VIETNAM

FINANCIAL VULNERABILITIES IN A CONTEXT OF SUSTAINED RECOVERY

Vietnam benefited from a solid recovery in its economic growth in 2022, supported by the dynamism of both the export sector and domestic demand. However, the country has also become increasingly vulnerable to the deterioration of the international environment. Exports fell in Q4 2022 and these difficulties are expected to persist in the short term. Inflation accelerated in 2022, the dong depreciated under the effect of US monetary tightening and capital outflows, and the Central Bank began to increase its policy rates. In addition, there was a confidence shock caused by reports of fraud in the local bond market. Against this backdrop, liquidity tensions emerged in the financial sector. They do not seem to be of any magnitude to generate systemic instability, but do highlight some fragility in the balance of payments and the financial sector. In the short term, domestic demand is expected to slow down. In the medium term, Vietnamese growth prospects remain good.

STRONG ECONOMIC GROWTH REBOUND IN 2022

In 2022, economic growth recovered vigorously to reach 8%, after two years marked by a significant slowdown linked to the health crisis. From Q4 2021, the authorities switched from a strict "zero Covid" policy to a "living with Covid" strategy, a change enabled by a strong acceleration of the vaccination campaign in previous months. The lifting of restrictions led to a rapid rise in the number of infections until March 2022, but without saturating healthcare infrastructure. Mobility indicators gradually improved, moving above their pre-Covid levels from spring 2022.

Economic activity has recovered at the same time since Q4 2021, driven firstly by production and exports of the manufacturing sector, then quickly also by the services sector and private consumption. Tourism activity also restarted due to the reopening of borders in March 2022. Finally, domestic demand has been encouraged by a new fiscal stimulus package (drop in the VAT rate from 10% to 8%, tax cuts for companies, public infrastructure investment programme) and the continuation of an accommodative monetary policy.

However, in recent months, the Vietnamese economy has increasingly felt the effects of the deterioration of the international environment following the war in Ukraine and US monetary tightening. On the one hand, external trade performance deteriorated sharply in Q4 2022 due to weakening global demand. Exports fell by 6% year-on-year, after an increase of 16% in Q3 and 18% in H1. The decline in sales to the United States (29% of Vietnamese exports) was particularly pronounced.

On the other hand, rising global commodity prices contributed to accelerating inflation. This has also been fuelled by the rebound in domestic demand and the labour market, as well as by the depreciation of the dong. Consumer price inflation thus increased from 1.9% y/y in Q4 2021 to 4.4% in Q4 2022, driven by the rise in food prices (+5.2% in Q4 2022 compared to +0.2% in Q4 2021) and energy prices, and by underlying inflation (+4.8% in Q4 2022 compared to +0.6% in Q4 2021). It has exceeded the official target of 4% y/y since October.

The Central Bank (State Bank of Vietnam, or SBV) began a monetary tightening cycle in September 2022. However, after two consecutive key rate hikes in September and October (the refinancing rate went from 4% to 6%), the SBV interrupted its action despite continued inflationary pressures. The authorities adjusted their priorities due to significant liquidity tensions in the financial sector.

DEPRECIATION OF THE DONG AND EROSION OF FOREX RESERVES

The rise in Vietnamese interest rates has added to other shocks. First of all, the US monetary tightening in 2022 and the strengthening of the dollar (up to its weakening in recent weeks) have led to capital outflows. These have been observed in deposits and loans transactions of the "other investments" item of the balance of payments, and above all in "errors and omissions" whose negative balance reached USD 23.5 billion over the first three quarters of 2022 compared with USD 8.8 billion over 2021 as a whole. Capital flight has come in particular from residents, whose confidence in the dong (VND) has been eroded by the rise in inflation and its loss of value against the USD, after several years of relative stability in the exchange rate.

FORECASTS

	2020	2021	2022e	2023e	2024e
Real GDP growth (%)	2.9	2.6	8.0	6.0	6.5
Inflation (CPI, year average, %)	3.2	1.8	3.2	3.8	3.5
Budget balance / GDP (%)	-2.9	-3.5	-4.6	-4.7	-4.4
General government debt / GDP (%)	41.7	39.7	40.4	41.6	41.7
Current account balance / GDP (%)	4.3	-1.8	-0.5	0.9	1.4
External debt / GDP (%)	36.5	37.2	35.0	34.8	33.6
Forex reserves (USD bn)	94.8	109.4	87.0	95.3	107.4
Forex reserves, in months of imports	4.2	3.9	2.8	2.8	2.8

TABLE 1 e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

VIETNAM: INFLATION AND INTEREST RATES

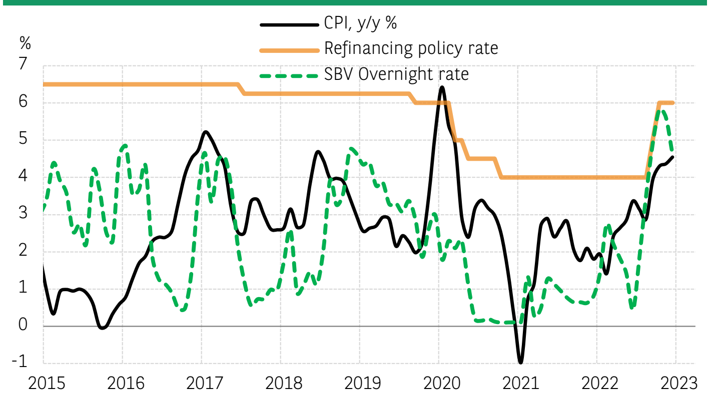

CHART 1 SOURCE: SBV, BNP PARIBAS

These dynamics were only partially offset by the improvement in the current account balance (which is estimated to have moved from a deficit in H1 to a surplus in H2). Net inflows of foreign direct investment (FDI) have recently weakened but remained strong (at almost USD 10 billion over the first three quarters of 2022) and largely above the slight current account deficit expected for 2022 as a whole.

SBV has increased its intervention in the foreign exchange market to defend the VND. Last October, it also widened the VND/USD trading band from ±3% to ±5% around the reference rate (the Vietnamese exchange rate regime is based on a managed float and crawling band system). In the end, the VND only depreciated by 8% against the USD (spot rate) over the first ten months of 2022, and strengthened in November-December (+5% against the USD). By contrast, forex reserves fell rapidly, from USD 109 billion at the end of 2021 to USD 86 billion at the end of October 2022, bringing an end to six years of improvement in the external liquidity position. Forex reserves once again covered less than 3 months of imports of goods and services in 2022 (compared with almost 4 months in 2021) and offer limited protection against new external shocks.

CRACKS IN THE FINANCIAL SECTOR

Vietnam's monetary policy tightening and capital outflows have led to a significant and sudden tightening of liquidity (as shown by the rise in interbank rates until last November). In addition, a confidence shock has been caused by the authorities' anti-corruption campaign, which in particular uncovered fraudulent practices by property developers on the local bond market. The arrests of company directors and the authorities' directives to stop financing developers culpable of fraud have led to a correction in the bond market as well as significant withdrawals of deposits from private banks connected to these developers. The stock market also suffered a correction (the Ho Chi Minh stock market index lost 17% in H2 2022, returning to its level at the end of 2019).

Given, on the one hand, the excessive debt of the Vietnamese economy and, on the other hand, the fragility of the banking sector as a whole (notably due to insufficient capitalisation ratios) and the smaller private banks in particular (which have less stable funding sources and a more risky loan portfolio than large banks), the recent events are raising concerns. Will corruption scandals increase? Can rising interest rates lead to a dangerous rise in default risks? Will the stress on the bond market and banking liquidity last and extend to other institutions? Are banks able to cope with such shocks? The answers to these questions are uncertain, all the more so since opacity remains high in the banking sector (for example, the official non-performing loan ratio was only 2% at the end of 2021, but most certainly underestimated).

There are, however, some positive points. Firstly, financing difficulties have so far been limited to a few small private banks, and the four major public banks have not experienced any particular stress on their liquidity. Secondly, tensions on the interbank market and on the dong have eased in recent weeks: the main effects of US monetary tightening seem to have passed, which has given Vietnamese authorities some leeway to improve financing conditions and try to restore confidence. At the beginning of December 2022, the SBV raised the ceiling on bank credit growth for 2022 (from 14% to 16%) – a quota banks can use to finance companies via the local bond market. This market is narrow and concentrated. Corporate bonds accounted for around 7% of GDP in 2021 (compared to domestic bank credit to the private sector, equivalent to 125% of GDP), which limits the potential systemic effects of a bond market crisis. Caution remains necessary, however, as property developers are among the largest bond issuers and are expected to continue to face difficulties in the short term.

VIETNAM: VND /USD EXCHANGE RATE

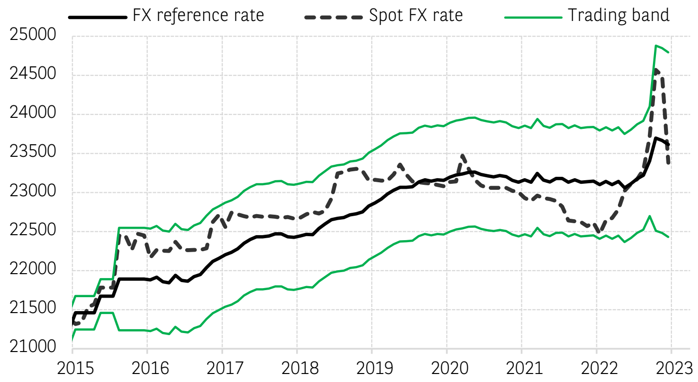

CHART 2

SOURCE: SBV, CEIC, BNP PARIBAS

MEDIUM-TERM ECONOMIC PROSPECTS REMAIN GOOD

Finally, Vietnam's macroeconomic fundamentals improved in the decade before the pandemic, making it more resilient to shocks. Strong GDP growth rates, strengthened external accounts and fiscal consolidation in particular were enabled by the rapid expansion of the export manufacturing sector, supported by FDI. These dynamics have been interrupted since 2020, but the deterioration of fiscal deficits and the current account balance has been limited. At the end of 2022, public debt and external debt ratios remained moderate, estimated at 40% and 35% of GDP respectively, i.e. levels close to those at the end of 2019. The government has faced rising interest rates in recent months, but covering external financing needs is not a problem, especially as Vietnam's basic balance (current balance + FDI) remains positive.

Finally, the medium-term economic growth outlook remains strong. Admittedly, economic growth will be penalised in the short term by the slowdown in both the export sector (slightly offset by the rebound in tourism) and domestic demand: due to lessening post-Covid catch-up effects, the rise in inflation, less favourable credit conditions and the expected deterioration of the labour market. In the medium term, Vietnam's manufacturing sector should continue to benefit from adjustments in Asian value chains and from substitution effects (particularly because firms should relocate part of their production outside China). The expected real GDP growth for the next five years remains above 6.5% per year on average.

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