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Summary

- Vietnam is a solid BB-rated credit that continues to register very strong growth. Debt ratios are comparable to both regional and ratings counterparts. Relative to China, with which it is often compared, Vietnam has a higher debt and higher inflation profile than present-day China.
- At 45% of GDP, public sector debt levels are manageable but rising gradually. An expansionary fiscal policy and contingent liabilities related to guarantees for SOE and provincial debt are the risks to debt sustainability.
- The exchange rate has been very stable, but the need to modernise the central bank and monetary policy could bring shifts in the future.
- From a balance of payments perspective, there is limited room to issue more foreign currency debt. Ratios that measure foreign exchange reserve coverage are low, although greater sterilisation of the ever-rising level of capital inflows would boost reserves held by the central bank.

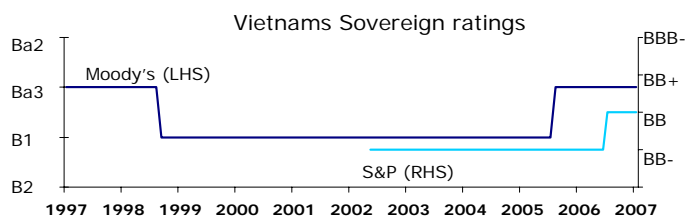
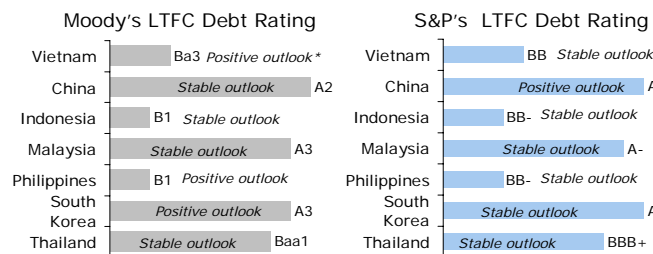
Vietnam's economic performance has been attracted considerable international attention. High GDP growth rates, a reformist government that encourages investment and rapidly expanding capital markets have all seen investors clambering to put capital into Asia's newest emerging market. Accession to the WTO in November 2006 is only going to accelerate this trend. While most are now familiar with the Vietnamese economy's headline-grabbing statistics, this paper seeks to analyse some of the underlying issues and aspects of the economy that still bear the hallmarks of a centrally planned economy.

In particular, we focus on Vietnam's growth and inflation rates, fiscal and external balances, and public domestic and foreign currency debt. The general conclusion we draw is that the economy exhibits significant strength at this relatively early stage of development. Fiscal and debt positions are manageable and on a sustainable path. Monetary policy is immature, as might be expected, and will require adjustment. Strong economic indicators and an ambitious reform agenda should see these trends continue into the future.

Comparing Vietnam to its peers

Vietnam has had its sovereign foreign currency long-term debt rating raised by both Moody's and Standard & Poor's in the last 18 months. S&P raised the rating from BB- to BB (Sept 2006) and Moody's from B1 to Ba3 (July 2005).

Vietnam's sovereign rating



Source: Standard & Poors, Moody's * Outlook upgraded on 15 March 2007

Our Vision:

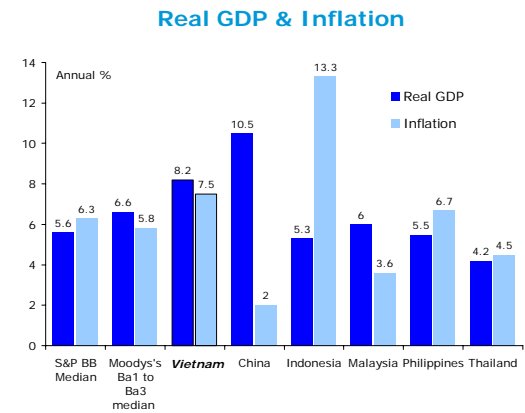
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The upgrades have moved Vietnam's rating to above that of Indonesia and the Philippines. Both agencies cited strong economic growth and ongoing reforms as the main reasons for the upgrade. Similarly, both highlight the risks to the fiscal situation posed by off-budget expenditures and contingent liabilities, which are examined later in this report.

Section I Economic Growth & Inflation

Vietnam's rate of real GDP growth exceeds the medians of its rating cohorts and is the second-fastest growth rate in East Asia. The government is targeting a real GDP growth of above 8% per annum for the remainder of the decade. However, inflation also remains relatively high in Vietnam.

Vietnam's only formal inflation target is to hold the annual CPI inflation rate at below the rate of real GDP growth. Food prices, which are relatively autonomous of monetary policy, remain the primary driver of the inflation rate. Relatively underdeveloped policy instruments mean the government has little direct influence on prices via the State Banks of Vietnam's (SBV) monetary policy at this time.



Source: S&P, Moody's, IMF, GSO, Economics@ANZ

High growth seems sustainable

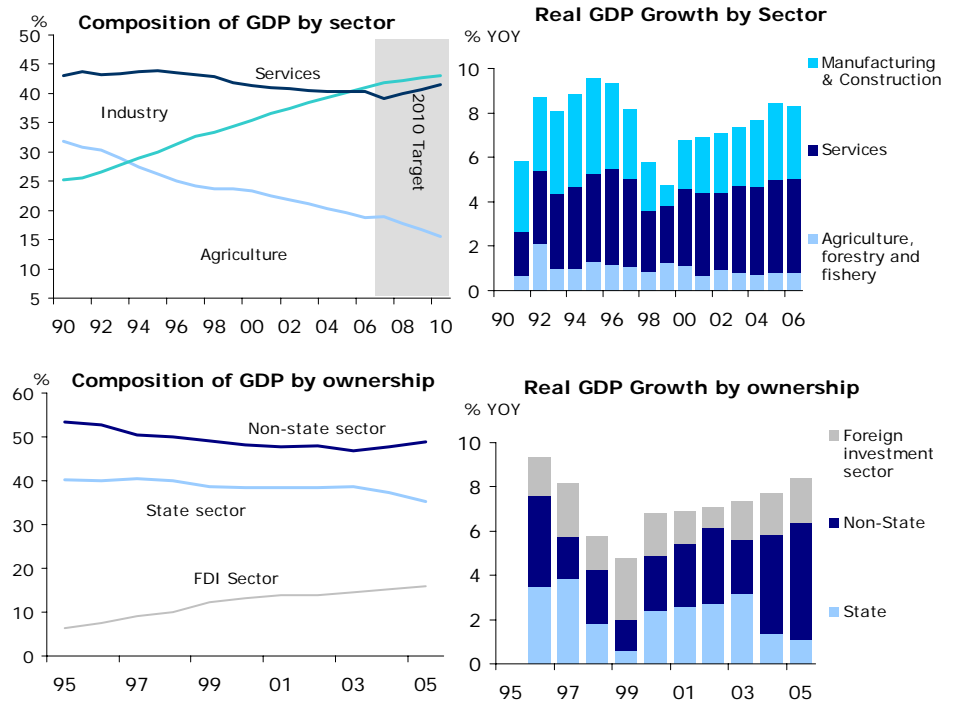
The Vietnamese economy continues to record impressive rates of GDP growth. The average GDP growth rate of 7.5% over the past five years exceeded that of the ASEAN region, and was second only to China in Asia as a whole.

Sustained high growth rates are possible in Vietnam due to the ongoing and significant transition of the economy from an agrarian to an industrialised economy. This process has been aided by a number of government reforms, including the opening of the economy to international trade and capital flows; the privatisation of much of the productive capacity of the economy; improvements in the legal and regulatory environment; and the ongoing simplification of the tax regime.

As a result, the services and the industry & construction sectors now account for 80% of the economy, while the contribution of the agricultural sector has shrunk to under 20%. If government plans are realised, this trend will continue and by 2010, agriculture will account for around 15% of GDP with the rest distributed relatively equally between industry and services. This composition would be in line with what is currently seen in ASEAN and in China.

Vietnam's economy expanded by 8.2% in 2006, driven by strong foreign direct investment, an expanding tradables sector and increasing efficiency of production driven by the government's reform program. Growth in agriculture came in at 3.4% YOY, industry and construction at 10.4% YOY, while services rose 8.3% YOY. The faster growth rates in the industry and services sector underlines the government's objective of industrialising the country from its agrarian base. For 2007, the government is targeting 8.5% GDP growth. The objective of economic policy as stated by the National Assembly is for the economy to reach US\$70 bn (from US\$55 bn at present, at market exchange rates) and for per capita incomes to rise to US\$820 (from US\$646 at present). A key driver of this expansion is expected to be rising trade and investment flows, as well as competition-driven efficiency, encouraged by Vietnam's entry into the WTO. Continued administrative reform will be given priority, especially those that facilitate the implementation of capital for development. The government has targeted 8% growth per annum for GDP until 2010.

Vietnam's economy in transition



Source: IMF, Economics@ANZ, Vietnam General Statistics Office

Productivity growth is highest in the private sector, as the non-state and foreign invested sectors now account for over 60% of the economy. Industrial sector output was up 17.0% YOY in 2006, of which the "non-state" sector and foreign-invested sector achieved 23.9% YOY and 18.8% YOY growth, respectively. State sector growth came in at 9.1% YOY. A similar pattern emerges in the retail sector, with growth in 2006 exceeding 20% YOY in the individual, private and foreign-invested sectors, while growth was held to 8.2% YOY in the state sector. It is hoped that a continued development of the private sector will further encourage productivity gains. As it stands, the cost of labour in Vietnam is less than that in China. However, productivity in Vietnam has not yet caught up to levels found in Chinese industry. With increased privatisation and competition from foreign companies, this gap would be expected to close in coming years as competition increases and other impediments such as infrastructure and education are addressed.

Similarly, the private and foreign invested sectors are also much more efficient in terms of capital and labour productivity than the state sector. The investment to GDP ratio in the non-state sector is twice that of the state sector. Despite constraints, each FDI dollar now produces twice as much GDP as it did a decade ago, and importantly produces 7.5 times the dollar value in exports over the same period. In terms of labour productivity, the foreign invested sector is 2.5 times more productive than the state sector. However, productivity in the non-state sector remains quite low due to the high number of self-employed.

Inflation coming down

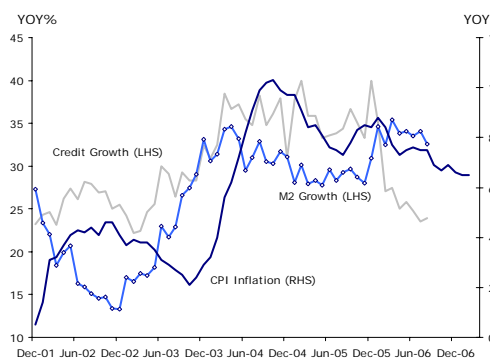
Vietnam's average annual inflation rate has fallen to 7.5% in 2006, from 8.2% in 2005 and 9.7% in 2004. Historically, food prices have been the key determinant of inflation in Vietnam. Currently, food and foodstuffs account for over 40% of the CPI inflation 'basket'¹, which is high even by regional standards. This contributes to the volatility and seasonality of inflation, with non-economic or policy factors having significant influence on the inflation rate. Oil prices have only a moderate direct impact on inflation as domestic price administration and government subsidies limit significant price

¹ The CPI index was revised in May 2006. The weight of food and foodstuffs was reduced to 42.85%, down from 47.9% previously.

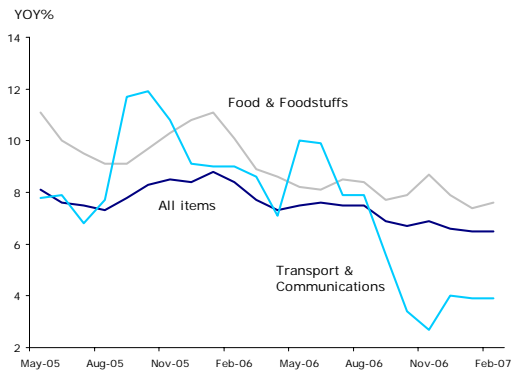
movement. However, there is some evidence to suggest that the indirect effect of oil prices has a secondary lagged impact via food prices.

Historically, monetary aggregates and credit have had little causal impact on the CPI inflation rate. However, since 2002 this relationship has been changing as Vietnam's financial system develops. IMF analysis demonstrates that the lagged correlation between M2 and credit growth has increased since this time. This development poses potential risks to inflation. The contraction of credit growth contracting in mid-2006 seems to have supported a falling inflation rate. However, this decline had more to do with a restructure of balance sheets at state-owned commercial banks (SOCBs) prior to equitisation than to monetary policy. Indeed, the ability of monetary policy instruments such as interest rates to affect credit or prices remains relatively weak. More recently, M2 rose sharply in 2006 on the back of high capital inflows. However, it remains to be seen whether inflation will be significantly impacted by any lagged influence of this M2 expansion.

Inflation, Credit and M2 growth

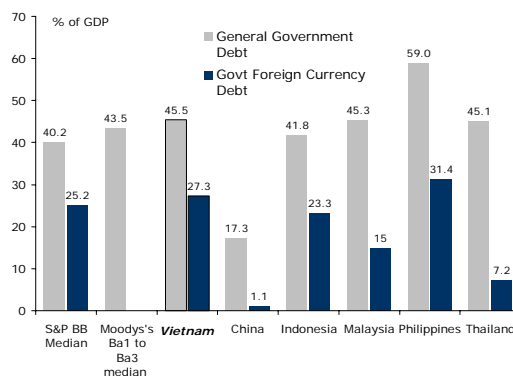


Inflation Components



Section II: Vietnam's Debt Position

Govt Domestic & Foreign Currency Debt



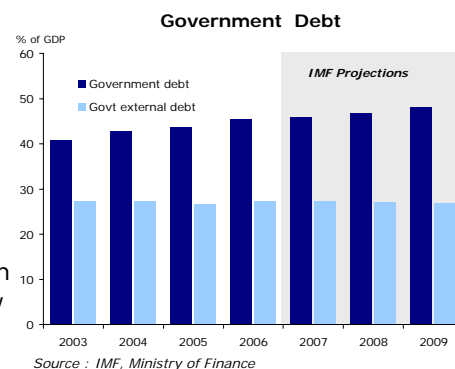
Source: S&P, Moody's, IMF, GSO, Economics@ANZ

Vietnam's public sector debt is on par with most of its ASEAN counterparts, but is expected to rise gradually in coming years while public debt in ASEAN countries is falling. Vietnam's public sector debt is characterised by a significant foreign currency debt component, similar to other ASEAN nations. Unlike other ASEAN nations, about 75% of the government's foreign currency debt is Overseas Development Aid (ODA), extended at concessional rates that lower the debt service burden. The government intends to issue a second foreign currency sovereign

bond in 2007 that will add only marginally to this debt. With the VND relatively stable, exchange rate risk is minimal at this time, although the immature state of monetary policy raises the risk of future FX volatility. In addition, foreign exchange reserves are reportedly increasing strongly, improving the country's short-term debt:reserves ratio significantly. Below we examine the main factors that determine the outlook for Vietnam's government debt ratios in both foreign and domestic currency.

General Government Debt

Although Vietnam has a rapidly growing economy, the debt stock is rising at an even faster rate and is expected to continue to do so in the next several years. Public sector debt reached about 45.5% of GDP in 2006, up slightly from 43.7% in 2005. Of this, public sector foreign currency debt amounted to 27.3% of GDP in 2006, increasing marginally from 26.6% in 2005.² The level of debt is below the 50% of GDP that is often viewed as a benchmark “sustainable” rate for a developing economy, but it is above most ASEAN counterparts as well as the ratings agencies’ BB/Ba median. Around three-quarters of the debt is highly concessional ODA, which allows for a lower debt servicing burden than other countries in the region that have similar debt levels. A continual flow of ODA is relatively secure until 2010 helping to sustain strong public infrastructure investment.



Public Sector Debt ¹

	2002	2003	2004	2005
(billions VND)				
Public & publicly guaranteed debt	204,723	252,101	305,663	368,992
Domestic debt	54,363	84,134	109,972	145,844
T-bills and bonds	34,728	42,795	50,649	63,019
Disbursements	15,210	22,895	27,452	33,250
Amortization	10,499	14,828	19,596	20,050
Interest	2,494	2,189	4,056	5,440
Development Assistance Fund ²	14,735	23,890	32,800	38,801
Education bonds	0	2,579	2,579	5,395
Reform bonds	4,900	8,050	9,540	9,540
Infrastructure bonds	0	5,020	10,040	20,625
Municipal bonds	0	1,800	4,364	7,864
Domestic guarantees	-	-	-	600
External Debt in billions of dong	150,360	167,967	195,692	223,148
Sovereign debt	141,906	156,551	175,835	204,353
External guarantees	6,969	9,665	17,516	15,980
Short term publicly guaranteed	1,486	1,751	2,341	2,815
(% of GDP)				
Public & publicly guaranteed debt	38.2	41.1	42.7	44.0
Domestic debt	10.1	13.7	15.4	17.4
T-bills and bonds	6.5	7.0	7.1	7.5
Development Assistance Fund ²	2.8	3.9	4.6	4.6
Education bonds	0.0	0.4	0.4	0.6
Reform Bonds	0.9	1.3	1.3	1.1
Infrastructure bonds	0.0	0.8	1.4	2.5
Municipal bonds	0.0	0.3	0.6	0.9
Domestic guarantees	-	-	-	0.1
External Debt	28.1	27.4	27.4	26.6
Sovereign debt	26.5	25.5	24.6	24.4
External guarantees	1.3	1.6	2.4	1.9
Short term publicly guaranteed	0.3	0.3	0.3	0.3

Source: IMF, provided by Vietnamese authorities, Ministry of Finance, 1/ Data not comparable due to revisions from sources 2/ Includes DAF bonds (now handled by Vietnam Development Bank) as well as liabilities to the Postal Savings Service Company and Social Security Fund; capital mobilized by branches (deposits); and Project Bonds.

Publicly guaranteed debt in Vietnam has been increasing rapidly, expanding over 20% per annum in the last three years. Strong demand for the government’s local currency debt has seen amounts outstanding increase by

² Total external debt, including public and private debt, was 32.5% and 32.6% of GDP in 2005 and 2006 respectively. Private external debt is relatively small due to the funding from overseas for private entities being restricted by the government.

an average of 40% per year between 2003 and 2005. Of this, more than 50% are issued by the government to support spending on social, infrastructure and company projects, and are classified as “off-budget” expenditures (further discussed later in this report). However, the size of bond issues remains small at VND300 mn to VND1.0 bn (US\$18-65 mn) with limited liquidity in the local market.

The foreign currency component of government debt going forward is expected to decline slightly to 26.5% of GDP in 2010. This is based on a continuation of strong growth; greater private sector investment; decreased foreign currency obligations issued by SOEs and guaranteed by the government; modest increases in government international bond issues equivalent to around 1% of GDP; and a relatively stable exchange rate going forward. In addition, it is expected that the government will continue with external borrowing limits and maintain a relatively restrictive policy on capital outflows.

The government issued its first Global bond in 2005 for US\$750 mn. It is understood that the majority of funds raised were onlent to SOEs, which continue to have sizeable funding needs.

The authorities have suggested that the government will issue between US\$500 mn-US\$1 bn (around 0.8% and 1.6% of GDP) worth of foreign currency sovereign bonds in 2007. From a balance of payments perspective, there is limited room to issue more foreign currency debt. While external balances have improved significantly since 2000 (when the balance of payments was in deficit), Vietnam’s foreign exchange reserves are only US\$13 bn.

Public (or publicly guaranteed) foreign currency debt ratios

	2003	2004	2005	2006 (est)
External Debt (% of GDP)	27.4	27.4	26.6	27.3
Debt service/exports (%)	3.5	2.9	2.2	2.3
Import cover (in weeks)	8.5	9.8	10.7	11.2
Short-term f.c. debt/reserves (%)	2.0	2.4	2.1	2.1
M2: FX reserves	4.3	4.8	4.8	4.6

Source: IMF, General Statistics Office, Vietnamese authorities, Economics@ANZ

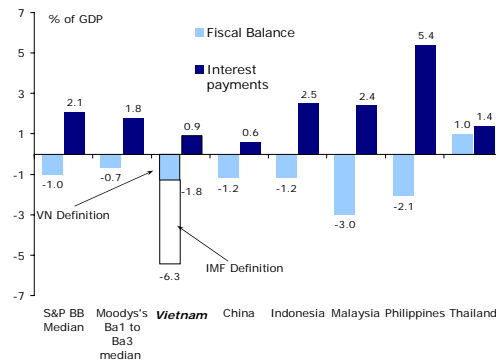
As seen in the table above, this level offers only the minimum cushion against conversion risk, relative to what are considered benchmark levels when looking at key foreign currency debt coverage ratios. For example, import cover is only now approaching 3 months – which is the minimum considered as prudent – while the monetary base (M2) is four times the size of foreign exchange reserves. A high M2/reserve ratio raises the possibility of capital flight risk (which is presently limited in part by regulations). It is important to note that there are no official data on foreign exchange reserves and so these key ratios cannot be fully verified.³

Conversion risk is not viewed as material in the present environment, given massive foreign capital inflows and very positive sentiment toward Vietnam. However, it is important to maintain strong coverage ratios in the event of a change in sentiment, particularly for a country with a managed exchange rate. The M2:reserves ratio has started to improve, but the huge inflows of investment and remittances suggest that the State Bank of Vietnam is not absorbing all of the foreign currency flowing into Vietnam (discussed further later). A greater level of sterilisation of inflows in the present environment would lead to a more rapid accumulation of foreign exchange reserves and rising coverage ratios.

³ Data is estimated by the IMF.

Fiscal Overview

Fiscal Balance & Interest payments

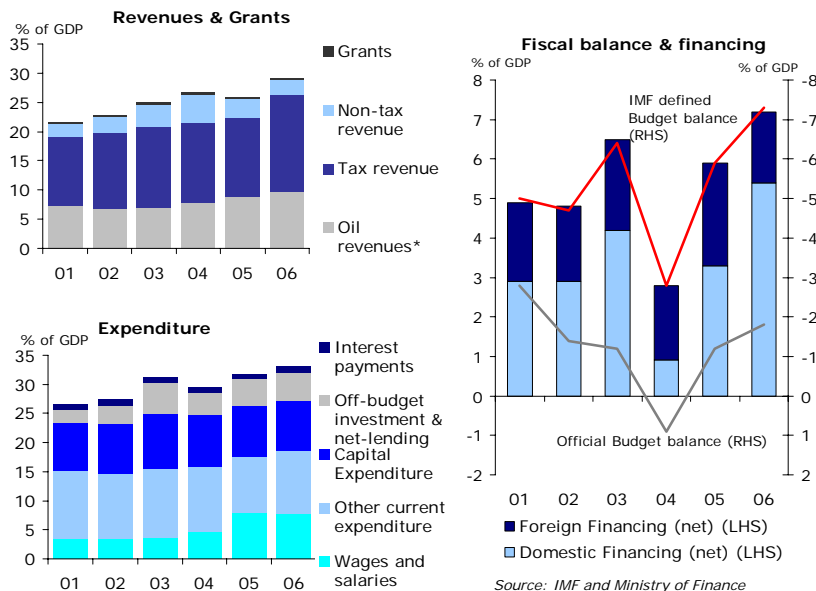


Source: S&P, Moody's, IMF, GSO, Economics@ANZ

The government of Vietnam consistently reports a fiscal deficit of 1-2% of GDP, which is comparable to both its ratings and regional cohorts. However, the real fiscal deficit has been considerably higher at around 6%, if off-budget expenditures that should be counted "above the line" according to IMF methodology are included. The government reports its off-budget expenditure as part of its "statutory deficit" – the total deficit approved by the legislature – which is generally set at -5% of GDP. As such, Vietnam's budgetary position has been expansionary for the past several years, and is a key driver of rising debt levels.

Government revenue and expenditure levels average around 25-30% of GDP, which is comparable for similarly-rated countries, but relatively high for a country with Vietnam's low per capita GDP. However, the revenue base is narrow and potentially volatile. As can be seen in the charts below, about 25% of revenues are related to oil prices, while trade-related tariffs account for another 20% of revenue. On the expenditure side, current expenditure accounts for 50% of the roughly 30% of GDP in total expenditure, while the rest is capital expenditure. A significant portion of this high level of capital expenditure goes to investment in public goods and social services, and as such may decline in the coming years. On the other hand, interest expenditure is low at less than 5% of expenditure, due to the concessional rates charged on roughly half of the government's debt stock. As this debt migrates toward market-based debt, the cost of the existing debt stock will rise.

Summary of Budgetary Operations



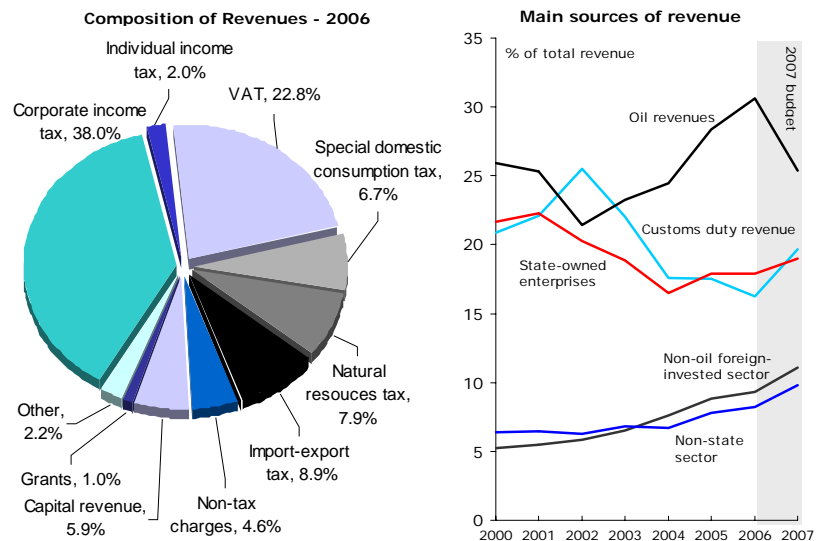
Source: IMF and Ministry of Finance

Revenues

In 2006, revenues increased by around 20% YOY, according to the first estimate of 2006 budget figures, more than double the 9.3% YOY increase from 2004 to 2005. Revenues now stand at around to 27% of GDP slightly up from just over 25% in 2005. This is compared with the 25.4% and 27.9% medians for equivalent rated countries by Moody's and Standard & Poors respectively. Higher-than-expected receipts from taxation and the oil sector boosted revenues by more than 10% than had been planned by the government. Taxation revenues were increased by significant administrative reform and the further development of taxation laws.

Corporate income tax is the largest source of revenue accounting, for 38% of receipts. However, the majority of these funds came from the foreign-invested oil sector that profited from higher oil prices throughout the year. Tax revenue from the oil sector accounted for around 90% of the revenue collected from foreign-invested enterprises (FIEs). The value added tax (VAT) also provided an increase to revenues as consumption increased along with private incomes. Tax collected from individual income tax is particularly weak. This is one area that requires ongoing development, with a relatively small proportion of the population paying any income tax at all. Despite the number of SOEs being reduced significantly in recent years, tax revenues as a proportion of total revenues from this sector have begun to increase. This is most likely due to reforms undertaken to improve the financial performance and balance sheets of SOEs, especially those that have been or will be “equitised” in the near future.

Budget Revenues



Source: Ministry of Finance

Oil revenues have provided a windfall gain for the government in the past few years. As a percentage of revenues, oil incomes have risen from 24.5% in 2004 and 28.4% in 2005 to peak at 30.6% in 2006. However, higher oil prices are not a clear cut positive for the government as, due to the country's lack of refinery capacity, all petroleum products are imported. Imports still have tariffs which provide income, though this will most likely be reduced in coming years due to WTO accession.⁴ On the other hand, petrol is subsidised; this was estimated to have cost US\$499-561mn last year. Consequently, the government has reduced subsidies throughout 2005-2006.

The IMF has questioned the authority's decision to spend the windfall revenues from oil, yet the government maintains that the economy is better served if the funds are put into public infrastructure rather than being used to pay down debt. In addition, some of these funds were also used to provide subsidies to oil traders to keep domestic prices in check. The government has stated that intend to maintain this practice with the authorities not having yet devised a plan to remove state subsidies from the energy industry.

Assuming oil prices remain at or below the US\$60/bbl mark this year, oil revenues should return to around 25.4% of revenue. Offsetting this, the government is expecting a significant boost in revenues from customs duties revenues, expected to climb from 16.3% in 2006 to 19.7% in 2007. Despite the lowering of tariffs taking place gradually over 5 years as WTO obligations are implemented, it is expected that revenues from duties will increase as the

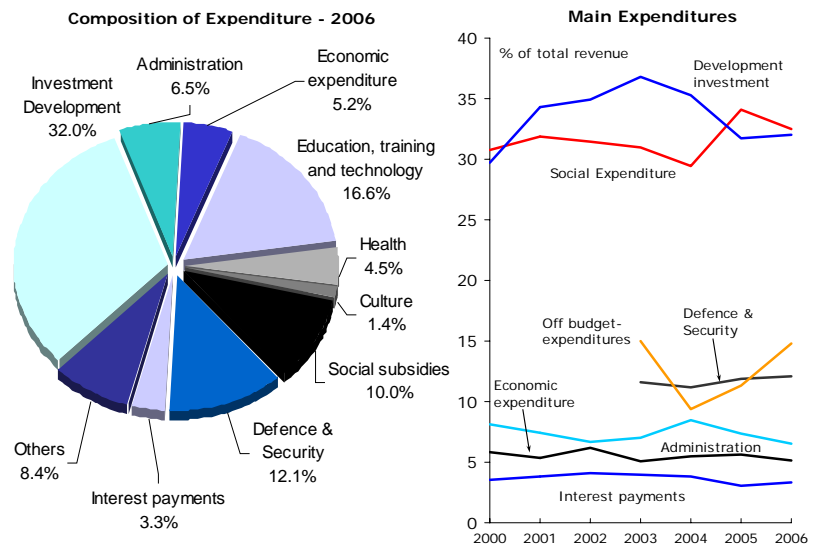
⁴ As recently as January 2007 the government actually increased tariffs on petroleum imports from 10% to 15% due to relative low world oil prices (this was after cutting the tariff from 20% to 10% in December). It remains government policy to increase or decrease tariffs in order to stabilise imports prices.

volume of trade accelerates due to increased access for both imports into Vietnam and Vietnamese exports into foreign markets.

Expenditures

Expenditures increased by just over 20% YOY in 2006, more than double the 7% YOY rise of 2005. Expenditures increased in line with budget revenue, thus reaching just over 29% of GDP last year (up from 28% in 2005). This is just below the 29.3% and 30.8% medians for equivalent rated countries by Moody's and Standard & Poors respectively. Investment accounts for around a third of expenditures. Above-the-line expenditure in investment has declined in recent years as a proportion of overall expenditure, as other sources of investment are increasingly made available and off-budget expenditures increase. Much of this expenditure is targeted at infrastructure development and key national projects aimed at restructuring the rural economy. Interest payments accounted for only 3% of expenditure last year.

Government Expenditures



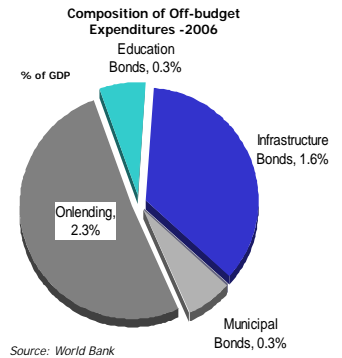
Source: Ministry of Finance

As the government increasingly decentralises public investment, there is emphasis on the necessity to improve this investment quality. Public projects are often significantly delayed, thus increasing costs. Disbursement of investment funding is often inefficient and frequently there is significant 'leakage' of funds, estimated at around 20-40% of some project outlays. The government has been implementing new measures to improve the planning, management and monitoring of public projects. A nation-wide campaign has been initiated to tackle corruption throughout Vietnam's various tiers of government, as well as in the administrative and judicial systems.

The other major component of expenditure is on social programs, which received a significant boost in 2005 and 2006 to reach around 33% of total expenditure. These increases have been targeted primarily at improving health and education & training. Additional spending on education and infrastructure is funded by the issuance of domestic bonds and is classified as off-budget expenditure. This may be due to the State Budget Law prohibiting borrowing for current expenditure.

Off-budget expenditures

A significant part of the budget story lies in off-budget expenditure, which has reached 14.8% of expenditure or 4.3% of GDP in 2006. These expenditures are, in part, motivated by the need for the government to fulfil an official statutory budget deficit level of 5% (Vietnamese accounting standards). Funds in this area have been used to recapitalise SOCBs and fund ongoing investment projects. Specifically, this off-budget expenditure includes: on-lending of government-borrowed funds to the Vietnam Development Bank (VDB), providing soft loans to approved projects⁵; servicing bonds that were issued to finance improvements in education and infrastructure; and servicing bonds that were issued to recapitalise state-owned commercial banks (SOCBs);



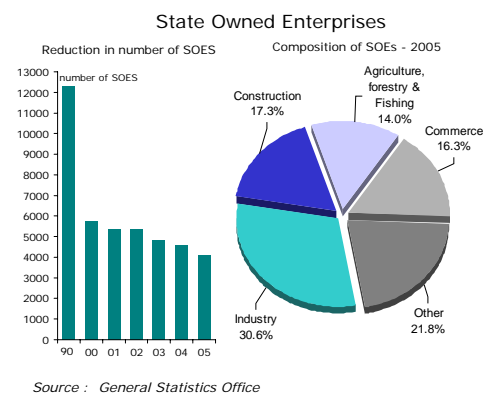
servicing municipal bonds issued by Hanoi and Ho Chi Minh City; and paying the arrears of local governments.

This type of off-budget expenditure has been criticised by observers for undermining fiscal transparency, complicating public expenditure management and introducing a level of moral hazard to SOEs and local governments. The existence of a soft budget constraint on the public sector outside of the central government raises the risk of levels of expenditure or a rise in the debt stock that may be unsustainable in the future. The government has stated that it intends to make the Vietnam Development Bank fiscally independent at some point in the next several years. Since as much as 10% of all public sector debt could be attributed to the VDB, the government argues that making the VDB autonomous would reduce both the stock of debt for which the government is liable and would eliminate the need for off-balance expenditure. The debt of VDB would not be explicitly guaranteed by the government, although some observers have suggested that there would be an implicit guarantee given the importance of this institution to the economy. If this is the case, rising levels of debt are still important for the government to monitor and must be included in measures of total public sector debt.

State Owned Enterprises

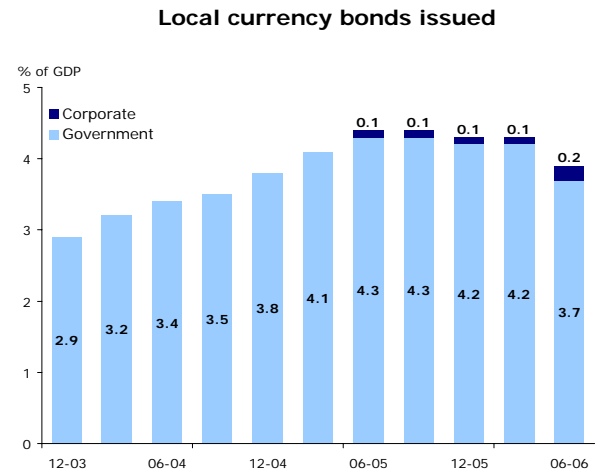
Though declining, SOEs are still a liability for the government. The government is seeking to significantly reduce the number of SOEs in recent years through a process of equitisation, liquidation or mergers. The process of equitisation is the most prevalent method of SOE reform and involves the issuing new shares to employees or on the stock exchange. Shareholding in any single listed company is limited to 49%, with the government remaining the majority share holder. The number of SOEs has fallen from more than 12,000 in 1992 to 4,086 in 2005, resulting in increased amounts of labour and capital per SOE.

The government has identified a further 200 SOEs and SOCBs for equitisation in the relatively short-term. It is hoped that this process will accelerate SOE reform, forcing companies to compete on a more commercial basis without reliance on administered prices and regulations, as well as to strengthen their balance sheets. The government has introduced a series of laws to push this process along. The Enterprise Law in 2006 requires all SOEs to become incorporated within 4 years. A new Securities Law will require listed firms to improve reporting and disclosure, have independently audited financial statements and meet minimum capital requirements.



⁵ The VDB's predecessor was the Development Assistance Fund, which performed an analogous role.

The equitisation process has also led to the development of a nascent corporate bond market, which was virtually non-existent until last year. Passage of Decree 52 in June 2006 allowed corporations to issue bonds without a credit guarantee from a financial institution. In addition, the government eased issuing requirements to allow newly “equitised” corporations to issue local currency denominated bonds. Over the past eight months, a handful of corporations have issued an estimated US\$400 mn in corporate bonds.



Source : Asian Development Bank

All of the issuers to date have been state-owned enterprises. The debt of SOEs does not carry an explicit sovereign guarantee. A number of issuers who have come to market do not yet have audited financial accounts, and only Vietcombank has been rated by a major rating agency. Company officers and the government are aware of the due diligence issues involved, and are working actively to have their accounts audited by international accountancy firms. The government is also seeking to establish a domestic credit rating agency, as the cost of obtaining a rating by an international agency is likely to be prohibitive for many local firms.

S&P assigned a BB foreign currency rating to Vietcombank (the Bank for Foreign Trade of Vietnam) – the same as the sovereign rating – citing the bank’s strong position in the industry and expectations of extraordinary government support given its systemic importance. S&P said it views Vietcombank’s profitability as modest and its asset quality and capitalisation as weak, but improving.⁶

State Owned Commercial Banks

This process of reform via equitisation is particularly significant for the five state-owned commercial banks (SOCBs), which face greater challenges to meet new prudential standards. The SOCBs hold 70% of system assets. It is widely thought that non-performing loans (NPLs) held by SOCBs are significantly understated due to differences in Vietnamese and international accounting standards (IAS). NPLs are officially reported at 3-4% in 2005, whereas independent observers indicate they may be as high as 15-20% under IAS.

The fiscal implications of the ongoing reform of the SOCBs could be significant. Further recapitalisation of SOCBs, if it were required, would add to public debt (despite most likely being off-budget) and the IMF highlights this as a risk to medium-term debt sustainability. The World Bank estimates that bringing NPL’s down from estimated levels could increase government debt by 7.5% of GDP by 2010, and analysis by the IMF yields similar results. It has been asset management companies are becoming more reluctant to take over NPLs.

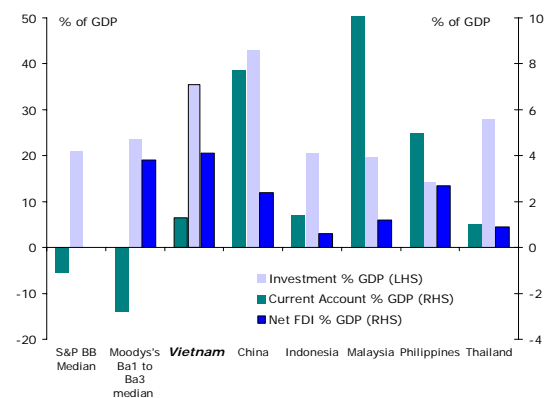
However, some proportion of NPLs may be offset by a revaluation of direct holdings of land and land held as collateral. With the equitisation of the SOCBs, this land will most likely be revalued and in the case of some defaults, it may be possible to recover 100% of the loan. As such, the ongoing recapitalisation of the banking sector could have a lesser impact on public debt levels than would appear likely at first glance.

⁶ “Vietnam’s Vietcombank Assigned BB Rating; Outlook Stable,” S&P Ratings Direct, 12 February 2007

Section III External Balances

The support for foreign currency debt is still limited from a balance of payment point of view, although the outlook is improving. The current account has moved from a deficit to a small surplus position in recent years on stronger exports and remittances. Despite being above similar-rated nations, Vietnam's current account surplus is still below many of its regional cohorts, as the Asian region has experienced massive surpluses in recent years. The capital account is also in surplus thanks to strong foreign direct and portfolio investment inflows.

Current Account, Investment & FDI



Source: S&P, Moody's, IMF, GSO, Economics@ANZ

Current and Capital Accounts

Vietnam's current and capital account positions continue to improve due to:

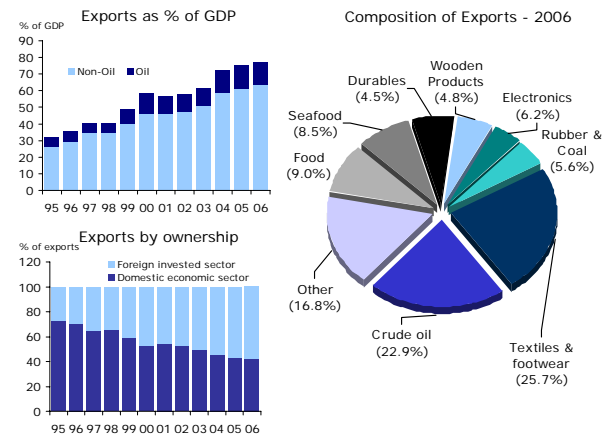
- Significant increases in recorded remittances from overseas that are expected to approach US\$5 bn in 2006, exceeding the US\$4.3 bn in 2005. Inflows generally peak in the latter months of the year due to Tet, the Lunar New Year holiday.
- An improving trade performance, with exports expanding by 22% to reach a record US\$39 bn in 2006. The trade balance (on a BOP basis) is expected to have recorded a small surplus.
- Unprecedented inflows from investment; FDI reached a record US\$10.2 billion in 2006, up 49% on 2005. The government is aiming to attract US\$12 bn of FDI to Vietnam in 2007 and a cumulative US\$55 bn in the period 2006-2010
- Capital inflows into the increasingly liberalised and rapidly developing stock and bond markets. A recent State Bank of Vietnam (SBV) report showed that foreign portfolio investment in December 2006 alone was US\$800mn.

Trade

Vietnam's trade performance has been steadily improving in recent years. The reported trade deficit continued to narrow in 2006,⁷ as exports rose 22.1% YOY to reach US\$39.6 bn, US\$2 bn more than the official target. The government will again be aiming for plus-20% growth again in 2007.

The foreign invested sector will continue to play a key role in export growth. The foreign invested and domestic exports sectors expanded at 23.2% and 20.5% in 2006, with the former accounting for over 57% of exports. Official forecasts predict strong growth in particular sectors, including heavy industry, electronics, aquatic products and in the traditional textiles & footwear sectors. The growth of these sectors has seen the proportion of oil exports decline in recent years.

Growth in exports continues in 2006



Source: General Statistics Office

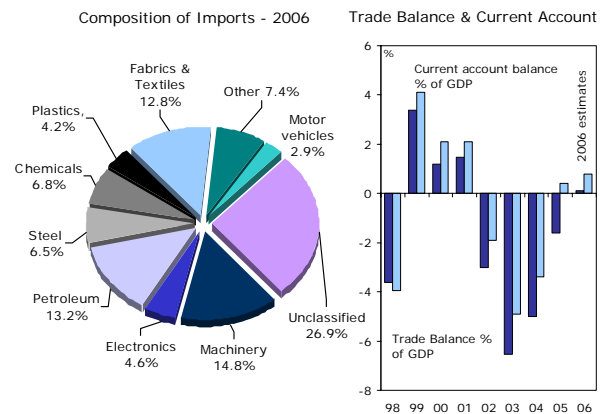
⁷ The trade deficit narrowed on a c.i.f (cost, insurance and freight) basis. However, on a balance of payments basis (i.e. a free on board basis) it is more than likely that a trade surplus was recorded in 2006.

The government has a specific focus on developing the domestic high-technology sector, as well as attracting foreign technology companies. Last year, Intel registered to invest US\$1 bn to build its largest production base amongst its seven plants worldwide. It is envisaged that 4,000 local labourers will be employed at the future plant. Heavy industry is also a priority for the government attracting over 54% of registered FDI capital and around 30% of total FDI projects. The largest of these projects has been Korea's Posco group investing US\$1.13 bn in a steel mill that is expected to employ 10,000 local workers.

Vietnam's imports expanded by just over 20% in 2006. The composition of imports is dominated by capital goods used in the development of the economy, as well as inputs into production that are often then exported. Consumer goods account for only small proportion of overall imports. Petroleum accounts for a significant proportion of imports despite Vietnam being a producer of oil. This is due to the current lack of domestic refining capacity, with Vietnam's first refinery to commence production in 2009. This

production will significantly reduce the on reliance on imported fuels, as well as reducing the amount of oil currently exported. ANZ estimates that in 2006 the trade deficit (on a balance of payments basis) should have become a small surplus. In addition, remittances via official channels are reported to have exceeded US\$5 billion in 2006. These two factors should more than offset the net deficits on the investment income and services balances resulting in a strengthening of the current account surplus for 2006.

Imports driven by strong growth, Trade balance on knife edge.



Source: General Statistics Office, Economics@ANZ

Current Account Balance (millions US\$)

	2003	2004	2005
Current account balance	-1,932	-1,565	218
Excluding official transfers	-2,071	-1,740	-12
Trade balance	-2,582	-2,287	-838
Non-factor services (net)	-778	-871	-1,106
Investment income (net)	-812	-891	-1,219
Transfers (net)	2,239	2,485	3,380

Source: IMF, provided by Vietnamese authorities.

That capital account surplus also continues to strengthen, driven by significant increases in foreign direct and portfolio investment. Around US\$10 bn of capital was slated for projects in Vietnam in 2006 and it would be expected that between US\$2-3 of this would be disbursed. Portfolio investment inflows have been directed mainly into the stock market in 2006. The stock market's capitalisation has increased from below US\$500 mn at the beginning of 2006 to over US\$16 bn as of March 2007. The contribution from foreign investors has been reported to be as much as US\$4 bn.

The amount of debt held offshore has not been rising nearly as quickly. The government has limited its offshore issuance, ODA is steady and the relatively small amount of debt issued to debt has limited offshore access to the government and corporate debt market. The strong inflows on both the current and capital accounts has allowed the central bank to accumulate an estimated US\$13 bn in foreign exchange reserves, up from around US\$9 bn at end 2005.

Capital Account Balance (millions US\$)

	2003	2004	2005
Capital account balance	4,083	2,447	1,913
Gross FDI Inflows	1,894	1,878	1,972
Equity	1,294	1,283	1,347
Loan disbursements	600	595	625
FDI loan repayments	590	536	524
Medium and long-term loans (net)	1,045	1,396	1,405
Disbursements	1,540	1,920	1,914
ODA loans	1,258	1,394	1,432
Commercial loans	283	526	483
Amortization ¹	495	523	509
Portfolio Investment ²	850
Short-term capital (net) ³	1,734	-291	-1790

Source: IMF, provided by Vietnamese authorities

Notes: 1/ Including debt buyback operation carried out in 2003. 2/ Includes US\$750 million sovereign bond issue in 2005. 3/ Including net errors and omissions and trade credit.

Section IV Monetary Policy

Monetary policy formulation and execution remains immature in Vietnam. The State Bank of Vietnam is not an independent central bank and has very limited autonomy (for certain operations, including the management of foreign currency reserves, actions are subject to the approval of the Prime Minister). The central bank's responsibilities are outlined by the Law of the State Bank, which states that the SBV's core task is to maintain stability in the value of the exchange rate. Two additional key responsibilities are to ensure the safety and development of the banking system; and to facilitate socio-economic development consistent with Vietnam's political ideologies. The impetus for inflation management is seen to be quite strong, given Vietnam's experience with a period of hyperinflation that preceded the economic reforms of the 1980's. Vietnam's economic and monetary policy objectives for the remainder of the decade, as outlined by the government and SBV, are detailed in the table below.

Economic & Monetary Policy Objectives

	End 2005	Objectives 2006-2010
Economic Growth (annual%)	8.4%	7.5-8%
Inflation (annual%)	8.1% (ave)	Lower than GDP rate
M2 Money Supply (annual%)	29.0% (ave)	18-20%
M2:GDP Ratio	84-85	100-115
Average Credit growth (annual%)	35.6% (ave)	18-20%

Source: IMF, Economic@ANZ, Vietnam General Statistics Office

Despite the mandate to control inflation, the CPI target – to keep the inflation rate below the real GDP growth rate - is itself high given growth is targeted to average 8% in coming years. It is arguable whether the SBV is able to adequately target inflation given its conflicting policy objectives. Considering the open nature of the economy and importance of exports, the exchange rate is seen as an important tool to support exports – and therefore GDP – growth. The SBV therefore manages a continual nominal depreciation of the VND against the US dollar. At the same time, a depreciating exchange rate will encourage imported inflation, particularly for producers who import most capital goods. The compromise in recent years has been for the SBV to target a very slow pace of nominal VND depreciation against the USD. The authorities have outlined an intention to move to a more flexible exchange rate regime in coming years, without providing any detail. Although recent high levels of capital inflows have prompted market discussion of a potential shift in the

exchange rate regime, in practice this may be quite difficult to implement given the SBV's lack of autonomy.

To maintain the exchange rate policy, the SBV is active in the FX market. In periods when capital inflows exceed outflows, as is currently the case, this intervention increases liquidity and therefore encourages inflation. With capital inflows on the rise, there is evidence to suggest that FX intervention is increasing, but it does not appear that all foreign capital inflows are being completely sterilised. This leads to lower foreign exchange reserve accumulation than might otherwise be the case. The SBV attempts to mitigate capital inflows by putting the funds in the SOCBs. However, this leads to a liquidity build-up in the SOCBs, with the effect that bank-lending rates increasingly reflect available liquidity and not the SBV's official policy stance. Ample liquidity held by commercial banks has been evident in a high rate of credit growth, which is estimated to have reached 40% YOY last year. While credit growth is now thought to be around 20-25%, it is unclear whether this is due to higher policy rates and OMO operations by the SBV, or restraint from SOCBs as they seek to improve their balance sheets prior to equitisation.

The adoption of a new Central Bank Law targeted for 2008 provides for an opportunity to modernise the SBV and its approach to monetary policy. This is important for the smooth functioning of Vietnam's local financial markets in the coming years. Among other things, the new law should provide the SBV with a clear mandate to target price stability and independently manage monetary policy. It should also transfer SBV's current ownership of the SOCBs to the Ministry of Finance, and reorganise and adopt new systems to monitor and regulate the banking and financial sectors.

Section V Outlook

We conclude from this analysis is that despite some risks, which have been largely recognised by the government, Vietnam is a solid BB-rated credit with sustainable fiscal and debt positions.

The growth target of 8% per annum until 2010 will be driven by foreign investment, the ongoing expansion of trade supported by WTO accession and continued economic, financial and administrative reforms. Inflation has been an ongoing concern for Vietnam and the SBV, and rising foreign currency flowing are creating challenges under the present policy settings. It is expected that with a new Central Bank Law will help address current issues.

On the fiscal side, Vietnam has robust levels of public sector revenue and expenditures. Future reforms should see a shift in the composition of revenues toward income and turnover taxes, and away from oil and trade related flows. Official expenditures are contained, but the practice of maintaining substantial off-balance sheet expenditures needs to be addressed. Debt levels will rise in the next few years as the total fiscal deficit is around 5% of GDP, but it should not be difficult for fiscal balance to be restored. Over the medium term, the evolution of off balance expenditures and the government's exposure to the debt of public sector entities such SOEs, SOCBs and provincial governments has the capacity to affect creditworthiness.

The balance of payments are improving, and should continue to do so going forward thanks to trade surpluses, remittances and net investment inflows. Greater foreign exchange reserve accumulation by the SBV would reduce conversion risk on Vietnam's foreign currency debt.

Economic Forecasts

	2005	2006	2007	2008
Nominal GDP (US\$)	53.1	61.3	70.1	80.2
Real GDP Growth (%)	8.4	8.2	8.1	8.0
Inflation (%)	8.2	7.5	7.0	6.9
Current Account (% of GDP)	0.4	0.8	1.5	1.7
Fiscal Balance (% of GDP)	-2.1	-1.8	-1.9	-1.8
FX reserves (US\$)	7.0	8.9	12.9	16.5

Source: Economics@ANZ

ANZ Research

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