

Vietnam at a glance

Great expectations

- ▶ The economy hit a sweet spot in 2015; GDP rose 6.7% – the fastest pace in eight years – while inflation slowed to 0.6%
- ▶ We maintain our forecast of 6.7% expansion in 2016 as the dual engine of domestic demand and exports should stay strong; rising price pressures will likely require tightening in Q3 16
- ▶ In the near term, the National Party Congress will be the focus as the new leadership provides clues about the reform outlook

Rising growth, slowing inflation. Q4 15 GDP rose 7.1%, putting full-year growth at 6.7%. This was the fastest pace since 2007 and comfortably above the government's 2015 target of 6.2%. Domestic demand was the key driver behind the acceleration, supporting a pick-up in service sector output. By expenditure component, final consumption increased 9.1% y-o-y, much higher than the 6.5% pace in 2014. 2015 marked a clear end to the de-leveraging cycle of the past few years: we estimate credit growth hit 18% last year, up from 14% in 2014. In stark contrast to the acceleration in growth, inflation slowed further to 0.6% in 2015. Much of this was due to falling energy prices, but both food and core price pressures also remained remarkably subdued.

2016 outlook: Strong growth set to continue, but macro policy management should get trickier. The government has set the 2016 growth target at 6.7%, which we think will be achieved. We see exports growth rebounding to double digits, reflecting new investments. Meanwhile, domestic demand should remain firm thanks to robust private spending, which should be helped by still-low rates. With growth having firmly shifted gears to the 6-7% range, we expect inflation to rebound emphatically in the second half of the year, prompting the central bank to shift into a tightening mode.

12th National Party Congress and leadership transition. Meanwhile, all eyes are on Hanoi as the National Party Congress convenes on 21-28 January. We expect the new leaders to continue pushing for reforms to achieve higher per capita GDP, though it is too early to tell whether progress will be quick enough.

Table 1. Main Vietnam forecasts

	Q3 15	Q4 15	Q1 16f	Q2 16f	Q3 16f	Q4 16f	2014	2015e	2016f
GDP (% y-o-y)	6.8	7.1	6.5	6.6	7.0	6.8	6.0	6.7	6.7
CPI, end (% y-o-y)	0.0	0.6	2.5	3.0	3.3	5.1	1.8	0.6	5.1
OMO rate, end quarter (%)	5.0	5.0	5.0	5.0	5.5	5.5	5.0	5.0	5.5
VND/USD end quarter	21,890	22,500	22,500	22,800	23,000	23,000	21,388	22,500	23,000

Source: HSBC forecasts

MACRO ASEAN ECONOMICS

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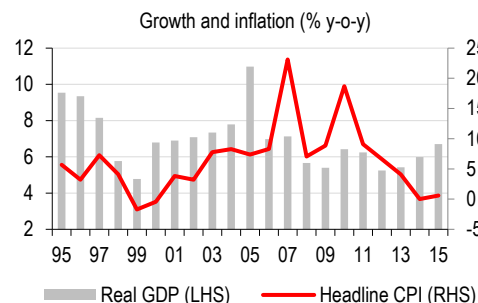
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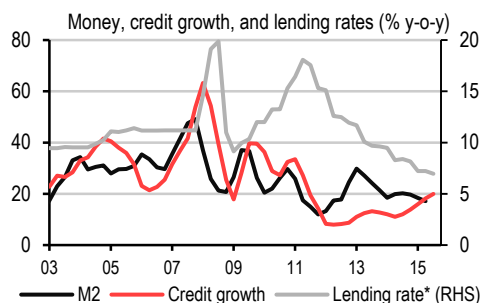
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Chart 1. Growth has been shifting to a higher gear, while inflation has stayed contained

Source: CEIC, HSBC

Chart 2. With de-leveraging pressures fading, credit growth is once again rising

Source: CEIC, HSBC

Life in the fast lane

6.7% growth in 2015 – fastest since 2007

In Q4 15, quarterly real GDP growth exceeded 7% for the first time in five years. This brought full-year growth to 6.7% – the fastest pace since 2007 and comfortably above the government's target of 6.2% (Chart 1). In the last few years, Vietnam's growth has increasingly been driven by the success of the country's competitive manufacturing/export sector. And, indeed, manufacturing output continued to shine in 2015 on the back of strong FDI inflows. Though export growth moderated to 8.1% y-o-y from the double-digit pace seen over the past decade, this is still significantly higher than the pace seen in the rest of Asia and partly reflects the effects of weaker commodity prices: exports fared much better in volume terms, rising 12.4% y-o-y.

The latest PMI report is a testament to the resilience of Vietnam's export sector: in December, the headline Nikkei manufacturing PMI rebounded to 51.3 from 49.4 in November. Encouragingly, new export orders also returned to growth, posting the first solid expansion since May 2015.

However, it's not just external demand that has been powering Vietnam's growth as of late. The biggest macro surprise out of Vietnam last year was the extent to which the banking system re-leveraged, driving domestic demand. Between 2011 and 2014, credit growth remained anaemic despite significant easing as banks faced significant de-leveraging pressure in the aftermath of Vietnam's domestic banking crisis.

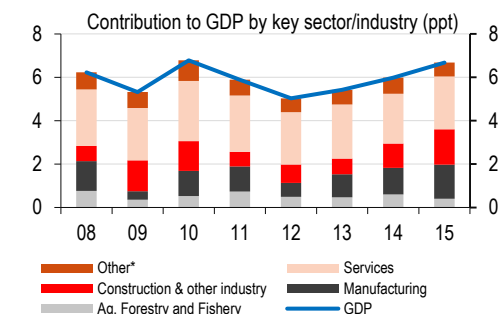
Though the banking sector still faces challenges reflecting unresolved bad debts¹ and slow pace of bank liquidation/consolidation, it appears that earlier reforms are starting to bear fruit: credit growth has been tracking 12.1% y-o-y YTD as of September and we estimate it will hit 18% in 2015. This is much higher than the 14% pace recorded in 2014 and the government/State Bank of Vietnam's (SBV) target of 13-15% set earlier in the year (subsequently revised upwards).

The revival of credit growth is reflected in a strong surge in consumption, as well as investment. In 2015, final consumption increased 9.1% y-o-y, surpassing growth of 6.5% in 2014. Meanwhile, gross capital formation was up 9.1% y-o-y, up from 8.9% previously. The strength of domestic demand is also reflected in the strong service sector performance (Chart 3). In 2015, the sector expanded 6.3% y-o-y and contributed 2.6ppt to headline GDP growth. By industry, growth was led by wholesale, retail sales & motor vehicles (9.1%), and financial, banking & insurance

2015 growth outperformed expectations, rising 6.7%...

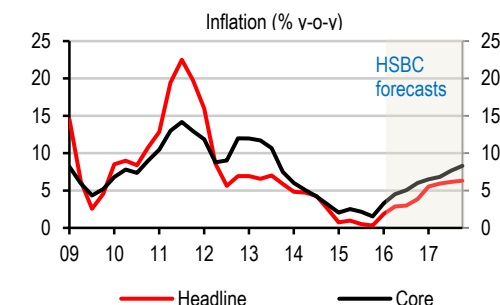
...as de-leveraging pressures faded, resulting in a pick-up in domestic demand

¹ According to the State Bank of Vietnam (SBV) the system-wide NPL ratio stood at 2.9% of total loans as of September 2015, down from 4.2% in December 2012. But the reduction in the NPL ratio is partly thanks to the transfer of bad debts to the Vietnam Asset Management Company (VAMC), which the government established to acquire, restructure, and sell NPLs. But the transfer is not intended to be permanent: the VAMC purchases bad debt from financial institutions (often at book value) in exchange for special bonds, which banks can use as collateral to access the SBV's refinancing facility. Should the VAMC, however, fail to dispose of the bad debt within five years, the loans theoretically go back on banks' balance sheets (the special bonds mature in five years). We think, however, that the timeframe for NPL disposal will ultimately be extended to at least 10 years in practice. Already, credit institutions that are under restructuring or facing financial difficulties can have an extension to 10 years under a new circular (14/2015/TT-NHN) that went into effect in October 2015.

Chart 3. A pick-up in construction activity has helped boost GDP

Source: GSO, HSBC. *Product Tax Excluding Product Subsidy and Implied errors & omissions

Inflation slowed further in 2015, driven by the decline in oil prices

Chart 4. Inflation fell to decade-lows in 2015, but prices are already showing early signs of bottoming out

Source: CEIC, GSO, HSBC forecasts

services (7.4%). Growth in secondary output also accelerated to 9.6% y-o-y from 7.1%. This was partly thanks to continued improvement in manufacturing, which rose 10.6% y-o-y and added 1.6ppt to GDP. However, construction activity also grew strongly (10.8% y-o-y), reflecting the recovery of the property markets. The acceleration in industry and services more than offset the slowdown in agriculture, forestry and fishery.

Despite the pick-up in growth, price pressures have stayed remarkably subdued: after slowing to 4.1% in 2014, inflation weakened further to 0.6% in 2015 (Chart 4). Headline prices even dipped into slightly negative territory in September and October, though they quickly rebounded to 0.3% y-o-y in November and 0.6% y-o-y in December. Disinflation was largely driven by the collapse in oil prices: in 2015, the transportation component contracted at an average pace of nearly 12% (vs. an expansion of 1.6% in 2014). Meanwhile, food inflation also slowed to 1.5% (vs. 4.0% in 2014), while core inflation was contained at 2.1% y-o-y (vs. 4.6% in 2014). The benign inflation backdrop has given the SBV room to keep interest rates steady in 2015, keeping the OMO rate at 5.0%.

2016 outlook: full throttle

Strong FDI flows will likely support acceleration in exports

Macro policy management will likely get trickier this year, as continued strong growth gradually stokes price pressures. On the external front, we expect exports to return to double-digit growth even as global growth remains lacklustre (in 2016, HSBC economists see a mere 0.1ppt acceleration in global GDP to 2.5% y-o-y). Implemented FDI rose to a record high USD14.5bn in 2015, up 17.4% from the previous year. We expect the number to rise further in 2016, reflecting improvements in the investment climate (including the potential relaxation of foreign investment restrictions).

Going forward, the new investments, coupled with continued market share gains in key products, such as electronics, footwear, and textiles and apparel, should boost Vietnam's shipments, even if global demand remains soggy. Vietnam's rapid gain in smartphones is a case in point: the product category barely registered in the customs data before 2011. Yet, in 2015, tech exports jumped another 34% to reach USD48bn thanks to steady investments by multinationals businesses, which are attracted by Vietnam's fast growth, low wages and large and eager work force (Table 2).

Just recently, a unit of Samsung Electronics won Vietnamese government approval to raise its investment in a Saigon electronics plant to USD2bn (*Reuters*, 29 December 2015). The

Table 2. Vietnam's top 10 exports in 2015 (USDm)

	2014	2015	% y-o-y
1. Phones & Spare Parts	23,563	30,663	30.1
2. Textile & Garments	21,219	22,869	7.8
3. Computer & Electronic Components	11,483	15,847	38.0
4. Footwear	10,420	12,063	15.8
5. Wooden Products	6,174	6,836	10.7
6. Aqua Products	7,979	6,733	-15.6
7. Crude Oil	7,458	3,738	-49.9
8. Rice	2,982	2,944	-1.3
9. Handbags, Wallets, Suitcases, Umbrellas	2,570	2,906	13.1
10. Coffee	3,453	2,555	-26.0
Other	52,832	55,364	4.8
Total	150,130	162,518	8.3
Ref: Electronics*	35,836	47,829	33.5

Source: GSO, HSBC. *Electronics is the sum of phones & spare parts, computer & electronics, and electric wires & cables. NB: Product categories as of Vietnam Government Statistics Office (GSO) merchandise trade data.

country's largest foreign investor, Samsung Group has – to date – pledged more than USD12bn of investments in Vietnam.

Meanwhile, domestic demand should remain firm thanks to robust private spending, which should be helped by still-low rates. In contrast, we see little, if any, scope for a more expansionary fiscal policy, given the government's tight finances. Putting it all together, we maintain our 2016 GDP forecast of 6.7% y-o-y, in line with the government's growth target. We raise our 2017 forecast by 0.1ppt to 6.8% y-o-y.

Inflation and credit

With growth having firmly shifted gears to the 6-7% range, we expect inflation to rebound emphatically in the second half of the year, though the uncertainty around this outlook is quite high, given the difficulty of forecasting the path of oil prices. Another source of uncertainty is gauging to what degree productivity increases may be contributing to the lack of core inflation momentum. It's certainly possible that new investments, especially in the manufacturing sector, may have helped raise both labour and total factor productivity, though it's hard to confirm this, given issues around the reliability of employment data.

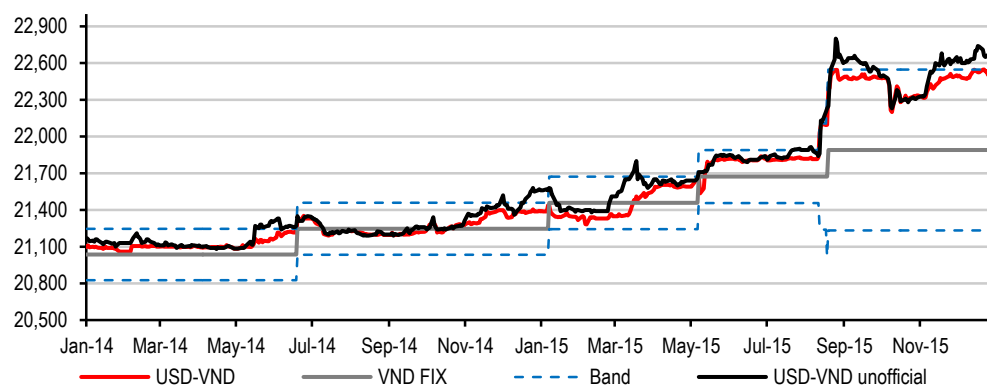
We forecast inflation to breach the SBV's 5% target in H2 2016, necessitating policy tightening

What we do know, however, is that some administered prices, such as school fees, will be raised this year. Together with base effects from stabilising oil prices and a likely pick-up in food inflation, we forecast headline inflation to pick up to 3.0% y-o-y by end-H1 16 and hit 5.1% y-o-y by end-H2 16, breaching the central bank's target. Officials at the Government Statistics Office (GSO) have also been highlighting the risks that inflation could exceed the 5% target in 2016, due to the rise in school fees and possible increases in health care service prices and electricity prices (*Bloomberg*, 24 December 2015).

For its part, the central bank has sounded more relaxed about the price outlook. In a recent interview with local media, SBV Governor Nguyen Van Binh explained that the central bank intended to keep policy rates stable at current levels if inflation is contained in the 3-5% range. He also said that the central bank would target annual growth of 18% y-o-y, though this could be raised as high as 20% (*Tuoi Tre*, 28 December 2015).

Even if credit growth is managed at the lower end of the target and core inflation stays contained (say, due to further commodity price disinflation), we think it would be prudent to commence gradual tightening in the second half of the year to mitigate the risks of another overheating of the economy. This is especially true in consideration of Vietnam's external imbalances, which we forecast will widen this year (see [Vietnam at a glance: Coming soon: the return of twin deficits](#), 2 December 2015). In the past, a tilt towards an overly pro-growth policy

Chart 5. The VND has faced increased pressure as of late; the SBV introduced a new, more market-based fixing mechanism on 4 January 2016



Source: Bloomberg, Reuters, CEIC, HSBC

has resulted in credit booms and overheating, which ultimately led to currency instability and required sharp policy tightening to reverse.

As such, we expect the central bank to switch to a tightening mode this year, delivering the first 50bp hike in Q3 16. However, the aforementioned comments by SBV Governor Nguyen Van Binh, as well as the recent shift in the government's policy stance, towards a more pro-growth orientation, raise the risks that tightened will be delayed. Given that we are less than half way through financial sector reforms and bank balance sheets remain fragile, we would be worried if credit growth begins to consistently top 20%.

VND to remain under pressure

The counterpart to the widening trade deficit is increasing pressure on the VND and FX reserves. As Chart 5 shows, the USD-VND has been trading at the upper side of the SBV's band since early 2015. Heightened RMB weakness post the People's Bank of China's (PBoC) 11 August 2015 fixing reforms have intensified the pressure on the VND. However, competitiveness concerns are only part of the story. The weakness of the VND is also a reflection of a strong appetite for imported goods, which has accompanied the revival in domestic demand.

In Q4 15, the SBV stuck by its promise to refrain from devaluing the VND further out of a desire to maintain a stable currency in the important run-up to the country's leadership transition in January 2016. However, given that the central bank's reserves are looking increasingly thin (import cover has fallen to 2.1 months as of Q3 15), the SBV is likely to pare back intervention and allow the currency to depreciate further in the months ahead. In fact, just yesterday, the central bank introduced a new fixing mechanism that would allow for a more market-based setting of the reference rate for USD-VND.

The SBV announced a new fixing mechanism for the VND, paving the way for greater two-way volatility for the currency

Table 3. Key dates surrounding the 12th NPC and Vietnam's leadership transition

2015	
15 Sep	Draft Political Report and Socio-Economic Plan for 2016-20 released to the public for comment
20 Oct	10th session of the 13th National Assembly opens
27 Nov	10th session of the 13th National Assembly concludes
14-22 Dec	Plenary meeting of the CPV Central Party Committee
2016	
21-28 Jan	12th National Party Congress: New leadership elected
22 May	Election of deputies to the 14th National Assembly and People's Councils (all levels) for the 2016-20 tenure (new leadership formally installed)

Source: Voice of Vietnam, VN Economic Times, Vietnam breaking news, HSBC

Crunch time for reforms

12th National Congress in the spotlight

One event that could prove pivotal to Vietnam's long-term economic prospects is the upcoming 12th National Party Congress (NPC), scheduled for 21-28 January 2016 (Table 3). Of the various duties of the NPC, the two that are likely to be most significant to Vietnam's economic management are: 1) the election of the new Central Committee and national leadership team, and 2) the adoption of a new Socio-Economic Development Plan (SEDP) for the next five and ten years (2016-2025) (Table 4).

On the leadership elections, the key positions to watch are the Communist Party of Vietnam (CPV) General Secretary, President, Prime Minister, and Chairman of the National Assembly. While we have no insight on the outcome of the voting, the candidates all seem to basically agree that further de-centralisation of the economy is necessary to ensure rising living standards.

Vietnam's potential is no doubt great, and we remain positive on the short-term outlook for the economy. However, numerous issues and potential obstacles remain if growth is to be sustained in the long run. Faster privatisation of state-owned enterprises (SOEs) is required to achieve accountability and improve the efficiency of capital. Meanwhile, the sector's close relationship with banks may need to be loosened. Financial sector reforms will need to be deepened and governance strengthened to improve credit allocation; otherwise there remains the risk that faster growth will trigger another boom-and-bust cycle down the line.

Table 4. Draft Socio-economic Development Plan (SEDP) for 2016-20

Macroeconomic targets	
Overall objective	Maintain macro-economic stability, while striving for higher economic growth than in previous years.
GDP target	The government targets average GDP growth over the next five years of 6.5-7% per year, totalling from VND33,840trn (USD1.51trn) to VND34,250trn (USD1.53trn). By 2020 GDP per capita will stand at USD3,670-3,750.
GDP per capita	
Economic structure	The contribution made by industry, construction and services is targeted to represent 70% of GDP.
Inflation	Inflation will be managed at around 5-7% per year.
Investment	Average total investment over the five years is to be around 31% of GDP, or VND10,506trn (USD470.35bn).
Productivity	Total-factor productivity (TFP) is to contribute 30-35% of economic growth. Labour productivity will grow 4-5% per year on average.
Public deficit	The public deficit in 2020 will have been managed at less than 4.8% of GDP, with the budget deficit to be gradually reduced to 4.8%.
Public debt	Public debt will not be higher than 65% of GDP by 2020, government debt no higher than 55% of GDP, and external borrowing no higher than 50% of GDP.
Budget balance and revenue	Mobilised budget funds will be set at 20-21% of GDP, of which 19-20% is to come from taxes and fees. The budget balance in 2016-20 is estimated at VND7,000trn (USD313.39bn). Budget revenue in the period is to increase 1.7-fold against the last five years.
Budget spending	The government has put budget spending at VND8,660trn (USD387.70bn) in the next five years, accounting for over 25% of GDP and, in 2020, will be 1.7-fold higher than in 2015, with average spending over the next five years to be 1.6-fold higher than in the last five years.
Appropriate public debt level	
Total borrowing	Total demand for borrowing by the government in the 2016-20 period will be from VND3,020trn to VND3,090trn (USD135.20bn to USD138.33bn). Borrowing to cover the budget deficit will be VND1,360trn (USD60.88bn) and borrowing for lending at about VND280trn (USD12.53bn), with the remainder for repaying existing debt as terms expire.
ODA borrowing	Total ODA borrowing and borrowing from preferential sources of donors to balance the budget over the next five years will be VND250trn (USD11.19bn).
External borrowing by enterprises	Total foreign borrowing by enterprises to 2020 is estimated to reach USD52-53bn, of which medium and long-term debt will be about USD35-36bn and short-term borrowing about USD17bn.
Legal framework	In the next five years the government will complete the legal framework on managing public debt in line with the Law on Public Debt 2015, the Law on Public Investment 2014, and other related laws.
Public debt ceiling	The government will also re-calculate the public debt ceiling each year in the next five years, based on analysis of the debt situation and to secure the ability to repay in certain economic conditions.
Debt structure	The structure of debt will be re-organised, increasing long-term debt, increasing foreign borrowing to ease repayment pressure in the short term and reduce the risk from global economic fluctuations.
Supervision and macro-prudential regulations	The government also commits to strictly supervising the use of loans and adopting regulations to increase consistency among fiscal policy, public investment, and public debt management.

Source: VN Economic Times, HSBC

Disclosure appendix

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