

# Vietnam: Awash in Money

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**With a booming economy attracting hordes to the stock market, the country needs to be careful to avoid a bust.**

Amid the myriad booms and bubbles the asset world has witnessed in recent months, one stands out, at least for originality: Vietnam. It is awash in more money than it can handle.

In mid-March, a thousand portfolio investors, investment bankers and fund managers crowded into Hanoi's Melia Hotel for an investment conference that coincided with a flurry of announcements about new funds being formed to invest in Asia's latest miracle economy. Here was the successor to China of the past decade, Thailand-Malaysia of the 1985-1995 era, Taiwan and Korea of 1975-1985 and Japan during the post-1965 boom. Vietnam is the latest to fly in the Asian geese formation.

Although a handful of pioneers have dabbled there since 1994 after its doi moi reform (which began in 1986) gradually moved in the direction of capitalism, the past few months have seen a foreign feeding frenzy that has caught the imagination of local punters, who have rushed to the stock market in unprecedented numbers. Although the market has come off 15 percent or so since an index peak of 1170 in early March, it is still double its level when the latest bull run began in November 2006 and four times the level of early 2006 when the markets began to wake up. (There are separate markets in Ho Chi Minh and Hanoi but the Ho Chi Minh one is the most active and the preferred listing location).

More remarkable, perhaps, than the rise in the index has been the increase in market capitalization from around a year ago to today's US\$15 billion plus ? around 24 percent of GDP. That has been the result of a flood of new listings thanks to tax changes that have forced many companies whose shares were once traded only on an over-the-counter basis to list. Hitherto many had preferred to avoid the reporting and regulatory requirements of a listing, but now they are finding that listing can bring share prices as well as tax benefits. (Altogether there are about 2,800 OTC companies but most seldom trade.)

New markets are particularly prone to speculative excesses and Vietnam is no exception. This has been a money-and-momentum driven market with scant regard for such niceties as price-to-earnings or price-to-book ratios. They are there for quick profits and an improvement on the modest yields of bank deposits. As for the foreigners, they say they are there for the long term, which is mostly true.

But what can they do other than buy stocks when they have fast-growing funds dedicated to doing just that, sometimes almost regardless of price? There are now some 20 foreign funds with money to invest in Vietnam, compared with only four a year ago. This is in addition to investment by foreign individuals or through participating certificates sold by investment banks, including HSBC and Merrill Lynch, which hold baskets of major stocks.

The fact is that Vietnam is being swamped with foreign money, adding to a credit-driven surge in local speculation. Combined, this could have destabilizing macro-economic effects as well as an equities bubble in danger of bursting. Some of the money earmarked for investment will remain on

the sidelines for the time being. Some will find its way into OTC shares or new equitizations ? the process of state companies becoming tradable, which in most cases also means issuing shares to private investors, managers and employees.

In one case, Dragon Capital, the oldest of the foreign funds, has used cash to buy control of a Canadian-listed company, Tiberon Minerals, whose main asset was a Vietnamese wolfram deposit.

But the estimated \$2 to 3 billion of new foreign portfolio money waiting in the wings is a huge amount for this market to absorb. It may not seem so big relative to a \$16bn market capitalization but it is huge relative both to the free float of those listed and bearing in mind that foreign holdings for some counters, mainly banks, are close to their limits (30 percent in the case of banks).

This is money earmarked for Vietnam. There is more discretionary foreign money that may still want to come in, for a long term punt on Asia's latest star. Meanwhile foreign direct investment into businesses is running at around \$10 billion in promised projects and around \$2 billion in actual disbursements.

Even if the foreigners decline to buy with an index trading at some 50 times earnings, there is no guarantee that locals will not continue to pile in as the market is fuelled by rapidly growing money supply, itself partly driven by the foreign cash inflow. There are plenty of examples. Big institutions had mostly exited Nasdaq well before its small investor-driven 2000 peak. Closer to home, the Bangladesh market continued to boom long after foreigners exited.

There has been talk that the government might try to dampen the market and money supply excesses by imposing new controls on foreign portfolio capital. The mess that Thailand made of this has probably been a deterrent. So, too, is the knowledge that the government should be able to take this opportunity to speed up the equitization and new listing processes.

The issue for Vietnam now is whether enough new large state companies can come to the market, or at least be made available during the equitization process, to absorb the excess of foreign and local money. There are several major companies planning to do so this year but whether that can happen quickly enough is debatable given that bureaucracy moves slowly. It also faces genuine problems in determining asset values of state companies, particularly those with large but unutilized land banks and the lack of any meaningful market in land.

The foreigners would like to use the current weight of money waiting to invest to persuade the authorities to increase foreign ownership limits – 30 percent for banks and 49 percent for most other companies. But the government fears that this would simply drive prices further and use up funds which it would prefer to see deployed in the new listings.

The market could anyway lose momentum of its own accord before the new listings arrive, in which case the authorities may face the choice of slowing them down or even halting them – as happened in the past in China – or seeing the weight of new paper collapsing the market, a result that could have political consequences.

Among foreign fund managers, the optimists do not expect a correction of more than 30 percent. They argue that accelerating earnings will soon show up in results and make the PE ratios look less inflated. They note, too, that the Vietnam stock index is capitalization-weighted and that though several of the heavyweight and liquid stocks are expensive by most measures, the smaller companies usually trade on much lower ratios. It is also argued that as new large stocks come to the market at IPO prices kept to moderate levels by the regulatory authority, the overall index valuation will come down without the necessity of a crash.

Others are less sanguine and suggest that once the domestic momentum goes out of the market, small punters will head for the exit in droves and the foreign money will only be a palliative. If that is the case, the market could easily go back to the 600 level or worse and, like its Chinese precursors, go through a long period of inaction with both PE and earnings falling. A worst case scenario could see the index back to 300 which would itself slow reform and bring new listings to a halt.

The theory is that the current average PE ratio is around 45 and could come down to 30 assuming (perhaps optimistically) earnings growth of 30 percent in 2007. But that would still leave it at about double what might be expected for a market with great growth potential but erratic corporate governance, a heavy presence of banking stocks and huge demands on capital if current 7-8 percent GDP growth is to be sustained.

Some of the biggest demands for capital will come from the power sector and Vietnam plans to use the market to raise capital for separately listed power producers under the Electricity Vietnam umbrella. Such capital intensive ventures are seldom the stuff of market booms.

For now the financial markets look promising only in parts. Participants mostly praise the structure and management of the stock exchanges which have had few trading problem – though abuses by brokers are believed widespread, as in other markets where profits come more from proprietary trading books than from commissions.

A bond market, too, is emerging to which foreigners have access. Thus far it trades mainly government bonds. But public debt issues will continue to grow – outstanding government bonds are only equal to about 10 percent of GDP compared with as much as 40 percent in Thailand and Malaysia. Corporate bond issues will also likely expand as investors become more confident of their accounts.

Generally speaking, Vietnam's institutional financial development is more advanced than China's was at a similar stage. However, there is one major problem which is being exacerbated by the current credit boom: the banking system. Its health is not only critical for macro-economic stability, it is also a key to stock prices: eight of the top 20 stocks by market capitalization are banks, and new ones are coming to the market soon.

As the banking system is largely state-owned it may not be in danger of the kind of meltdown suffered in many countries during the Asian financial crisis of 1997-1998. However, credit has almost certainly been growing too fast even for an economy with 13 percent nominal growth and still in the process of monetization. Large state-owned enterprises still get the lion's share of credit and although the official figures for nonperforming loans have been falling and are now around 5 percent, many foreign observers are skeptical. They suggest that a realistic 15 percent NPL for state banks is realistic.

Many banks could be technically insolvent and in need of new capital. To make matters worse, there are far too many banks and lately some are said to have been using their excess liquidity to play in the stock market. There are four large SOE banks and 36 joint-stock banks. Of the latter, four have 60 percent of Vietnam's loans so the rest are very small. The whole banking sector is changing for the better, including the central bank. But it looks to have lagged behind credit growth and thus exposes the economy to potential dangers.

For an increasingly open economy ? foreign trade is now equal to 80 percent of GDP –foreign exchange reserves are a modest US\$13 billion. Although up from \$9 billion at end-2005, it is barely satisfactory relative to foreign trade – it is not quite equal to three months of imports and it is only a quarter of the fast-growing monetary base.

Complicating matters is that some 25 percent of bank deposits are in foreign currencies. While banks hold significant liquid assets offshore, local borrowers of foreign currency could present the banks with major problems if the dong were to fall sharply or the local economy experience a major downturn. Despite the success of farm, footwear and textile exporters, oil still accounts for 25 percent of exports.

In short, Vietnam has probably not done enough during this period of easy money to reduce risk by increasing its forex reserves. So it will need to be on guard so that today's inflow excesses do not become tomorrow's outflow flood and drain those reserves. The sooner the government can get new listings to market while the foreign cash is available the quicker it can build its reserves and bring market prices to levels which make a future bust less likely.

For now the dong looks stable enough. Inflation has come down and with it the controlled depreciation. The current account deficit is only 2 percent of GDP and capital controls remain in place. However, looking ahead, the banking system will have to manage a transition to a more open economy. Foreign banks' access to dong deposits will increase and foreign ownership of local banks will be permitted from April 1.

By 2011 Vietnam aims to abolish most capital controls. These are ambitious targets and are requirements built into bilateral agreements linked to World Trade Organization accession. They carry opportunities for the modernization of a socialist-era banking system and for amalgamations to reduce the number of players. But all financial sector liberalizations carry risks either of credit excess or the privatization of entities which lack sufficient capital and expertise to survive tougher times.

The best argument for Vietnam is a macro one. But even the best macro performance – as in the case of China – can be ignored by the market for years. There are several reasons why this could happen in Vietnam. The price of capital, now at an all time low, could rise, putting a strain on financial markets in an economy with huge growth potential but also huge capital requirements. Another possibility is that, as happened in Vietnam in the mid-1990s and in China more recently, easy access to capital results in over investment, excess capacity and a sharp fall in profits.

Vietnam's economy has been growing at a fast yet quite steady pace for more than a decade. However, three events over the past years have served to underwrite confidence that this will continue and that Vietnam will take its place among the more successful and prosperous east Asian nations, perhaps catching Thailand in a generation and Taiwan by mid-century.

First, entry into the World Trade Organization. This was no surprise after years of negotiations during which Vietnam acquired trade access to the EU, US and other major markets. However, membership and related bilateral agreements, especially with the US, are set to force continued reform and opening up of the economy, including much of the service sector, to foreign entry and competition.

The Party Congress in 2006 which saw not only another smooth transition of leadership but the promotion of younger figures who came to prominence in the postwar years and are associated with economic reform and the continued shift to a market economy. The party remains highly authoritarian and will come under pressure for political change as the economy develops. But Vietnam has achieved more internal democracy and decentralization than its communist peers and never subjected the people to the violent ideological swings experienced in China. Reform has been slow but steady and seemingly well thought through.

However, as in any transition economy where the borders between the state and private sector are

blurred, corruption is rife. It is closely associated both with the normal obstructionism of the bureaucracy and now with the spoils that can come from equitization. More equitization is needed – 40 percent of the economy is still in SOE hands – but ill-gotten gains are a seemingly inevitable part of the process.

Meanwhile foreign investors, though often admiring the Vietnamese work ethic, find the bureaucracy a source of interminable delays and sometimes chauvinist attitudes, a sense that it is wrong for foreigners to be able to profit from the labor or resources of the Vietnamese. However, nationalism seems to have waned somewhat as opening up has come to be seen as a success. In any event, economic nationalism was never as entrenched in freewheeling Ho Chi Minh City and the south generally, as in Hanoi.

The third, already mentioned, was the tax decision which resulted in the dramatic development of the stock market and hence of foreign interest, which also spilled over into the bond and real estate markets.

The macro bull story is easy enough to understand. Firstly, Vietnam is playing catch-up with China and most of Southeast Asia. Its shift of manpower from agriculture to manufacturing is relatively recent. It could certainly be slowed by adverse global conditions or a shortage of capital but it is probably no more vulnerable than other Asian economies.

Second, it has among the best demographics in Asia if not the world. Population growth is slowing. The workforce is still expanding by 2 percent a year but that will gradually slow to less than 1 percent by 2020. The percentage in the working age 15-59 group will soon reach 66 percent and remain close to that very high level for the next fifteen years.

The macro story is enhanced by a high savings rate – currently 35 percent of GDP and still rising, which may be behind China but is up to the levels enjoyed by earlier fast developers like Taiwan and Thailand. And the fiscal position is stable enough with a deficit of less than 2 percent of GDP and government at 45 percent of GDP. The foreign debt proportion is high (27 percent of GDP) but most of it is long term, low interest loans. Short term debt is modest.

Vietnam lacks China's economies of scale and there is no equivalent to Taiwan or Hong Kong to provide instant access to capital and markets. But Vietnam does enjoy some compensating advantages. Most of its population is concentrated in two delta regions which keeps down infrastructure costs. And those regions are close to the sea and hence the markets of Asia and the world.

A combination of geography and domestic politics has also served to limit income imbalances, at least compared with China. The social, health and educational safety nets of socialism have not all been sacrificed on the altar of GDP growth. Vietnam is probably right to look for 8 percent growth, not 10 percent. It has a good record in tackling issues such as avian influenza and education is making progress albeit from a low base. Although the rural/urban income gap is, as everywhere, large at a ratio of two to one it is far less severe than in China. Pollution is not yet a very serious problem and reliance on gas and hydro for the majority of its power needs is an advantage.

But make no mistake, Vietnam has literally little room for maneuver. Population density per hectare of cultivable land is higher even than Bangladesh. But is a tribute to its productivity that despite this it remains among the top world exporters of rice, coffee, rubber and (mostly farmed) seafood and farm output continues to grow by 3-4 percent a year.

It may be that Vietnam is arriving at the maximum growth stage too late – as the export-driven

model of development looks likely to be under severe pressure from global trade imbalances. But Vietnam can probably gain market share at the expense both of higher cost China and low cost but low efficiency Indonesia and south Asia.

But whatever happens to global conditions it needs to beware of getting carried away by easy money, which inevitably ends not in a great leap forward but a crash of markets and hopes.

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