in Vietnam. Intel's announcement in 2006 that it will invest USD 1 bn in a chip assembly and testing plant (tripling an

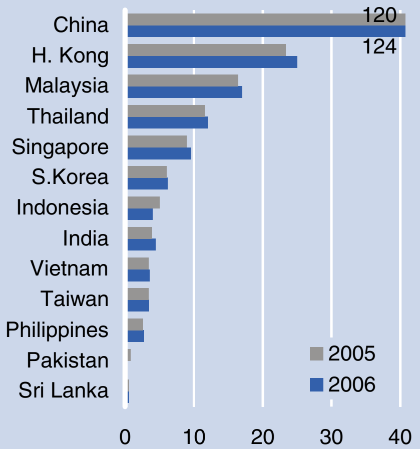
15 Masaki (2006).
16 Vietnam Investment Review (2007).
17 Vietnam Investment Review (2007).
18 World Bank (June 2006).
19 The US has the ability to re-impose quotas even after Vietnam's WTO accession, though.
20 World Bank (Dec 2006).

Vietnamese workers' wages still low, but managers are getting dear
USD



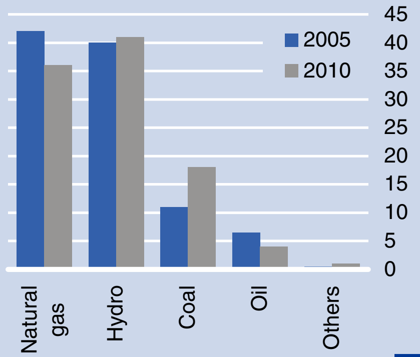
Source: JETRO survey for 2006 **20**

Vietnam: Plenty of room for growth in tourism
Tourists arrivals, m



Source: CEIC **21**

Hydropower to remain a major energy source
Sources of power generation, % of installed capacity



Source: Energy Economist **22**

original announcement of USD 300m[21]) has been seen as proof of Vietnam's attractiveness.

IT outsourcing: Still small scale

Although on a scale in no way comparable to that in India, several firms have been exploring the possibility of outsourcing software development projects to Vietnam, attracted by low labour costs and the comparatively high English proficiency. Wage inflation and high staff turnover in India have led firms to look at alternative locations like China, the Philippines and Vietnam. Industry observers estimate Vietnamese IT developers' salaries to be 15-20% lower than in India, and turnover ratios to be less than 5% compared to 35% at some Indian sites[22]. The still small scale of the operations can be an issue though, but with 50% annual growth in recent years[23] this could change soon. Vietnam's software outsourcing industry's revenue in 2005 was estimated at USD 70 m.[24] There are currently over 600 software-related firms in Vietnam.[25]

Tourism: "Vietnam – The hidden charm"

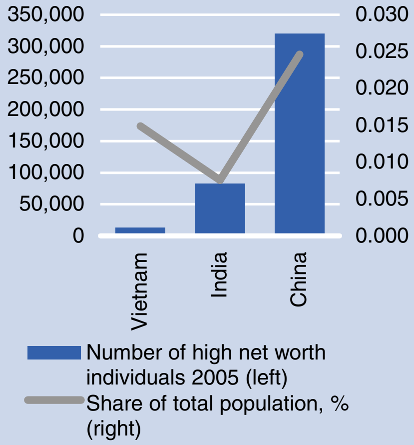
Vietnam has been a magnet for backpackers and adventurous travellers for some time, but in recent years more and more mainstream tourists have come to visit the country as beach resorts are expanding and marketing of the country as a safe, affordable, but still exotic destination has increased. Vietnam boasts approximately 3,400 km of coast, consisting mostly of sandy beaches. Tourism revenue reached roughly USD 3 bn[26] or 5% of GDP in 2006. Growth in tourist arrivals has been in double-digits in the last decade, from only 1.3 m people in 1995 to 3.6 m in 2006. Compared to other Asian countries, however, this is still paltry (see chart 21), pointing towards significant future growth potential, provided that skilled personnel becomes more easily available.

Infrastructure: Ambitious projects

As already mentioned, the country's infrastructure needs are still huge and the construction sector has been booming. Especially in the area of transportation (airports, ports) a lot of ambitious projects are under way. Upgrading and constructing six international airports, with one envisioned to be able to compete with Singapore and Bangkok[27], is on the drawing board as well as a subway in Ho-Chi-Minh City and an elevated railway in Hanoi. Another area in focus is the energy sector. Vietnam's relies to a large extent on hydropower to feed its energy needs (see chart 22), but droughts in the North can lead to major disruptions in the energy supply. Hence, natural gas and increasingly coal have been or will be tapped as a source of energy. Government plans include the construction of seven new coal power plants by 2010, one natural gas plant and one nuclear power plant[28] - with the help of foreign investors.

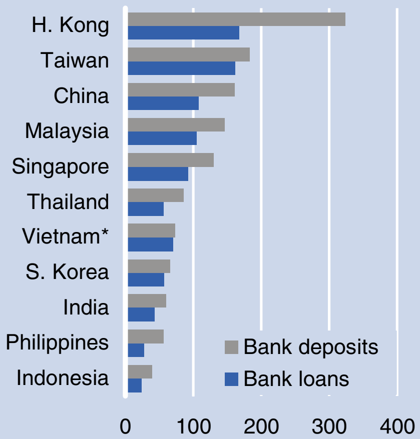
[21] Kazmin (Nov 13, 2006).
[22] See Murray (2006).
[23] VietNamNet Bridge (2006).
[24] VietNamNet Bridge (2006).
[25] Masaki (2006).
[26] VietNamNet Bridge (2007).
[27] BFAI (2006).
[28] BFAI (2006).

Number of rich people still low, but relative share similar to neighbours



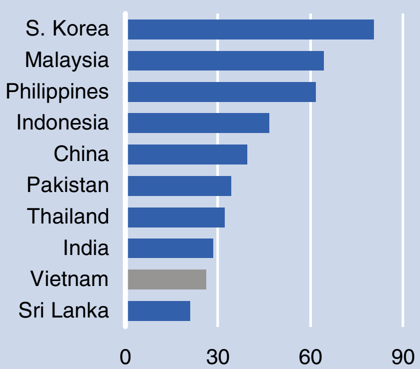
Sources: Capgemini/Merrill Lynch World Wealth report, EIU
23

High growth potential for the banking system
% of GDP, 2006



*Estimate based on latest IMF art.IV report.
Source: CEIC
24

Low urbanisation means low access to banking
Urban population, % of total population, 2004



Source: WDI
25

The banking sector: High growth potential from a low base

In the past couple of years, Vietnam's banking sector has become attractive for foreign banks looking for new growth markets. There is high growth potential as only about 5-7% of the 85 m population have bank accounts and use banking services (at least 50% of all payments transactions are still in cash). Moreover, there are only about 4 m people using credit cards at present (2005: 1-2 m).[29]

Hence, credit card business and consumer banking are considered the current growth areas. Market researchers estimate the annual average per capita income in Ho-Chi-Minh to be currently as high as USD 2,400[30] (which would be more than triple the country's average per capita income). The number of high net worth individuals (i.e. USD millionaires) is still very small at an estimated 12,500[31] – especially when compared to India's 83,000 or China's 320,000. But in terms of the overall population, Vietnam is not out of line with India and China (see chart 23). Moreover, the ratio of bank credit in relation to GDP in Vietnam is still relatively low (compared to its Asian peers) at an estimated 70% for 2006 (see chart 24), pointing to significant growth potential. However, only roughly a quarter of the population is urbanised, which is one of the lowest rates in emerging Asia (see chart 25), comparable to India's, but much lower than China's 40%. Ho-Chi-Minh is the biggest conurbation with about 7 m inhabitants. This makes it difficult for a large part of the population that lives in the countryside to access banking services.

The Vietnamese government has been cautious about embracing foreign banks. In line with WTO requirements, foreign banks should face a level playing field from April 1, 2007. They are now permitted to establish 100% foreign–owned subsidiaries, provided that the bank has total assets of more than USD 10 bn[32], and to receive unlimited VND deposits[33] and issue credit cards. Foreign ownership ceilings for banks have been raised to 15% for a single investor (which is less than the 20% originally expected) but remain at 30% for all foreign investors in a bank. There are currently 28 foreign banks in Vietnam and several have bought stakes in Vietnamese banks or announced plans to do so (see Appendix 1 and 2).

9. Banking sector reforms under way

More players, fiercer competition

The banking system is dominated by state-owned commercial banks (SOCBs – 4 big ones, 1 smaller one, see table 27) – , which have a market share of roughly 70% (of loans). The remainder is divided among 36 urban and rural joint-stock banks (JSBs – in principle private banks, but which often still can have a state entity as main shareholder[34]) with about 15% market share and 28 foreign banks

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29 As estimated by local bankers.
30 McCool (2006).
31 EIU (2006a).
32 Foreign bank branches have already been allowed if the parent has assets of more than USD 20 bn and joint ventures are possible as well.
33 Some restrictions with regard to foreign bank branches accepting VND deposits from Vietnamese natural persons with whom the bank has no credit relations may apply unit 2011.
34 Capital supplied for the establishment of JSBs often came from a mix of SOCBS, SOEs, private businesses and individuals.

Vietnam's banking sector

5	State-Owned Commercial Banks (SOCBs)
2	Policy Banks
31	Urban Commercial Joint Stock Banks
4	Rural Commercial Joint Stock Banks
5	Joint Venture Banks
28	Foreign Banks (some with 2 branches)
21	Financial and leasing companies
> 900	People's Credit funds

Sources: State Bank of Vietnam, latest available information, EIU 26

plus 5 joint-venture banks (see table 28) with about another 15% market share.

Despite the seemingly over-banked and fragmented state of the banking sector, the State Bank of Vietnam (SBV) is still licensing new banks (about 10 new banks are currently awaiting a license) while merger regulations in the banking sector remain very unclear. Banks are still focused more on market share than profits. Hence, competition has become relatively heated, especially among JSBs which often tend to be relatively small in size and focus on consumer lending and SMEs. Still, there are some cooperation initiatives, such as "Banknet", which links ATMs of different banks.

The state-owned commercial banks*

Abbreviation	Full name	Chartered capital, VND bn
Vietcombank	The Vietnam Bank of Foreign Trade	4,365
Incombank aka ICBV	Industrial and Commercial Bank Vietnam	7,646
Agribank aka BARD or VBARD	The Vietnam Agriculture and Rural Development Bank	5,190
BIDV	Bank for Investment and Development Vietnam	7,477
-	The Mekong Delta Housing Development Bank	768

*There are also 2 policy banks: The Vietnam Bank for Social Policies and the Vietnam Development Bank; Source: SBV (latest available data) 27

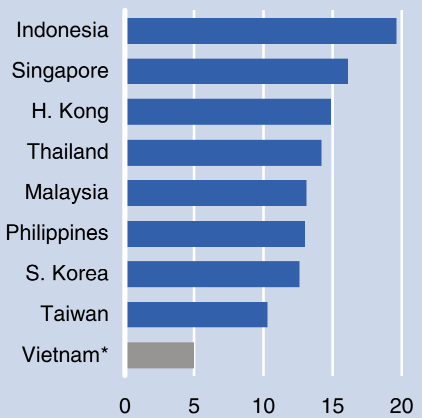
Joint-Venture Banks

Name	Head-quarter	Foreign partner(s)	Domestic partner
VID Public Bank	Hanoi	Public Bank Berhad (Malaysia)	BIDV
Indovina Bank	HCMC	Cathay United Bank (Taiwan)	ICBV
ShinhanVina Bank	HCMC	Shinhan Bank (S. Korea)	Vietcombank
VinaSiam Bank	HCMC	Siam Commercial Bank PCL & Charoen Pokphand Group (Thailand)	VBARD
Vietnam-Russia Bank	Hanoi	Vneshtorgbank (Russia)	BIDV

Source: Company websites 28

Capital adequacy ratio of Asian banking sectors

%, 2005



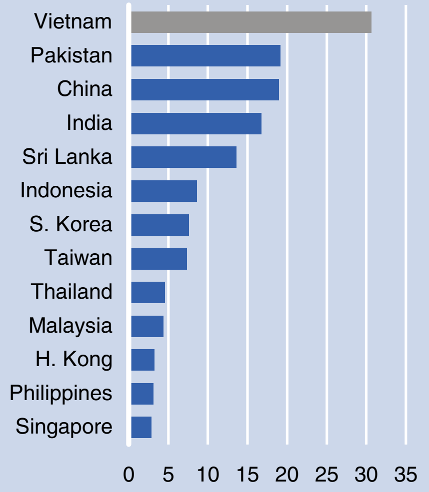
*DB Research estimate. Source: Moody's 29

Significant capital needs drive bond issues & IPOs

It is estimated that only few banks in the system meet the 8% Basel I threshold. The banking system is undercapitalised in absolute terms and also in comparison to its Asian peers (see chart 29). There has been some progress in restructuring and recapitalising SOCBs since 2001 (when the capital adequacy ratio (CAR) was estimated officially at around or below 4%) with an official capital injection of about VND 10.4 tr between 2001 and 2005. Today, SOCB CAR is estimated at around 4-6%.[35] Average JSB CAR tends to be somewhat higher.

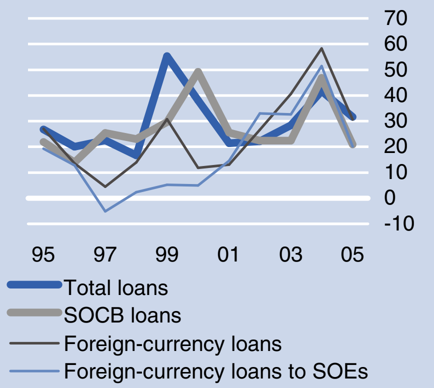
[35] Vietcombank might have reached 8% due to plans for listing.

Very high domestic credit growth in recent years
Domestic credit growth, average growth 2003-2006, %



Source: DB Research 30

Last lending boom driven by foreign-currency loans to SOEs
Loan growth, % yoy



Source: CEIC 31

The State Bank of Vietnam (SBV) has issued minimum chartered capital requirements:

— JSBs must have chartered capital of VND 1tr (USD 60m) by 2008, VND 3tr (USD 185m) by 2010.[36] It is estimated that perhaps half of the JSBs meet this requirement (see Appendix 2). If so, JSBs may need to raise VND 10-15 tr (USD 0.6-1 bn[37]).

— SOCBs are required to have a minimum chartered capital of VND 3tr by 2008[38]. As of Q3 2006 it was estimated that the SOCBs may need to raise VND 30-50 tr (USD 1.8-3 bn[39]) to be Basel-compliant by 2010.

Since last year JSBs have started to increase their capital base through domestic bond issues and IPOs (as well as stake sales to foreign partners (see Appendix 2)). Plans have been set up for SOCBs to be equitised[40], with Vietcombank (VCB) equitisation planed for this year. The government intends to retain majority ownership in the SOCBs (at least 51%). Interestingly, SOCBs plan a domestic listing before taking on a foreign stake holder (for a stake of 10%) and listing internationally in either Singapore or Hong Kong.

Credit risk assessment still immature

The true extent of NPLs in the banking system is unknown, with estimates ranging between 15%-20% of GDP[41], a legacy of policy-directed lending. JSBs' NPLs are officially estimated below 4-5% as they have been relatively unencumbered by policy-directed lending. No official figures are given for SOCBs' NPLs, but they are estimated to be much higher. Rapid credit growth in the past few years (30-40% yoy, the highest growth rate in emerging Asia, see chart 30) could lead to more NPLs. Due to these concerns, the government has tried to slow down lending growth, with mixed results. Risk appetite at SOCBs was successfully reduced (loan growth at SOCBs is currently estimated at 10-15%) but high deposit growth at these banks led to an accumulation of excess liquidity which SOCBs lent out in the interbank market to fund-starved JSBs. This allowed for further rapid growth in JSBs' loans (30-60% yoy at some JSBs). Loans are generally collateralized by property, plant and equipment (PPE), but foreclosure laws remain weak.

Furthermore, the degree of dollarisation in the banking system has slowly crept up again in recent years with foreign currency loans accounting for about a quarter of total loans. Contrary to the lending boom in 1999/2000, foreign-currency loans (mostly directed at state-owned enterprises (SOEs)) have grown more rapidly than total loans (see chart 31). The de facto peg to the USD in place since late 2004 might have been encouraging this development. Dollarisation may increase the vulnerability of the banking system, especially since it is unclear whether the currency risk has been properly hedged by borrowers and whether the government has sufficient capabilities to support USD-indebted SOEs if need be.

The government is trying to clamp-down on stock-market related lending, but the purpose of a loan is often difficult to track. Moreover, banks are not supposed to lend to their affiliated securities firms.

[36] This applies to joint venture and foreign-invested banks as well; see World Bank (Dec 2006).
[37] MacCana (2006).
[38] World Bank (Dec 2006).
[39] MacCana (2006).
[40] "Equitisation" means turning an SOE into a joint-stock corporation and divesting part of the state shares – a first step towards listing a company.
[41] IMF estimate for debt sustainability analysis.

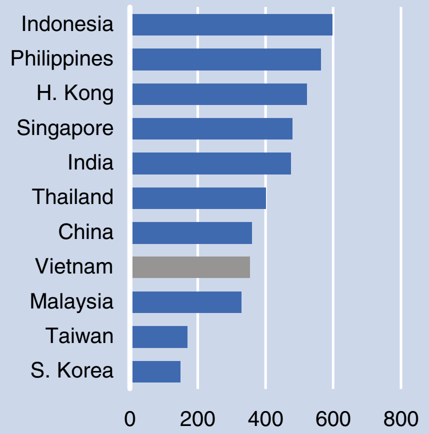
However, they lend to other banks instead, which in turn lend to the first bank's securities firms.

Further and faster reforms needed

The IMF estimates the cost of banking reform in Vietnam at 15%-20% of GDP and stresses the need for faster reforms to reduce the contingent liability to the government. A realistic valuation of the legacy NPL burden is needed to clearly assess the size of the problem and to formulate solutions. Current reform efforts in the banking system focus on the problems of poor information and disclosure, as well as intransparent accounting and classification. International 5-category asset classification rules have been introduced, but implementation remains incomplete. There are plans to set up a credit bureau for individuals with the help of the International Financial Corporation (IFC), the World Bank's private sector development arm. Banks should be Basel I compliant by 2010.

Margins in Vietnam not very high compared to neighbours

Lending - deposit rate spread (latest available), bp



Sources: IFS, CEIC 32

Moreover, banks need to diversify into fee-income business to increase their revenue base and thus to increase their ability to withstand a downturn in the credit cycle. Currently Vietnamese banks mainly derive their income from interest rate spreads which are relatively tight compared to other Asian economies (see chart 32). SOCB managers need to be given operational autonomy to make decisions based on commercial profit-oriented considerations free of political interference. For example, during 2006, banks and especially SOCBs were still encouraged to fix deposit interest rates to avoid a further escalation of rates and thus a compression of margins.

Supervisory reform is also under way. The official banking sector roadmap sees a reorganisation of the SBV's relationship with commercial banks. Currently, the central bank is both the supervisory authority and a co-owner of the banks. This can lead to conflicts of interest[42]. Proposed changes to the laws governing the SBV would eliminate its ownership role so that the central bank will be responsible for monetary policy and banking supervision only[43]. The establishment of an independent financial supervision board in the medium term is being planned. Currently, supervision is heavily rule-based with an only limited assessment of credit and operational risks (e.g. adequacy of lending procedures or risk management). Finally, there is a need to shore up prudential supervision with regard to banks' contingent liabilities or off-balance-sheet risks (e.g. issuance of guarantees for SOE bonds).

Vietnam's stock market

2	Trading centres (Ho-Chi-Minh City, Hanoi)
107	Listed companies
55	Securities companies
18	Fund management companies
6	Custodian banks
1	Designated settlement bank

Source: State Securities Commission, latest available information 33

10. Rapid financial market development

The tiny stock market has taken off

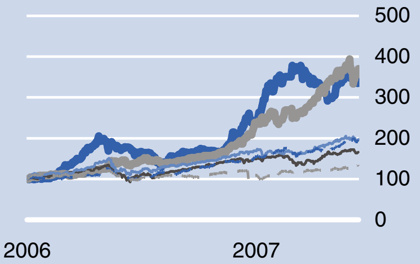
In 2006, portfolio investors around the world took notice of Vietnam's stock market, which trumped the already high returns of its neighbours (see chart 34)[44]. The Vietnam index yielded a yearly return of 142% (on USD basis); China's Shanghai composite came close with 138%, while India's Sensex "only" delivered 49%. The

[42] There is a Deposit Insurance Agency (VND deposits up to VND 30m per individual per bank are covered) with independent examination powers, but which nevertheless relies on data supplied by the SBV.

[43] See ADB Proposed Program loan document, Sep 2006.

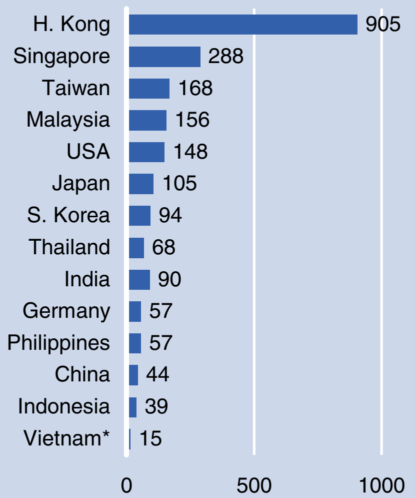
[44] In early 2007 the Shanghai stock market outperformed Vietnam's as the Vietnamese government tried to cool down the stock market.

Vietnam's stock index outperformed neighbours' in 2006
Index Jan 2006 = 100 (based on USD stock market series)



Source: Bloomberg **34**

Vietnam's market capitalisation still very small in comparision
Market cap (as of end-2006), % of GDP



*Own estimate. Sources: World Federation of Exchanges, DB Research **35**

Trading on the Ho-Chi-Minh City stock exchange

There are three trading sessions each day of a total of just 70 minutes, each separated by a 20-40-minute break:

— 8:20 – 8:40 am to determine the opening price
— 9-9:20 am for order matching
— 10-10:30 am determining the closing price
— there is one session for bonds at 10:30-11 am

Buy and sell orders, which are hand-entered, are matched at the end of each trading session, but for the second session a continuous order matching system is being introduced. Settlement is t+3 for stocks, t+1 for bonds.

market has become relatively expensive, with current P/E ratios for some stocks listed at the Ho-Chi-Minh City market estimated at 40-70x expected earnings[45].

2006 was a watershed year for Vietnam's stock market with a marked increase in overall activity. Over the course of the year, the number of listed companies increased to 106 from about 30. Daily turnover increased to USD 50 m[46]. In Q1 2007, there were 160,000 trading accounts (with about 3,000 foreign accounts). Market capitalisation increased from less than 1% of GDP at the end of 2005 to about 15% or roughly USD 9 bn[47] one year later. In the first half of 2007 capitalisation reached about 23% of 2006 GDP. There are expectations that market capitalisation could reach USD 80 bn[48] by 2010. Compared to its neighbours, though, Vietnam's stock market capitalisation is still very small relative to GDP, less than half of China's and way below India's 90% (see chart 35). Foreign investors make up about 30% of the market. Individual domestic investors make up 90% in number and 50% in value. Total flows mobilised by Vietnam-related funds worldwide until mid-2007 are estimated to have reached about USD 6 bn[49].

There are two trading centres in Vietnam: The main exchange for trading shares of listed firms is the "Ho-Chi-Minh Security Trading Centre" (established in July 2000 with 2 listed firms) and the "Hanoi Security Trading Centre" (established in March 2005) focuses on small caps and bonds. Securities firms have mushroomed from 14 at the end of 2005 to currently 55. Joint ventures between foreign and local securities companies are allowed, but the foreign partner is allowed to hold only 49% (there are plans to increase the limit to 100% in 2012).

More investor-friendly regulation

This rush of activity in Vietnam’s stock market has been mainly due to a change in policy. Over the course of the last two years, the government gradually eased restrictions in order to further the development of the formal market (versus a relatively large informal market, also called "OTC market" in Vietnam). First came the lifting of the foreign investment ceiling in a listed company (ex banks) to 49% from 30% in October 2005. Foreign-invested enterprises (FIE) got permission to list on the stock exchange and Taiwan's Taya Electronic Wire and Cable Co. became the first FIE to list in February 2006. In a further step, the government phased out tax incentives for listed firms starting 2007, thus inducing a rush of firms to come to the market before the end of 2006 (December 2006 alone saw 49 listings).

The new Securities Law (in force since January 2007) aims to improve the regulatory environment for Vietnamese securities and to raise transparency and financial disclosure. It will convert the Ho-Chi-Minh City Security Trading Centre into a full stock exchange with jurisdiction over listings, there will be a separation of securities brokers and asset management companies and any – listed or not listed – public company with 50 or more shareholders will be required to disclose financial information. In effect it will introduce the same rules of disclosure on the informal market as those on the main board, thus giving firms further incentives to list (financial

[45] Local industry estimates.
[46] Kazmin (Feb 2007).
[47] Kazmin (Jan 2007).
[48] Herb (2006).
[49] Kazmin (July 2007).

Selected planned equitisations

2007	Vietcombank, Mekong Delta Housing bank, Vietnam Insurance Corporation, subsidiaries of Vietnam National Shipping Lines (Vinalines) and Electricity of Vietnam
2008	Vietnam Mobile Telecom Services Company (operator of Mobifone), Vinaphone, Vietnam Airlines, Vietnam Textile and Apparel Group, BIDV, Incombank
2009	Paper Corporation, Steel Corporation, Norther Foodstuff Corporation
2010	Agribank, Vietnam Cement Corporation, Chemical Corporation

Source: Bundesagentur für Außenwirtschaft (bfai) 36

disclosure requirements were one of the reasons why firms had shied away from listing as they were afraid of giving away valuable business information to competitors). A next reform step could be to reform regulatory oversight. Vietnam has a State Securities Commission, but it operates under the aegis of the Ministry of Finance which is also an issuer of securities and thus is potentially in conflict with its role as regulator.

Expected increase in supply

In the longer term, an increased supply of paper coming to the market is expected to come through the listings of former state-owned firms (SOEs). Until 2010, especially the 8 newly-formed "economic groups" in strategic sectors with the potential to become global players[50] are supposed to provide an increased supply of securities to the market to balance supply and demand. Moreover, the "OTC" market where currently an estimated 2,000 companies trade (with an estimated market capitalisation of 5-10 times the formal market) is the likeliest source for increased supply of paper in the near term. The HCMC stock exchange expects to have about 200 listed firms by year-end 2007 (up from 107 currently). However, progress in "equitisation" (i.e. turning an SOE into a joint-stock corporation and divesting part of the state shares – a first step towards listing a company) has been very gradual in the past and might be slower than many investors currently anticipate. Up to now, about 2,000[51]-3,000 state-owned enterprises have been equitised[52]. Now, there is talk about equitisation of all remaining SOEs by 2010[53], but more realistically, the equitisation of another 1,000 to 1,500 firms of the remaining 2,600[54] by 2010 is likely. Sectors in focus are transportation, telecommunication and banks (see box 36). The government has set up a State Capital Investment Corporation (SCIC) with the assistance of Singapore's Temasek to manage equitised capital.

The bond market is small, but developing

The size of Vietnam's bond market was about 13% of GDP at the end of 2006.[55] There are currently close to 500 bonds listed. The domestic yield curve stretches to up to 15 years.[56] There are no ceilings on the proportion of domestic bonds held by foreign institutions.[57] The bond market has long been dominated by government issues (issued by the Ministry of Finance). Trading volume in the market is still relatively low at about USD 20-30 m daily and although liquidity for government securities of less than 5 years maturity has improved, longer-dated ones still face liquidity risk. Issue size still tends to be relatively small with average size

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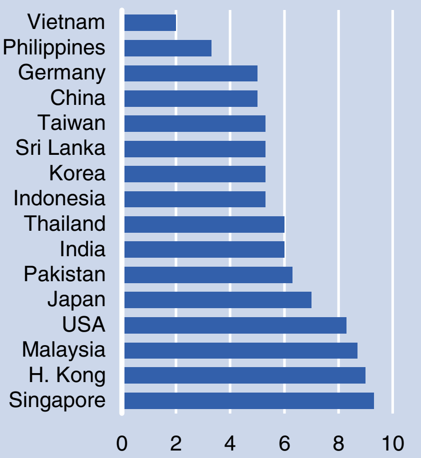
50 These are Baoviet (insurance), Vinacomin (minerals), VNPT (telecommunications), Vinashin (shipping), Vinatex (garments and textiles, EVN (electricity), Vietnam Rubber Corporation, and Petrovietnam (oil); see World Bank, Taking Stock, June 9-10, 2006.
51 Institutional Investor (2006).
52 Robaschik (2007).
53 See ADB Proposed Program loan document, Sep 2006.
54 World Bank (June 2006).
55 Goel (2007) – For more detailed information on Vietnam's bond market, see S. Goel, Vietnam bond primer (July 2007).
56 The state treasury issues bonds of 3, 5 and 7 years maturity, the Vietnam Development Bank (less liquid) issues maturities of 2,3,5,10 and 15 years.
57 However, bonds held by foreign investors (except for tax-exempt bonds) are subject to a withholding tax of 0.1% of the par value and coupon of the bonds, at the time of receipt of the coupon. At the time of sale or transfer of bonds, they are further subject to a tax of 0.1% of the prevailing total value of the bonds (see Goel, 2007).

Two distinct segments of the bond market:

1. A long-term segment which generally buys and holds government bonds with 10-15y maturities. Players are mainly insurance companies (Bao Viet, Bao Minh, Manulife, Prudential, AIG).
2. A short-term segment which trades government bonds with maturities up to 5 years. Players include SOCBs (esp. VCB with market share of 20%, BIDV 20%), big JSBs (Techcombank, VIB, Sacom, EAB, ACB) and foreign banks (DB: 10-15% market share, HSBC: 10-15%, Citibank, Standard Chartered, ANZ).

Source: DB Vietnam

Still very weak investor protection
Index (higher values indicate better protection)



Source: World Bank Doing Business, 2006 **37**

about VND 700 bn (USD 44 m) as government bond issuance follows the theme of "raise-as-you-go" (issuing about 3-4 a month). The government has been issuing bonds to finance infrastructure spending related to transportation, irrigation and education. Recently, municipalities (Ho-Chi-Minh City and Hanoi) and provinces have issued bonds as well to finance local infrastructure projects. The former Development Assistance Fund (DAF[58]), now Vietnam Development Bank (VDB), has been issuing bonds to finance long-term state investment projects. The debt is guaranteed by the government. Authorities also issued recap bonds for a total of about VND 9.7 tr (USD 600 m) to recapitalise state banks[59]. There will likely be a continued stream of supply of government paper as infrastructure needs remain high. Official plans include the issue of about USD 4 bn in infrastructure bonds by 2010[60], but considering the extent of infrastructure bottlenecks, the figure might be significantly higher.

Corporate bond issues have increased markedly of late, with big firms and banks raising debt worth USD 500 m in 2006. Some banks issued convertible bonds. Big issuers include Electricity of Vietnam (EVN) and the Bank for Investment and Development of Vietnam (BIDV) with issues the size of VND 1,000 bn (USD 63 m) and VND 2,200 bn (USD 138 m) respectively. EVN's 10-year bond was the first corporate bond with a tenor of 10 years and the first VND-denominated one to be offered to offshore investors as well.

Vietnam's securities markets are still developing

As capital markets are still a very recent phenomenon in Vietnam, the physical and regulatory infrastructure is still a work in progress. The level of retail investor sophistication is considered by authorities to be relatively low and is thus a source of concern, especially with regard to excessive speculation and bubble-building. Although fundamentals justify part of the growth in share prices, sentiment plays a significant role as well. Unsurprisingly, herd-behaviour among domestic retail investors is widespread, so that the market mostly trades on rumours instead of fundamentals. The development of the index is driven by only a handful of blue chips (the top 10 shares account for about 60% of market cap). Proper valuation of listed companies remains an issue as disclosure standards are still suboptimal. Current financial statements are only audited by local firms and are fairly basic compared to developed market standards, usually without detailed notes. There is still significant scope for insider trading. There is a daily price fluctuation cap of ±5% for listed shares and investment funds (but not for bonds), but this does not appear to have slowed down share price developments. Hence, tighter regulations are under consideration.

11. Challenges ahead

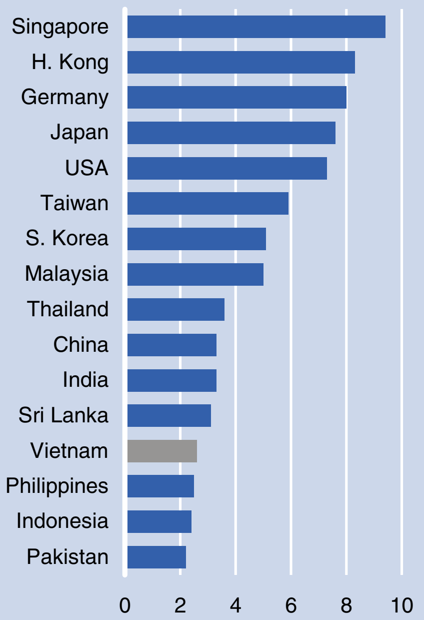
Urgent need to improve regulations and governance

Vietnam's weak legal system and low transparency are considered one of the biggest obstacles for potential foreign investors. There is a plethora of laws and regulations from different ministries and government offices which often do not fit together. Contract

[58] The DAF is one of the largest lenders in Vietnam with outstanding loans equivalent to 12% of GDP – half of it is financed by ODA.
[59] IMF article IV consultation (Jan 2006).
[60] Institutional Investor (2006).

Governance needs improvement

Corruption Perception Index 2006
(scale 0 - 10, the higher the less corrupt)



Source: Transparency International 38

WTO membership: a double-edged sword?

Vietnam officially became the WTO's 150th member on January 11, 2007. This brings to a close 11 years of negotiations. Vietnam promises to reduce or phase out duties on goods until 2010/14 and immediate compliance with TRIPS (intellectual property rights protection). It has reserved rights to maintain foreign ownership limits in some service sectors, though. Conversely, Vietnam's trading partners reserve their rights to classify the country as a "non-market economy" until 2018, putting it at disadvantage in trade disputes. Although its membership was generally welcomed it will bring quite a few challenges as well: There are questions about the international competitiveness of Vietnam's industry, especially with regard to many inefficient, highly subsidised SOEs. Will they be able to hold their own against tougher foreign competition considering that reform progress has been very gradual? There are indications that WTO entry will lead to an influx of cheaper imports into the country, which could stoke protectionist sentiments among politicians.

enforceability and law enforcement in general remain big problems. Foreclosure laws are still weak. A more comprehensible tax system is needed. In general, investor protection is still relatively weak in Vietnam (see chart 37). The judiciary decision-making process can be relatively intransparent. Interpretations can differ from case to case and laws can apply retroactively. Contrary to China, which has a coherent legal framework, the Vietnamese legal system is a patchwork system containing French, Russian, Chinese and other elements. Unfortunately, despite the rapid development of the economy over the last few years, there have been no significant improvements with regard to the legal system. Another area which is in urgent need of improvement is transparency and data quality. More and better data would help to better identify the areas most in need of reforms. Finally, rooting out widespread corruption should be made a priority (see chart 38).

Macroeconomic risks need to be managed carefully

In general, Vietnam's macroeconomic environment has been relatively stable, but some risks need to be monitored closely:

— *High inflation:* There is a risk of entrenched high inflation (5-7%), especially as additional price pressures might emerge from the liberalisation of administered prices (planned for petroleum, steel, cement, and fertiliser for example). Using administrative measures is currently preferred by the authorities over the usual monetary policy tools.

— *Rising fiscal deficit and public debt:* Fiscal accounts remain deep in the red (about 4% of GDP) and the use of off-budget items is a concern. Public debt (around 50% of GDP) is rising. The issue is how to avoid jeopardising medium-term debt sustainability given the need to expand public infrastructure spending.

— *Tightly managed exchange rate:* The Vietnamese dong (VND) is only fully convertible on the current account. The exchange rate is tightly managed by the central bank in a trading band of +/- 0.5% (widened from +/- 0.25% in January 2007). There are plans by the government to progressively liberalise the currency regime, possibly making the VND fully convertible (i.e. also on the capital account) by 2010. The possibility of a Chinese-style basket peg is being mulled over. Trading bands will be gradually loosened and capital controls gradually relaxed[61]. However, recently officials have become wary about appreciation pressures stemming from strong capital inflows for export competitiveness reasons.

Monitoring the potential for social unrest

Similar to China, the Vietnamese government is deeply concerned about maintaining social harmony in the face of rapid economic growth and widening income disparities. The current Socio-Economic Development Plan 2006-2010 focuses not just on keeping growth momentum, but on social inclusion and environmental sustainability as well. Developments which need to be monitored are:

— Restructuring of SOEs, which has led to rising unemployment and thus could strain the social fabric;

[61] Recent moves in this direction include: unproblematic repatriation of profits, as long as taxes have been paid and documents are in order, and a new Foreign Exchange Law (since June 2006) that removes the stipulation that capital inflows have to remain in the country for a year.

— The 53 ethnic minorities (the biggest groups are Tay, Muong, Khome, Hoa and Hmong) seem to be lagging behind regarding improvements in living standards (more than 60% are still living in poverty compared to a country average slightly above 20%[62]), which could cause resentment;

— Similar to several of its neighbours, Vietnam has been grappling with outbreaks of bird flu since late 2003. So far there have been 93 human cases with 42 fatalities. Although it was not the case in 2006, the winter season seems to herald periodic outbreaks of bird flu across the region. It helps that Vietnam's government appears to have an effective control even over the remote regions and seems to be able to discover and contain outbreaks at a relatively early stage. Extensive cooperation with international organisation is helpful as well; and

— Some regions are prone to natural hazards like floods or droughts or typhoons which could cause economic disruption.

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[62] See ADB Country Strategy and Program, Viet Nam 2007-2010.

Appendix 1

Foreign banks in Vietnam

Name	Home country	Branches in
ABN Amro Bank	Netherlands	Hanoi + HCMC
ANZ	Australia	Hanoi + HCMC
Bank of China	China	HCMC
Bank of Tokyo Mitsubishi UFJ	Japan	HCMC
Bangkok Bank	Thailand	Hanoi + HCMC
BNP Paribas	France	HCMC
Calyon Bank (Credit Agricole Group)	France	Hanoi+HCMC
Cathay United Bank	Taiwan	Chu Lai
Chinatrust Bank	Taiwan	HCMC
Chinfon Bank	Taiwan	Hanoi
Citibank	US	Hanoi+HCMC
Deutsche Bank	Germany	HCMC
Far East National Bank (Bank Sinopac)	Taiwan	HCMC
First Commercial Bank	Taiwan	HCMC
HSBC	UK	Hanoi + HCMC
JP Morgan Chase	US	HCMC
Korea Exchange Bank (KEB)	S. Korea	Hanoi
Lao-Viet Bank	Laos (JV with BIDV)	Hanoi + HCMC
Maybank	Malaysia	Hanoi + HCMC
Mega International Commercial Bank	Taiwan	HCMC
Mizuho Corporate Bank	Japan	Hanoi
Natexis	France	HCMC
OCBC	Singapore	HCMC
Shinhan Bank	S. Korea	HCMC
Standard Chartered	UK	Hanoi + HCMC
Sumitomo Mitsui Banking Corp	Japan	HCMC
UOB	Singapore	HCMC
Woori Bank	S. Korea	Hanoi + HCMC

Sources: SBV, company websites 39

Appendix 2

Vietnam's urban joint-stock banks

Name	Chartered capital *, VND bn	Head office	Foreign investor	Purchase value of stake	Date of deal announced
Sacombank (Saigon Thuong Tin Commercial Joint Stock Bank)	2089	HCMC	ANZ	USD 27 m (10% stake)	Mar-05
Techcombank (Vietnam Technological and Commercial Joint Stock Bank)	1500	Hanoi	HSBC	USD 17.3 m (10% stake) - expected to pay another USD 71.5 m to double its stake to 20%	Dec-05
Phuong Nam Bank (Southern Bank)	1290	HCMC	UOB	USD 30 m (10% stake) - expected to pay another USD 29 m for another 10%	Jan-07
Eximbank (Vietnam Export-Import Commercial Joint Stock Bank)	1212	HCMC		*Negotiations with several banks*	
ABB (An Binh Commerical Joint Stock Bank)	1131	HCMC			
ACB (Asia Commercial Bank)	1100	HCMC	Standard Chartered	USD 22 m (8.56% stake)	Jun-05
Military Bank	1045	Hanoi			
Habubank (Hanoi Building Commercial Joint Stock Bank)	1000	Hanoi	Deutsche Bank	n.a.	Feb-07
SEABank (Southeast Asia Bank, Dong Nam A)	1000	Hanoi			
VIB (Vietnam International Joint Stock Bank)	1000	Hanoi			
EAB (Eastern Asia Commercial Bank)	880	HCMC	Citigroup has signed MOU	Plans for purchase of 10% stake	Expected in 2007
VP Bank (Vietnam Joint-Stock Commerical Bank for Private Enterprise	750	Hanoi	OCBC	USD 15.7 m (10% stake)	Mar-06
Maritime Bank	700	Hanoi			
Saigon Bank for Industry and Trade (Sai gon cong thuong)	689	HCMC			
SCB (Saigon Commercial Joint Stock Bank)	600	HCMC			
Navibank	500	HCMC			
OCB (Orient commerical joint stock bank, Phuong Dong Bank)	567	HCMC	BNP Paribas	n.a.	Nov-06
Nam A Bank	550	HCMC			
HCMC Housing Development Bank	500	HCMC			
GP Bank (Dau Khi Toan Cau)	500	Hanoi			
Saigon-Hanoi Bank (SHB)	500	Can Tho			
Viet A Bank (Vietnam Asia Bank)	500	HCMC			
Bac A	400	Vinh			
De Nhat	300	HCMC			
Kien Long Bank	290	Rach Gia			
Gia Dinh	210	HCMC			
Petrolimex Bank (PG Bank)	200				
Ocean Bank (Dai Dung Bank)	200	Hai Duong			
Vietnam Thuong Tin Bank	200	Soc Trang			
Pacific Bank (Thai Binh Duong Bank)	189	HCMC			
Viet Hoa Bank	73	HCMC			

*Latest available data from central bank website. Sources: SBV, various news articles, company websites

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