No Eggs in One Basket: Foreign Companies leave China and Head Towards Vietnam

Vietnam is waking from its slumber. The Vietnamese economy, frozen for the past decade after a bubble burst, has been thawing since 2011, mainly due to rapidly increasing foreign direct investment. Samsung Electronics has chosen Vietnam as its new overseas smart phone production base to replace China. Under the second *Doi Mo* reforms, Vietnam now faces the challenge of cultivating a full range of industries from raw materials to finished goods. Will Vietnam's dreams be fulfilled?

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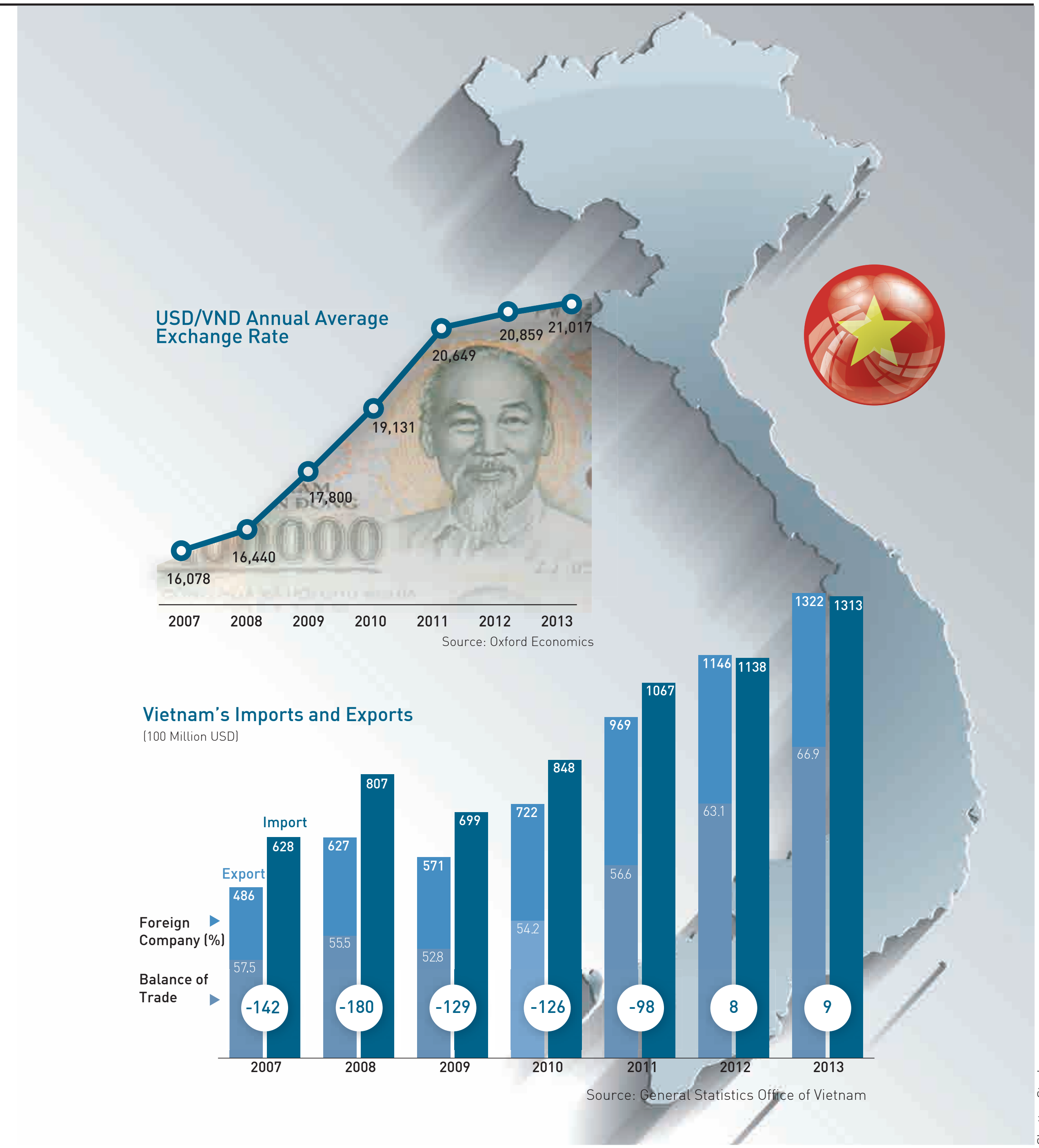
Vietnam Stands at a Critical Juncture: Remain a Subcontracting Base or Pursue Economic Resilience?



Shutter Stock

Vietnam saw its GDP grow 5.4% in 2013. Although this was only a slight increase from the 5.3% growth recorded in 2012, the country's GDP increased significantly from 4.9% in the first half of 2013 to 5.8% in the second half of the year, hinting at the possibility of economic recovery. However, this was not a full-blown recovery compared to the growth rates of more than 6.0% recorded in 2010-2011. Taking into consideration the Vietnamese economy's high dependence on foreign trade, it is hard to anticipate a full-blown recovery in the near future as the world economy has not fully recovered either.

Foreign investment firms and electronics industry fuel Vietnam's export boom

For the past five years, Vietnam's economic fundamentals have greatly improved. Although the country was once considered to be at the greatest risk of foreign exchange crisis, there's little talk of forex liquidity crises anymore. From 2007 to 2010, Vietnam ran trade deficits of more than USD 10 billion annually. The trade deficit was the Vietnamese economy's worst disadvantage. However, in

For the past five years, Vietnam's economic fundamentals have greatly improved. This is mainly attributed to its rapidly developing electronics industry, which has driven export increases.

2011 the deficit fell under the USD 10 billion barrier and dropped to USD 9.8 billion, and the country even recorded a modest trade surplus in 2012-2013. As a result, the value of the Vietnamese dong (VND) stabilized after having taken a nosedive in 2007. The consumer price index (CPI) also rose to 6.0% last year–a record low for the past decade.

Why have Vietnam's external economic fundamentals improved so much? The main reason is the surge in exports. Exports stood at only USD 48.6 billion in 2007, but increased 2.7 times to USD 132.2 billion in 2013. Imports also rose 2.1 times, from USD 62.8 billion to USD 131.3 billion, during the same period. Vietnam exported less than the Philippines in 2007, but its exports rose 2.5 times higher than Philippines' total exports of USD 54 billion in 2013.

Two features of the Vietnamese economy can explain the country's booming exports. First, exports by foreign-invested companies have risen sharply. In 2009, their share of exports plunged to 52.8% in the wake of the global financial crisis, but increased rapidly to 66.9% in 2013. The recent export boom has been mainly propped up by foreign-invested companies. The second reason can be found in the export structure. Exports of commodities such as crude oil and rice have been a strong suit for the Vietnamese economy, greatly contributing to foreign exchange earnings and price stabilization during industrialization. But commodity exports have already become stagnant and even declined. The country's exports of textile products and shoes–the classic labor-intensive industries–have increased, but their share of total exports did not expand. Instead, the share of electronic products increased significantly. In particular, exports of communications devices (e.g., mobile phones), which had been almost non-existent in 2008, rose to USD 21.5 billion in 2013, accounting for 16.3% of total exports as they became last year's top export product. The rapidly developing electronics industry has led Vietnam's export increases for years, and has even strengthened the country's overall economic structure.

Foreigners wary of "China risk" eyeing Vietnam as a new investment destination

The Vietnamese electronics industry has developed thanks to investment by multinational companies. In other words, the recent boost to Vietnam's economic fundamentals owes much to friendly foreign investment. In 1986, Vietnam carried out the reform and opening policy called *Doi Moi* (renovation). Its aim was to promote industrialization by attracting foreign investment, just as Singapore, Malaysia, Thailand, and China had in the past. Abundant labor and production of commodities seemed to be a necessary and sufficient condition for success. And in the 1990s, the Vietnamese economy developed rapidly, with per capita income increasing from USD 290 in 1995 to USD 2,000 in 2013.

But high economic growth created a bubble and caused inflation to shoot up. In the 2000s, foreign direct investment (FDI) shifted focus from manufacturing to real estate development. In 2009, manufacturing accounted for only 13.6% of new FDI approvals, while real estate development accounted for 45.1%. Likewise in 2010, investment in real estate was higher than that in manufacturing.

While China is promoting a full range of industries from raw materials to finished goods, Vietnam is at risk of remaining a subcontracting base due to its poor components industry.

Vietnam's strategy to promote export-led industrialization through FDI was disrupted. The real estate development boom worsened the bubble, and at the same time, increased demand for imports, leading to widening trade deficits.

But since 2011, the quality of foreign investment has improved greatly. Foreign direct investment in real estate development, which had triggered inflation years earlier, has shrunk. Meanwhile, FDI in manufacturing, a reliable job creator, has climbed. In 2012-2013, foreign direct investment in manufacturing rose to more than 70% of all FDI. Additional investment by existing companies also soared. For instance, approvals for FDI amounted to USD 21.6 billion in 2013, USD 7.3 billion of which was added to existing investment. This increase shows that companies already investing in Vietnam are satisfied with their business performance.

Accordingly, the nature of FDI in Vietnam has changed recently because the investment environment has changed as well. But if that's the case, how could the investment conditions have changed so suddenly over the last couple of years? Vietnam has a population of 90 million, and a relatively high proportion is of working age between 15 and 64. As Vietnam's urbanization rate is still only around 30%, the country is likely to continue to have cheap labor. Vietnam is more success-oriented and has a higher education level than any other country. As its agricultural competiveness is high, prices can be stabilized at low levels. But this can't explain everything because Vietnam has also enjoyed the same advantages in the past.

In fact, the rising FDI in the Vietnamese manufacturing sector is mainly attributed to multinational companies' changing strategies toward China. Multinationals that have been focusing on China now face pressure for technology transfer imposed by Beijing and a deteriorating investment environment marked by surging labor costs. Not wishing to put all of their eggs in one basket, multinational companies have been looking for alternative investment destinations to avoid the so-called "China risk," which has led them to choose Vietnam.

Desirable division of labor with China in the global market

Even though Vietnam's economic fundamentals have improved in recent years, it is unclear whether the country will be able to maintain sustainable growth. Now, Vietnam should review seriously how to promote division of labor with China. Vietnam and China have the same development strategies and similar factor endowments. The only difference is that China is cultivating a full range of industries from raw materials to finished goods. Vietnam's labor-intensive products must compete with those of China in the global market. Moreover, China's consumer goods are sold in Vietnam too. This could be a lethal blow to Vietnamese companies. Also, China provides Vietnam with textiles and plastics, as well as other parts and materials required for industrialization. From a positive perspective, this means multinational companies maintaining a presence in Vietnam and Vietnamese companies join the international production network. At the same time, however, it means for Vietnam as a whole that imports will rise and the rate of foreign exchange earnings will fall.

Young Vietnamese on motorcycles fill four-lane roads on their evening commute.

Mobile phones, the main driver behind the rise in Vietnam's exports, constitute a clear example of the division of labor between Vietnam and China. Multinational assembly firms build mobile phone components in Vietnam and export the finished products to Europe and other advanced countries. Such assembly firms usually seek to enter Vietnam jointly with their partners, due to the country's lack of development in component-related industries. Although a joint entry increases the local purchase rate, it hampers the development of Vietnamese companies. Multinational electronics companies purchase only work gloves and packaging materials locally. They import those products that cannot be purchased in Vietnam. In 2013, Vietnam imported mobile phone components worth a total of nearly USD 8 billion, with USD 5.7 billion worth coming from China and USD 2.2 billion worth coming from Korea. South Korea's Samsung Electronics is the leading foreign maker of mobile phones in Vietnam. Nevertheless, Vietnam imports substantially more components from China than Korea. In addition, China supplies textiles, clothing and shoe materials, steel, and electronic components to Vietnam. It's fair to say that China is the real beneficiary of Vietnam's industrialization. Vietnam's trade deficit with China stood at USD 23.7 billion in 2013, with USD 13.3 billion in exports and USD 37 billion in imports.

Vietnam should improve its basic investment environment, including infrastructure and institutions, to ensure profitability and growth potential. But what is more urgent is to find investment areas that do not compete directly with China in the global market. Vietnam should attract foreign investment in these areas and encourage domestic companies to enter them as well. The recent steady increase in exports of labor-intensive shoes and wood products using Vietnamese resources clearly shows where Vietnam should go. The Vietnamese government should try to replace parts and material imports with domestic products.

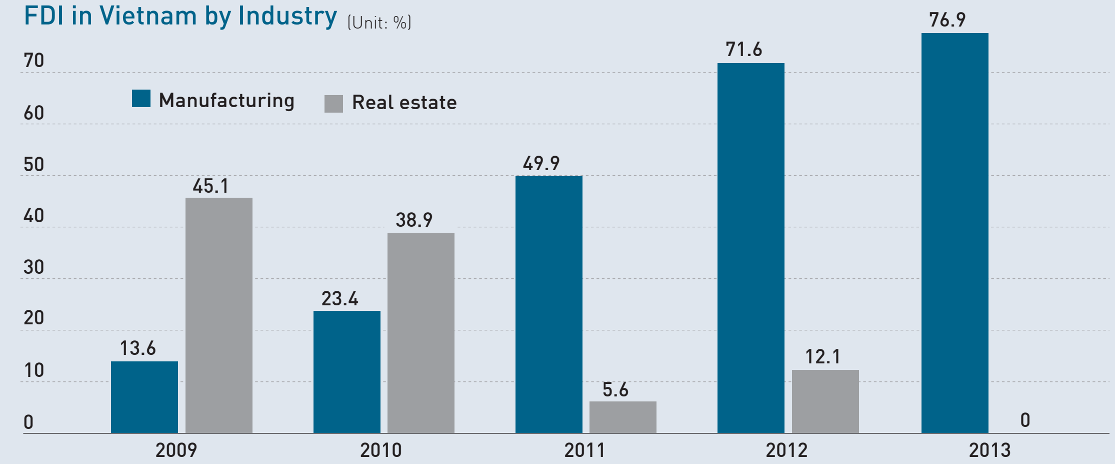
Long-term efforts are required to nurture domestic firms and build technological capability

Vietnam now stands at an important juncture. If Vietnam fails to choose proper development strategies, it is highly likely to remain a subcontracting base that only supplies labor to multinational companies. If so, Vietnam will likely fall into the middle-income trap, as has been the case with Malaysia, Thailand, and other early movers attempting to attract multinational corporations. Until an economy takes off, FDI is important but afterwards it needs the capability to develop industries on its own for sustainable growth. Vietnam should amend its industrial structure to make effective use of labor, the country's most important asset, in an effort to improve economic efficiency and productivity. Taking into consideration the high unemployment rate and low urbanization rate, it is urgent for Vietnam to develop industries or corporations that create job opportunities.

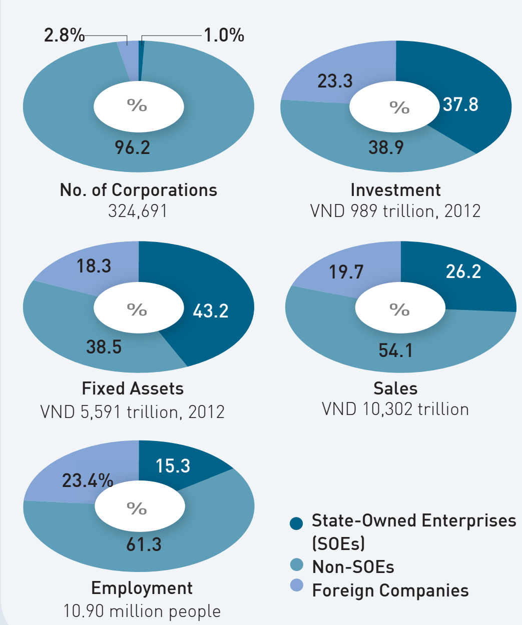
To create jobs in the long term, several things must be done. First, entrepreneurship should be promoted in every sector of the economy. If the number of start-ups increases actively, employment will also rise. In order to nurture entrepreneurs, capital should flow into the private sector. Vietnam has conducted privatization of state-owned enterprises (SOE) since 1992, but the pace of privatization has slowed since the 1998 global financial crisis and state-owned enterprises have become insolvent. Although the number of SOEs is not high, they accounted for 37.8% of total investment in 2012. Moreover, SOEs accounted for 43.2% of fixed assets in 2011, but only 15.3% of employment and 26.2% of sales. This means that non-SOEs are much more effective than SOEs at creating jobs. If entrepreneurs with high growth potential are given more opportunities to launch businesses, resources will be used more effectively and job creation will also become easier. By allowing capable entrepreneurs to become involved in privatizing state-owned enterprises, dynamic private enterprises should be encouraged to start and grow.

Second, Vietnam needs to select technology tailored to its environment in order to promote job creation. The country should no longer expect that multinational companies will transfer their technologies actively to Vietnam. As the global market becomes more integrated and technology product cycles grow shorter, it is not necessary for Vietnam to waste resources on acquiring high technology beyond its level of economic development. It is almost impossible for a single Vietnamese company to equip itself with technology as advanced as that used by a multinational. In this regard, the Vietnamese government should actively lead technology development at the intermediate level. In that process, the government should make policies encouraging Vietnamese companies to produce parts and materials locally, thus allowing them to join the international production network. Also, Vietnamese policymakers must pay close attention to investment in education in order to boost capabilities for technology and innovation.

FDI in Vietnam by Industry (Unit: %)



Status of Vietnam's State-Owned Enterprises (2011)



Vietnam's Major Exports by Value (USD Millions)

	2008	2009	2010	2011	2012	2013
Crude oil	10,450	6,210	4,944	7,236	8,395	7,236
Rice	2,902	2,662	3,212	3,643	3,689	2,986
Coffee	2,022	1,710	1,763	2,741	3,686	2,694
Rubber	1,597	1,199	2,376	3,223	2,876	2,526
Fisheries products	4,562	4,207	4,953	6,107	6,156	6,734
Textiles	9,108	9,004	11,172	14,028	15,035	17,891
Shoes	4,697	4,015	5,079	6,523	7,246	8,366
Wood products	2,779	2,550	3,408	3,905	4,641	5,496
Electronics, Computers	2,703	2,774	3,558	4,198	7,882	10,677
Mobile phones	-	-	2,307	6,860	12,644	21,517

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Lured by Geographic Advantages and Financial Incentives, Foreign Investors Rush to Vietnam

Vietnam's financial capital of Ho Chi Minh City receives tremendous FDI inflows.

The Electricity of Vietnam (EVN) and Marubeni Corporation of Japan held a groundbreaking ceremony for Section 11 of the Thai Binh Thermal Power Plant on February 22, 2014. The two-unit power plant with a combined design capacity of 600MW reportedly cost USD 1.27 billion, 85% of which was provided by the Japan International Cooperation Agency (JICA) and the remaining 15% by the EVN.

Vietnamese newspaper *Tien Phong*, Page 2, Feb. 23, 2014

India's Tata Group unveiled its plan to return to Vietnam by investing USD 1.8 billion in the Long Phu 2 Thermal Power Project in Soc Trang.

Vietnamese newspaper *Dau Tu*, Page 4, Feb. 24, 2014

These are excerpts from recent Vietnamese media reports covering foreign direct investment (FDI) in Vietnam. Vietnamese newspapers have published reports on FDI almost every day this year. Foreign direct investment is now rushing into Vietnam.

FDI in Vietnam: A plunge in 2009 and a recovery in 2012

As of February 17 this year, the Vietnamese financial capital of Ho Chi Minh City has granted investment licenses to 39 new foreign direct investment projects with a total registered capital of USD 150 million. In other words, with the exception of holidays, hardly a day has gone by without an FDI agreement concluded between foreign investors and Ho Chi Minh City. The same is true in other parts of the country. During the same period, the Department of Planning and Investment of Binh Duong Province approved 20 new projects with a combined capital of USD 189 million, complementing 19 ongoing projects worth USD 525 million.

Foreign direct investment flowing into Vietnam peaked in 2008. According to *The Vietnam Industrial Investment Report* 2011 released by the United Nations Industrial Development Organization (UNIDO) and the Vietnamese Ministry of Planning and Investment (MPI), the level of inbound FDI reached a record peak thanks to strong global economic growth in 2007. That was also the year that Vietnam joined the World Trade Organization (WTO).

However, foreign capital flows into Vietnam shrunk considerably after the global financial crisis. In 2008, FDI capital reached a record high of USD 71.7 billion, but took a nosedive to USD 23 billion in 2009, according to the Vietnamese General Statistics Office (GSO). After successfully reversing the downward trend in 2011, Vietnam has maintained steady FDI growth since 2012.

According to the MPI-affiliated Foreign Investment Agency, Vietnam attracted USD 21.6 billion worth of FDI in 2013, a year-on-year increase of 54.5%. That included USD 14.3 billion in registered capital committed to 1,275 newly licensed projects, an increase of 70.5%, and USD 7.3 billion of additional registered capital invested in 472 ongoing projects, an increase of 30.8%. What's more, these figures do not include additional investment by Britain's Technostar Management in the Vung Ro petrochemical and oil refinery complex in the central province of Phu Yen. With Technostar's increased investment capital from USD 1.7 billion to USD 3.18 billion, Vietnam was able to attract a total of USD 23 billion in FDI last year, according to VietNamNet. This is the second-largest amount of FDI attracted since 2008. By sector, manufacturing and processing attracted USD 14.9 billion in FDI, accounting for 77.6% of total registered capital, during the ten-month period from January to October last year, while power generation, distribution, and air ventilation accounted for 10.6%.

Foreign direct investment inflows to the country are expected to increase sharply by 2015, according to the Vietnamese National Financial Supervision Commission (NFSC). The sharp rise is mainly attributed to the ongoing world economic recovery and anticipated closer international cooperation through the Trans-Pacific Partnership Agreement (TPP).

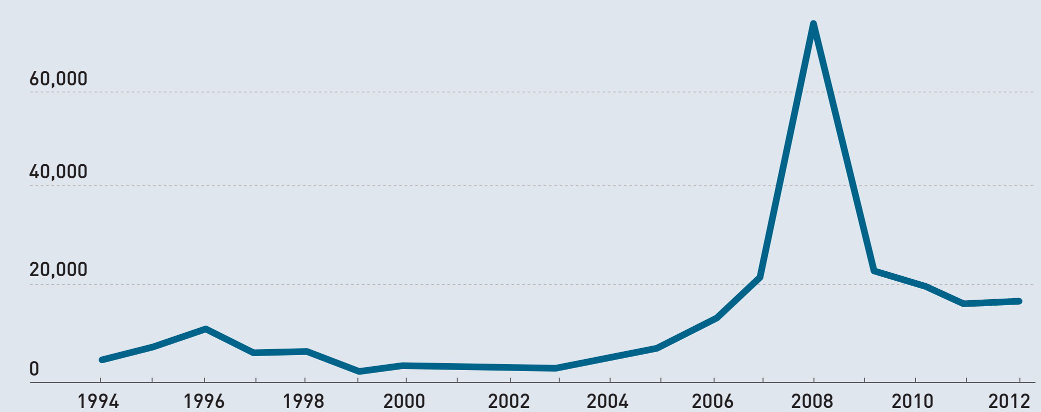
Foreign direct investment in Vietnam rose by 54.5% in 2013. The processing and manufacturing sectors are drawing an increasing amount of FDI.

Positive impacts of FDI

How did last year's injection of 23 billion dollars in FDI affect the Vietnamese economy?

First, the most concrete proof of its effects can be seen in the trade balance. Vietnam has suffered chronic trade deficits caused by excessive imports. Since 2001, the country has maintained a series of trade deficits, but has also recorded modest surpluses since 2012 thanks to increased FDI in 2011. Last year, Vietnam recorded a trade surplus of USD 900 million, with USD 132.2 billion in exports and USD 131.3 billion in imports. Inbound FDI has been heavily focused on manufacturing, increasing production and contributing significantly to the surge in exports. Foreign-invested firms have led the overall export increase in Vietnam

Foreign Direct Investment in Vietnam (USD 1 Million)



Source: Stratfor

The Electricity of Vietnam (EVN) and Marubeni Corporation of Japan agreed on the joint construction of the Thai Binh Thermal Power Plant. (Top)
Samsung Vietnam accounts for 98% of Vietnam's mobile phone exports. [JoongAng Photo]

Foreign direct investment in Vietnam rose by 54.5% in 2013. The processing and manufacturing sectors are drawing an increasing amount of FDI.

with their exports outweighing those of domestic firms since 2003. Foreign-invested enterprises accounted for more than two-thirds of total exports, totaling 64% in 2012, and 67% or USD 88.4 billion in 2013.

With increased exports by foreign-invested enterprises, the export structure has also changed. Products made in Vietnamese plants operated by Samsung Electronics, LG Electronics, Nokia, and Intel represent the lion's share of the country's overall exports. In particular, exports of consumer electronics, especially mobile phones, have surged exponentially in recent years. The Korea Trade-Investment Promotion Agency (KOTRA) estimates that South Korean-invested Samsung Vietnam, which accounts for 98% of the Southeast Asian country's mobile phone exports, will see its exports surpass USD 30 billion by 2015. Last year, its exports of electronic devices and computers exceeded USD 10 billion for the first time, an increase of 36.2% from 2012.

As foreign direct investment in Vietnam creates jobs and improves the quality of human resources, it also changes the structure of the labor market. "Foreign investment sector created over 2 million direct jobs and about 3-4 million indirect jobs, having strong impact on labor restructuring towards industrialization-modernization," said Vietnam National University Professor Tran Dinh Lam in his paper "Foreign Direct Investment in Vietnam."

Foreign direct investment comprises a significant share of Vietnam's GDP. While the foreign investment sector's contribution to GDP stood at only 2% in 1992, it surged to an estimated 20% in 2013.

Thanks to such auspicious outcomes, the outlook is rosy for Vietnam this year despite mounting concerns over a possible crisis in emerging markets caused by the U.S. Federal Reserve's tapering policy (reduction of quantitative easing). "The future is looking brighter for Vietnam as the country begins the Year of the Horse," the International Business Times proclaimed earlier this year, summarizing the forecasts of economists from around the world. Vietnam was able to avoid the direct impact of U.S. tapering because of its relatively small capital market, but its trade account surplus rally has also played a significant role. "Exports, especially foreign-invested manufacturing firms, will provide a boost to Vietnam's growth [in 2014]," said Trinh D Nguyen, an economist at HSBC. Nguyen expects exports to rise 20% this year, up from 15.4% in 2013, which will help the gross domestic product expand 5.6% this year, 0.2%p higher than 5.4% last year.

The Vietnamese government's efforts to attract FDI

There are several reasons for the heavy FDI flows into Vietnam. First, Vietnam shares borders with China, the world's largest market, and is geographically close to India, a country often described as "the Next China." With a population of 92.47 million (as of July 2013), Vietnam has a large market of almost 100 million people. The country's wages are also low. According to a report by the Japan External Trade Organization (JETRO), monthly pay for the average worker in Vietnam is about 32% of the levels in China, 43% of those in Malaysia and Thailand, and 62% of those in Indonesia.

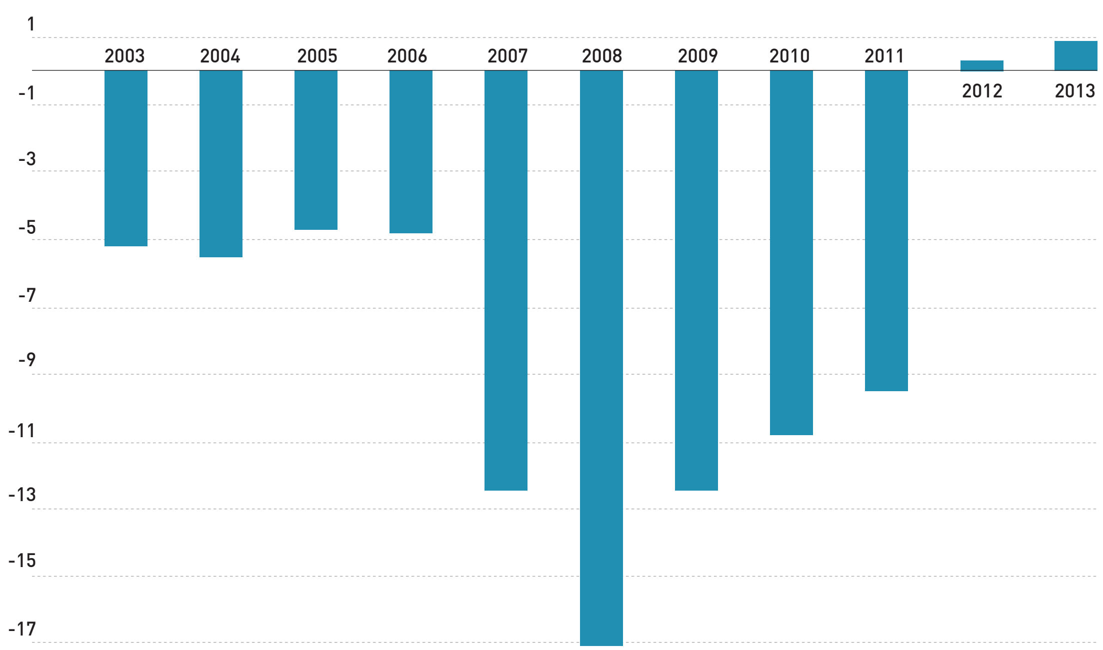
At the same time, we must not overlook a more important reason: the Vietnamese government's policies and efforts to attract FDI. Professor Tran Dinh Lam points out that the increase in FDI owes much to the Vietnamese government's policy of reform and opening up to the world.

The Vietnamese economy embarked on the road to openness with the *Doi Moi* reforms of 1986. As it transitioned from a socialist planned economy to a market economy, Vietnam enacted its new Foreign Investment Law in 1987. Since then, the country has taken various measures to increase its attractiveness to foreign investors. Since 1990, the private sector has also been allowed to participate in FDI projects. In 1992, an amendment to the law was made to reduce restrictions on FDI and simplify the related approvals process. The Vietnamese government has also established a "one-stop agency" to serve as an intermediary between investors and authorities.

Currently, Vietnam has no minimum capital requirement for foreign investors and no limit on foreign ownership. It also has no restrictions on repatriation of profits and dividends. And the Vietnamese government has pledged not to nationalize foreign assets or impose restrictions on corporate management.

The government also grants various incentives to foreign investors. It offers tax holidays to foreign-invested enterprises for the first two years. The corporate income tax for foreign-invested enterprises in key sectors is only 10-15%. Moreover, in order to encourage these enterprises to reinvest their profits, they are eligible for corporate tax rebates on reinvested funds. Likewise, foreign-invested companies are not required to pay import duties on raw materials and components used in

Vietnam's Balance of Trade (USD 1 Billion)



Sources: *Bloomberg*, HSBC

manufacturing goods for export.

In 1991, Vietnam set up the Tan Thuan Export Processing Zone (EPZ), which covered a total area of 300 hectares and enjoyed significant loosening of various regulations. Within the first six years of operation, it attracted 139 foreign investors, primarily from Taiwan and Japan. More than 100 licenses have been issued in this zone with a total capital of USD 482 million. Motivated by the success of the Tan Thuan EPZ, Vietnam has established 25 industrial complexes in other areas.

Despite strenuous efforts made by the Vietnamese government, however, many foreign investors still complain of difficulties. In addition to insufficient infrastructure, many obstacles to foreign direct investment still exist, including a lack of administrative services and laws necessary to promote market competition, and socialist practices still rampant in the country.

Looking ahead, JETRO outlines five major risks that Japanese-invested companies may face in Vietnam: wage hikes, cumbersome administrative procedures, unreliable policies, complex customs procedures, and lack of legal institutions. Korean investors would do well to take note of these risks as well.

No Industrial Park in Vietnam for South Korea?

Korean companies are one of the "major players" in the Vietnamese economy. Since Korean firms began entering Vietnam in the early 1990s, the number of Korean companies doing business in the country has grown to more than 3,000 as of late 2013, according to KOTRA Hanoi. Korea has invested USD 28.8 billion in 3,514 projects as of November 2013, thus becoming the third-largest investor in terms of capital value after Japan and Singapore. Vietnam is the fourth-largest investment destination for Korea after the U.S., China, and Hong Kong, and the largest investment destination in the ASEAN region.

Korean investment in Vietnam began in earnest after the two countries established diplomatic relations in 1992. At first, Korean companies' entry into Vietnam focused on heavy industry, including home appliances and steel. However, as Vietnam has become a link in the export chain for Korean trade with the U.S. since the normalization of U.S.-Vietnam relations in 1995, Korean investment in Vietnam has focused on manufacturing, especially labor-intensive sectors, such as textiles, sewing, apparel, and shoes. Recently, the focus has shifted to high value-added industries, including metals, electrical equipment, and electronic components. The newly opened distribution and service sectors are also attracting increasing investment.

Investment approaches have changed, too. Unlike individual and small-scale investment in the past, large-scale investment and joint entry have become prevalent in recent years. As Samsung Electronics, LG Electronics, Doosan Heavy Industries and Construction, POSCO, and other large South Korean companies have increased their investment in Vietnam in partnership with South Korean small and medium-sized enterprises, an increasing number of first- and second-tier suppliers are making inroads into the country.

Thanks to such active interest by large South Korean firms, Korea overtook Singapore to become the second-largest investor in Vietnam from January to October last year. According to the MPI, Japan, the largest investor, invested USD 4.84 billion in the country during the same period, accounting for 25.2% of total investment. Korea invested USD 4.01 billion, followed by Singapore with 3.98 billion, China with 2.2 billion, and Russia with USD 1.01 billion.

Despite surging investment by South Korean companies, there is still no industrial park in Vietnam exclusive to South Korea. As of July 2013, Vietnam had nine Japanese industrial parks, including those under construction. "Currently, South Korean companies seeking to enter Vietnam need to spend much time to select sites for industrial parks. This is one of the major obstacles for Korea's FDI in Vietnam," KOTRA Hanoi points out, "It will be helpful to boost Korean FDI in the country, taking into consideration the Vietnamese government's determination to attract FDI and South Korean firms' demand for investment."

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Vietnam's Financial Market Stabilizes after Liberalization and Restructuring, Sustainable Growth Depends on Local Companies

Bloomberg

Status of Vietnam's Financial Restructuring

Bank M&A Deals	
2011	Ficombank,TinNghiaBank, SCB
2012	SHB, HBB
2013	PVFC, Western Bank
2014~	Eximbank, Sacombank, HDbank, DaiABank
VAMC's Bad Debt Cleanup	
2013	Purchase of VND 39 trillion of NPLs
2014	To purchase VND 100-150 trillion of NPLs
~2018	To hold or dispose of purchased NPLs
Control of Further Insolvency	
Decreases policy rates, and lowers lending rates, extends loan maturity, eases real estate regulations, delays adoption of Basel II	

Source: Vietnamese government, Vietnamese media, Korea Investment and Securities

Vietnam's financial market has been fairly stable for the past two to three years. This is in stark contrast to the faltering in other emerging financial markets amid the Eurozone crisis, U.S. tapering measures, and China's economic slowdown.

The exchange rate of the Vietnamese dong (VND) against the U.S. dollar was VND 21,036 in early 2012, VND 20,860 in early 2013, and VND 21,120 at the end of February 2014. The Vietnamese currency has increased against the U.S. dollar by only 0.4% since 2012, while the currencies of other emerging countries have gained substantially against the greenback: 28% for Brazil, 16% for India, 30% for Indonesia, and 15% for Turkey. With the adoption of a fixed exchange rate system, Vietnam's foreign exchange market has remained fairly stable without a steep rise in the basic exchange rate.

The Vietnam Stock Index (VN-Index) listed on the Ho Chi Minh City Stock Exchange rose by 17.7% in 2012, 22.0% in 2013, and 13.4% in January-February 2014. These figures are quite remarkable compared to the MSCI Emerging Markets Index designed to measure equity market performance in emerging markets, which increased by 15.1% in 2012 but declined by 5.0% in 2013 and by 4.5% in January-February 2014.

The yield on Vietnam's one-year government bonds declined from 12.8% in early 2012 to 8.7% in early 2013, and to 5.8% at the end of February this year. On the other hand, amid fears of financial instability Brazil saw its one-year government bond yield climb by 10.1% in 2012, 7.1% in 2013, and 11.7% in January-February 2014 this year. Bond yields in other major emerging markets mostly increased.

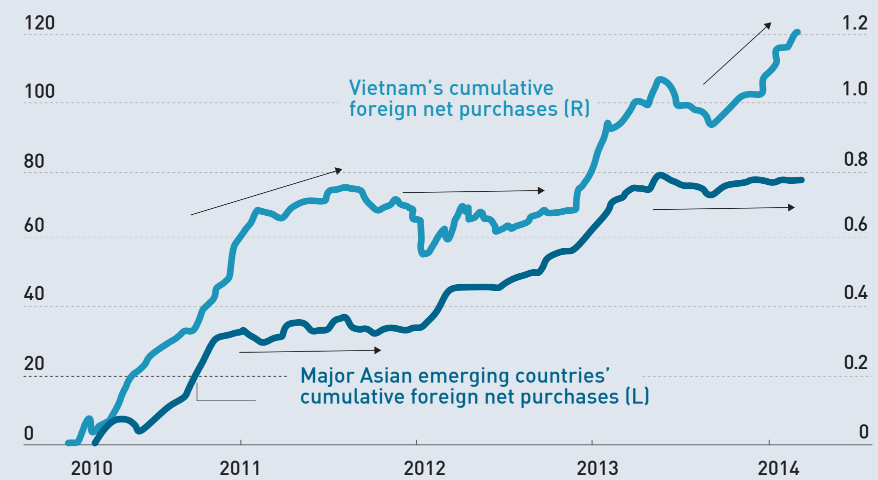
FDI and improved trade balance spur financial market development

Vietnam has been able to keep its financial market stable owing to constant foreign direct investment and portfolio investment inflows. Despite a strong preference for safe assets in global capital markets, Vietnam has attracted foreign capital since 2012 on the basis of its improved financial soundness index, implementation of economic stimulus packages, strengthened corporate performance, financial restructuring, and policies to improve the financial market. Vietnam's net foreign stock investment fund inflows grew from USD 150 million in 2012 to USD 280 million in 2013, and have reached almost USD 100 million so far this year. Long-term investment in the Vietnamese stock market continues to rise as the Vietnamese economy's growth momentum has become especially prominent amid China's recent economic restructuring, Japan's Abenomics, natural disasters in Northeast Asia, and ongoing negotiations for the Trans-Pacific Partnership (TPP). Such a positive trend is in complete contrast to the large-scale net foreign selling that has hit most Northeast Asian stock markets since 2013.

With foreign capital inflows, Vietnam's balance of trade has improved dramatically. Vietnam recorded trade deficits of more than USD 10 billion each year during 2007-2010. However, the country's trade balance went into the black by USD 2 billion in 2012 when Samsung Vietnam's exports of mobile phones began to take off and the Vietnamese government imposed regulations on imports. With a trade surplus of USD 380 million in 2013, Vietnam's trade balance has improved for

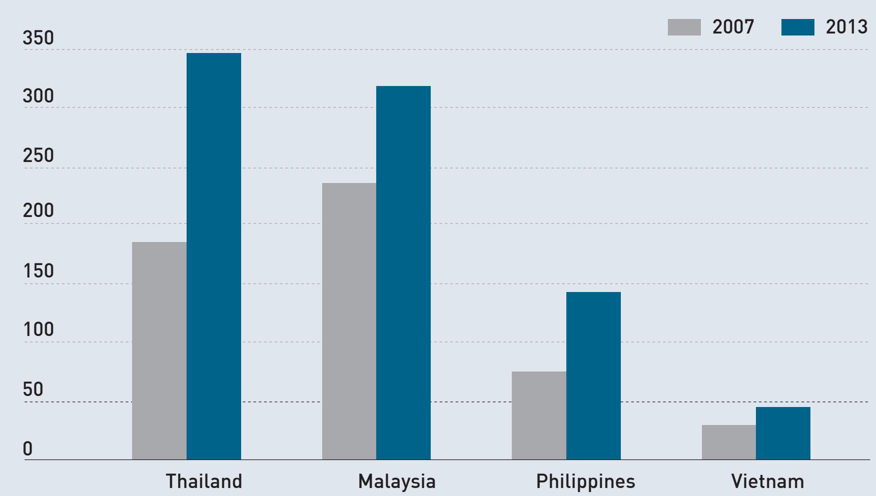
Trend in Net Foreign Purchase of Stocks

(USD 1 Billion)



Aggregate Market Values in Southeast Asia

(USD 1 Billion)



Thanks to the development of the capital market and improved financial stability, increasing numbers of foreign companies are marching into Vietnam, but local companies seem to remain rather slow in improving their economic activities.

two consecutive years.

As foreign capital flows into the country, Vietnam's stock market has regained vitality but is still relatively small. The aggregate value of stock (AV) listed on the Ho Chi Minh City Stock Exchange and Hanoi Stock Exchange was USD 31.6 billion in 2007 and USD 55.2 billion, respectively, at the end of February this year. The value is much smaller than the USD 314.9 billion of Malaysia, USD 354.4 billion of Thailand, and USD 156 billion of the Philippines, let alone Korea's USD 1.06 trillion. The Vietnamese government is working to expand its stock market by privatizing outstanding state-owned enterprises (SOE) in order to finance businesses smoothly and attract foreign capital. In the wake of the global financial crisis, leading SOEs, such as Vietcombank, Vietinbank, BIDV, and Petrovietnam Gas, have been listed, and privatization of other SOEs, including Vinatex, Vietnam Airlines, and VNPT, is in the pipeline this year.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Financial market bolstered by government policies

The financial market is expected to remain stable for the time being, as most of the factors that affect financial stability are improving on a structural level. In addition, the Vietnamese government is putting much effort into amending financial market policies. While nurturing the direct financial market, opening up the capital market, and implementing policies for financial restructuring, the Vietnamese government is currently making the most of capital inflows and restructuring with a view to activating the direct financial market where stocks and bonds are traded.

With respect to capital market opening, Vietnam is expected to loosen regulations and raise foreign ownership caps. Currently, the foreign ownership cap is 49% for listed companies and 30% for banks. However, in line with Vietnam's WTO commitments to open its capital market, the country is expected to extend the foreign ownership limit for companies to 60-65% within this year. Thanks to relaxed regulations on foreign ownership limits, additional foreign capital will flow into Vietnam and the financial market will see strengthened stability.

Since 2012, the Vietnamese government has been implementing financial restructuring. Having classified banks by their level of insolvency, Vietnamese authorities have also ramped up measures to clean up banking bad debts and merge unprofitable banks. The Vietnam Asset Management Company (VAMC), established in July 2013 with funds provided by the Ministry of Finance, has purchased USD 1.8 billion in non-performing loans (NPL) from banks last year, and plans to purchase additional NPLs worth USD 4.7-7.1 billion this year with a view to holding or disposing of them by 2018. Banks have sold bad loans to the VAMC by swapping bad loans for VAMC bonds, improving their liquidity by using VAMC bonds as collateral. Of course, credit creation has not been made at the level intended by the Vietnamese government. However, it will be much easier for companies to finance their businesses thanks to increasing demand for funds amid economic recovery and uncertainty eased by ongoing restructuring.

Lackluster synergy creation between finance and business

With the development of the capital market and improved financial stability, increasing numbers of foreign companies are marching into Vietnam, but local companies seem to remain rather slow in improving their economic activities. Although big electronics and communications companies, such as Samsung Electronics, LG Electronics, and Intel, have established production bases in Vietnam, the local supply of parts and materials is still substandard. The tenants at Samsung and LG's parts and material complexes for consumer electronics in Bac Ninh Province, Thai Nguyen Province, and Hai Phong are mostly foreign companies. Furthermore, foreign companies have taken the lead in the recently prospering retail, distribution, logistics, and entertainment sectors.

Some local companies stand out—Highlands Coffee, e-commerce website Vatgia.com, and software outsourcing service provider FTP Software. However, large state-owned companies continue to show relatively poor competitiveness in energy, agriculture, and light industry. At the end of last year, the Vietnamese government set up the Hanoi Supporting Industry Business Association (HANSIBA) to nurture the domestic parts and materials industries, but this is only a first step as the association is still in its infancy.

Despite the robust Vietnamese economy and growing financial market, local entrepreneurs have been unable to show significant growth. If capital market development can spur financial activity that leads to stronger performance by local companies, the Vietnamese economy will be able to maintain sustainable growth. But while the Vietnamese government has successfully drawn investment, foreign trade, and finance, it still must meet the final challenge of creating synergy between finance and business.