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REMEMBERING THE FUTURE

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Vietnam in the New Era of Global Statecraft: The Awakening of a Promising Tiger

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Introduction

Vietnam is the only country that China has invaded yet failed to conquer and occupy. Thus, China now has reverted to checkbook diplomacy, as it has been doing with Cambodia, Laos, Thailand, Papua New Guinea, Africa, Latin America and many other places. The old Marxian dogma of blaming everything on the relationships around the means of production has been metamorphosized: controlling the means of production by financing them, is the answer to all problems (similar one-size fits them all answer to Milton Friedman's dogma-answer of steady money growth rate).

China was instrumental for America's stalemate inability to become a land owner in Southeast Asia. China assisted both Vietnamese and N. Koreans to keep the US out. China believes that it has historical and cultural – let alone economic – ties with Vietnam. Since losing its Soviet patron, Vietnam has resumed the Sino-Vietnamese relations that are shaping Southeast Asia.

Vietnam has been developing a vibrant agricultural, manufacturing, and service industry that is balanced and dynamic, with good foundations ready to capitalize on its competitive advantages. The rule of law is taking root, education is advancing, foreign investments are keep coming in, and its currency flexibility allows her to take advantage of the classic growth model via exports. The smart money might be in Vietnam.

An Overview of Vietnam's Economy and Its institutional Reforms

In 2007 Vietnam joined the WTO. This followed a period of twenty years since 'doi moi" a.k.a. a period of structural reforms and renovations, when economic liberalization and enhancement of its export industries took place. The economic modernization continues via integration into the international community, trade and exchanges. By doing so Vietnam anchored its export-led growth machine.

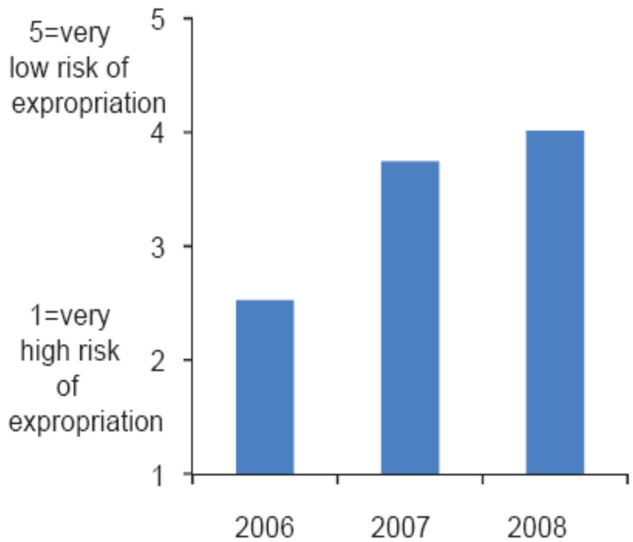
Its sustainable growth rate of about 6% is not fueled by credit and is not based on the formation of bubbles. Vietnam's main exports are agricultural products, however in its trajectory, Vietnam's agricultural sector is declining and is being replaced by manufacturing. This healthy industrialization advances the income and living standards of its citizens. While it imports energy it is to some extent self-sufficient in terms of oil, natural gas and electricity.

Poverty has declined significantly in the last 15 years and its demographics represent a rosy picture in terms of employment growth, middle-class formation, and business-oriented climate that is shaping up to bear significant profits and long-term growth prospects. Half of Vietnam's population is under the age of 25. When you combine the latter with stabilization and reform policies, you have a micro-picture of China in the mid to late 1980s, but with more transparency. While Vietnam has a trade deficit (attributable to the recent global crisis as well as the need to import industrial machinery for its growth, i.e. to some extent a healthy trade deficit), it has taken the right steps to address the issue and its exports are rising in a very healthy manner. This along with the rise in disposable incomes and the urbanization that comes with industrialization, form a dynamic trio that feeds itself. For example, the proportion of households with access to uninterrupted electricity has doubled in the last 15 years to 95%.

At the same time literacy programs are expanding so much that almost all kids now attend elementary school. Approximately 65% of those kids continue into secondary education. Moreover, health indicators are improving significantly as health services are expanding. From that perspective Vietnam has been doing exactly what needs to be done in terms constructing an educational and social infrastructure that is necessary and an *a priori* condition for sustainable growth.

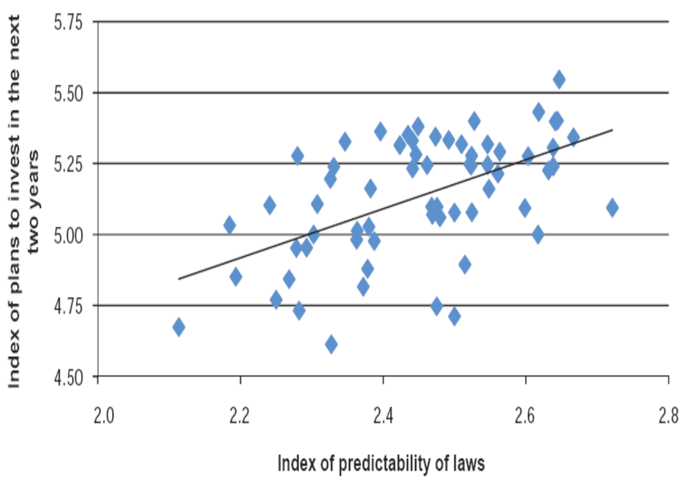
Without a doubt the climate of reform, rule of law, and transparency has had a major impact on the country as the following graphs shows.

Graph 1: Confidence in Land Property Rights in Vietnam



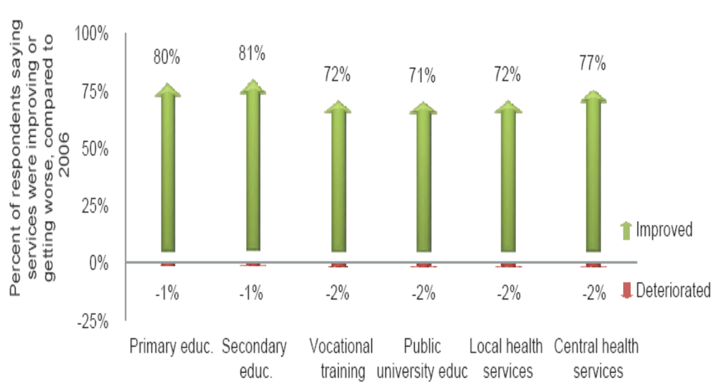
Source: World Bank, World Development Report, 2010

Graph 2: Predictable Laws and Investment Plans in Vietnam



Source: World bank, World Development Report, 2010

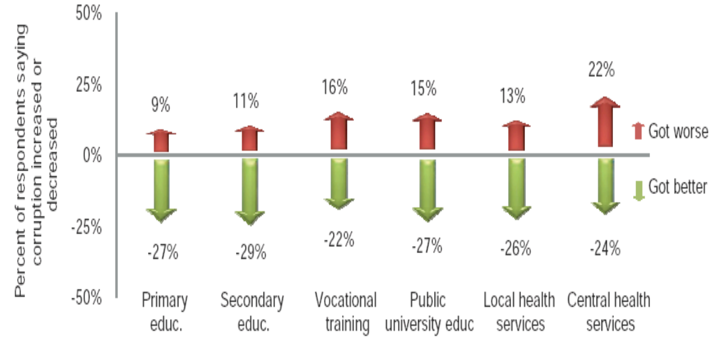
Graph 3: Health & Education Services Perception in Vietnam



Source: World bank, World Development Report, 2010

Another very interesting thing is that corruption which was prevalent throughout the country –and still is – is declining as the following graph shows.

Graph 4: Trends in Corruption According to Households (2006-'08)



Source: World bank, World Development Report, 2010

Growth and Investment Prospects

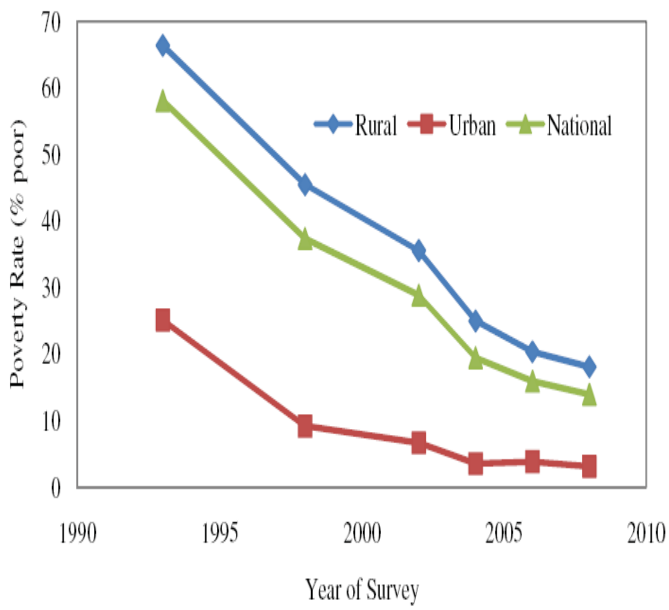
Vietnam's economy experienced a significant slowdown due to the economic crisis. Its GDP growth rate dropped substantially in 2008, its exports declined, its inflation worsened, and the FDIs (foreign direct investments) came to a standstill. However, within just a few months, the proper measures were taken, growth started again at significant rates, inflation dropped substantially, exports were rebooted and its economic engine started functioning again pretty smoothly by mid to late 2009, as the following figure shows.

Figure 5: Vietnamese GDP Growth Rate

Source: Vietnam's GSO (General Statistics Office)

We are of the opinion – and we have published reports and articles to that effect in an ongoing project/research - that a nation that does not take serious steps in the formation and advancement of its middle class is doomed to fail. The pre-requisite for such formation and advancement is the decline in poverty among the nation's households. When we look at Vietnam we are very encouraged. As the following figure shows, poverty has been declining constantly – with a pause in 2008-'09 due to the global crisis – which in combination with rising incomes, urbanization, institutional reforms, and industrialization form the basis for higher living standards, employment, growth, and of course of businesses profits.

Figure 6: Trends in Poverty over the last 15 Years



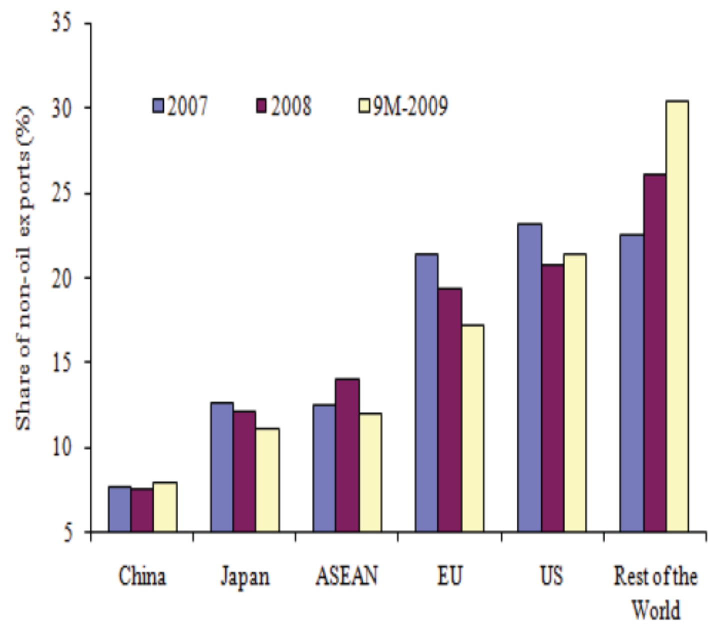
Source: World Bank Estimates

Now we need to take into account that 70% of Vietnam's GDP is made up of exports. Thus, when its export engine stalled due to the global crisis, the corresponding decline in its exports was significant. During the crisis exports dropped by approximately 15%, while imports dropped by more than 21%. That resulted in an improvement in its balance of payments but it was not a healthy improvement since it lowered incomes growth and FDIs.

The US remains the largest-single trade partner of Vietnam while its trade with other parts of the world (Latin America, Africa, Middle East) is growing rapidly as the following graph shows. It's also interesting to observe that the level of Chinese trade remains constant which may imply that a possible bursting of some of China's bubbles may not affect Vietnam as much (assuming that such a burst will not affect the US significantly either, which might be more of a wish than a real presupposition).

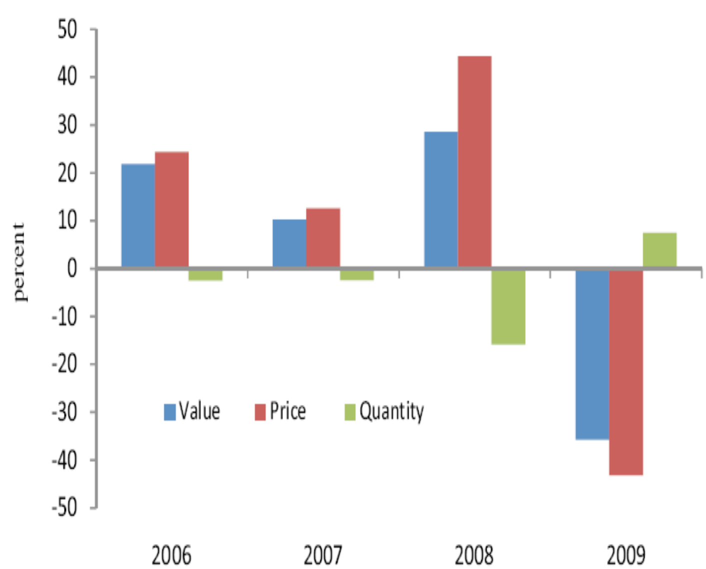
There are three things that we like in the smooth machine called Vietnamese exports: First, the ability to mitigate the risks of lower prices by its flexible muscle in terms of quantities (see figure 7 below). Second, it's small enough (small is beautiful) that its currency policies of devaluation does not cause major alarms (in a similar manner as the Chinese devaluation of 1994 became the forerunner of its substantial growth in subsequent years. Third, its monetary, fiscal, and credit policies create sound buffers that prevent slowdowns from becoming domestic crises.

Graph 7: Vietnamese Export Markets



Source: GSO

Figure 7: Vietnamese Muscle of Exports During the Crisis



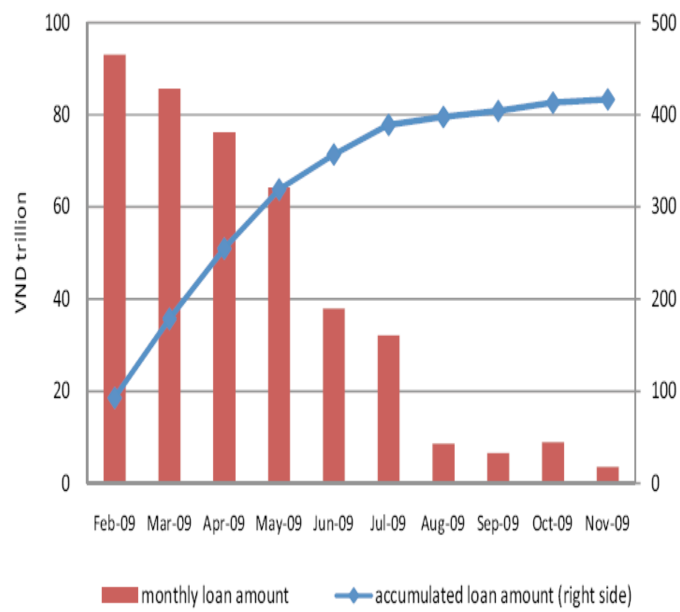
Source: World Bank Estimates

As the figure above shows, while exports declined in terms of prices and values due to the crisis, they increased in terms of quantity. This kind of export muscle is the foundational block of Vietnam's future. Of course, when we consider the fact that in 2010 prices rose then we can understand that its future is even brighter in an era of rising commodity prices. Vietnam's export growth in the last few years – due to industrialization – are characterized by high value added per unit of final outpout. Thus its exports of natural resources and raw material (oil, metallic ore, coal, etc.) have held up better and will advance its prospects vis a vis the declining value added of other exports in footwear, garments, and seafood.

Fiscal and Monetary Conditions and Some Words of Caution

We wrote earlier that one of the things we like about Vietnam's prospects is its fiscal and monetary response to the crisis. The government delayed tax payments due, lowered taxes, subsidized the interest on loans refinanced, increased cash payments to workers (cushion for consumption in the emerging middle class of workers), while it kept credit flowing to the private sector. These measures contained the financial stress, while the eligibility rules (part of the financial reform) were stringent enough that slowed down the credit extension once the crisis started abiding, avoiding bubbles and inflationary pressures (Vietnam has an inflation rate close to 7%, which is much lower than previous years, i.e. one more area of significant success), as the following figure shows.

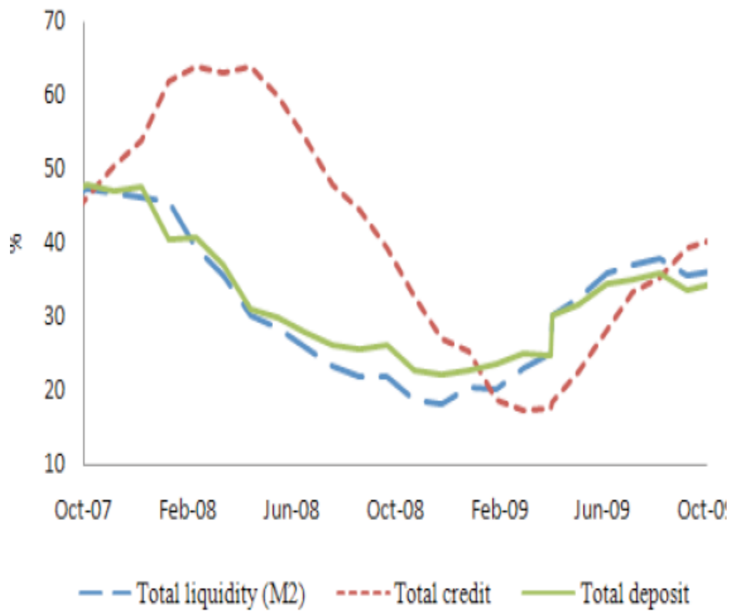
Figure 8: Credit Extension During the Crisis



Source: World Bank Estimates

The fiscal stimulus was well coordinated with the monetary one and the combination of the two resulted in healthy credit expansion while monetary aggregates and liquidity increased. This also allowed medium and small size companies (the heart and essence of Vietnam's future) to refinance their long term and working capital loans at lower rates. The smooth monetary cycle (see figure below) is another foundational promise for Vietnam's future. It is also interesting to observe in the graph below that the liquidity squeeze that is so apparent in some western economies has subsided in Vietnam.

Figure 9: The Smooth Cycle of Monetary Aggregates



Source: State bank of Vietnam (SBV) and IMF

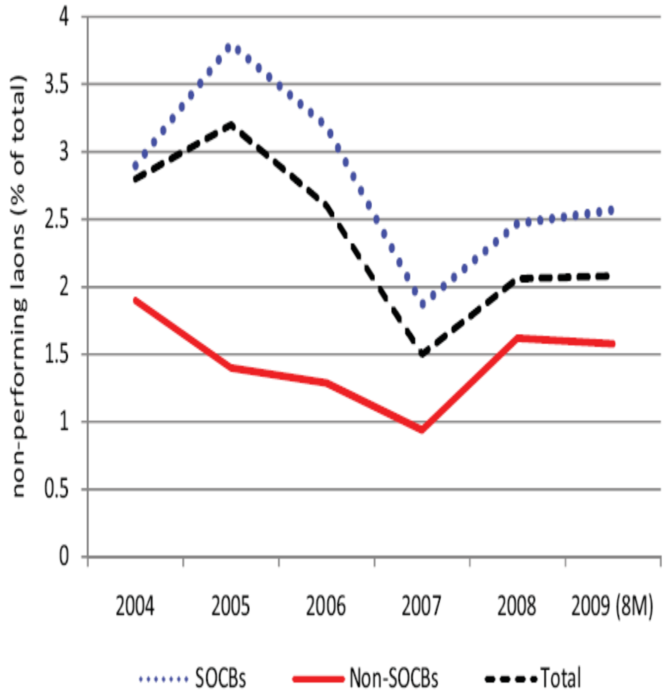
Of course not everything is rosy in Vietnam. Its comparative advantage is still in its low wages as the figure below shows. Low wages however do not guarantee long-term growth without physical infrastructure, banking reform, stable prices and a solid foreign reserves account.

Figure 10: Wages in Southeast Asia

Thus while Vietnamese labor is cheaper than Chinese and most of its neighbors, the shaky and underdeveloped infrastructure is a major impediment to its prospects. In addition some over-regulated industries (such as banking) are state-controlled and thus the lack of healthy competitive forces deprive Vietnam of achieving higher productivity growth rates by keeping the cost of capital high.

The portfolio quality of Vietnamese banks combined with the crisis and the lower commodity (export) prices in 2008-' 09, lower the ability of enterprises to repay their loans, which deteriorated the balance sheets of banks. Thus, the number of NPLs (non-performing loans) in both state-owned commercial banks (SOCBc) and non state-owned commercial banks (Non-SOCBs) increased significantly, at a time when the banking sector was getting ready to float its shares in the equity market.

Figure 11: NPLs in Vietnam's Banking Sector

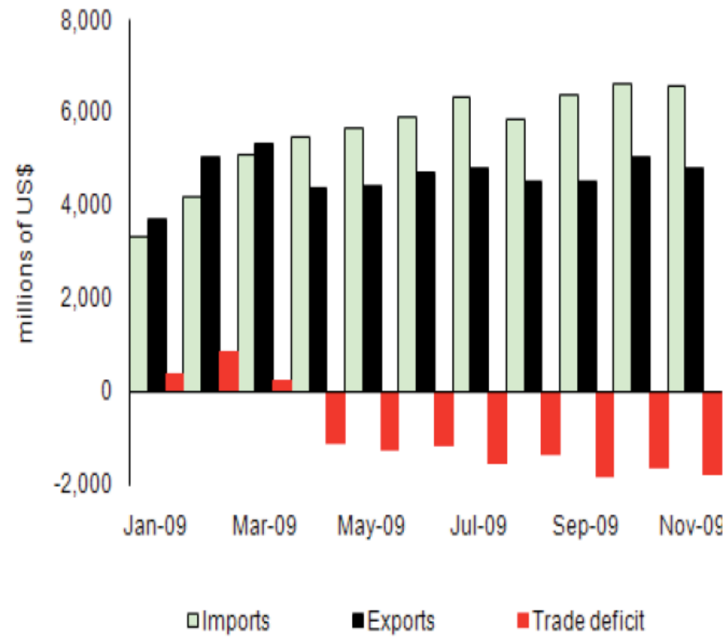


Source: SBV

Overall however we judge that the banking system in Vietnam is healthy and adequately capitalized, without toxic loans or assets in its portfolios. The sources of bank revenue are good, the loan diversification satisfactory, the fee-based services growing, and its capital gains from bond portfolios very satisfactory. Moreover, the SBV has upgraded its regulatory framework and increased the capital requirements. The great majority of banks met the higher capital standards and those who could not are being forced to merge.

Another area of concern is the widening trade deficit, as the following figure portrays.

Figure 12: The Rising Trade Deficit

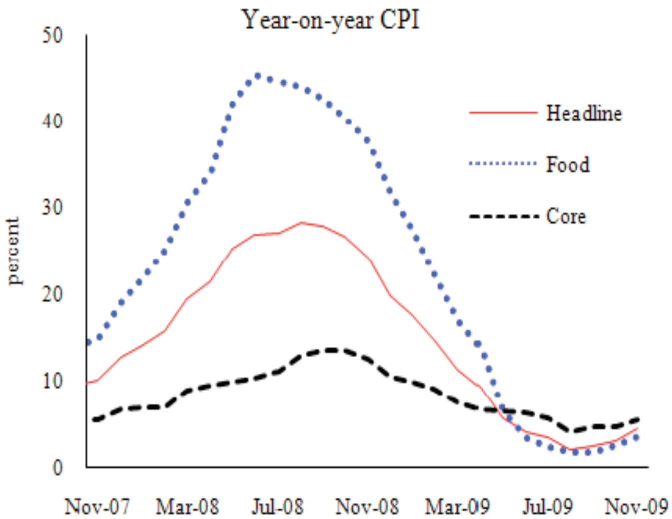


Source: GSO

The fact is however, that the capital account surplus is approximately 20% higher than the trade account deficit, which means that there is adequate buffer in the capital account of the country. Moreover, devaluation expectations of the dong served like self-fulfilling prophesies, where the dollarization of the economy and the large stock of foreign currency in circulation have been affecting portfolio decisions. The latter is geared toward assets denominated in foreign currencies and thus this reallocation has also misallocated capital and moved it towards speculation rather than growth. Therefore, the devaluation expectations have to be crashed in order for those misallocations to be stopped as well.

The disinflation too – as the following figure demonstrates - is pretty encouraging. It seems that both the fiscal and monetary policies are perceived as credible and this encourages us to believe that in the worst case scenario there might be another round of currency devaluation which if it is also perceived as the last one, will advance credibility, reduce uncertainty and become another milestone in Vietnam's trajectory to become the place to be for investors in Asia. Another word of caution is also prudent here: the latest figures from Vietnam show that the CPI is running at 8.2% on an annual basis. This might be contributed to the dong's devaluation however the figure itself remains troublesome for both FDIs, productivity, exports' growth, and competitiveness.

Figure 13: The Deceleration of Inflation



Source: GSO

Conclusion

As the above analysis portrays we are pretty optimistic about Vietnam. Its institutional reform efforts are taking roots. Its structural transformation is healthy. Its competitive advantages are growing. Its middle class is being formed. Its fiscal and monetary policies are gaining credibility. Its manufacturing sector is expanding. Its growth potential is dynamic despite crisis' challenges. Its banking sector is relative healthy and stable. Assuming that reforms will continue our stand is that we slowly but steadily will start taking a position in the Vietnamese market for our clients.

Vietnam, is the place where Cicero could cry out again: Dum Spiro Spero!