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Vietnam yields cautionary tale over Chinese investment

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China's new charm offensive in Asia – using infrastructure development to garner soft power at the expense of rivals US and Japan – has reached new heights in recent weeks. Multi-billion US dollar deals with strategic partners such as Sri Lanka and Pakistan aside, even countries with reservations about China's rise have begun taking a more pragmatic view toward using China's huge foreign exchange reserves to their benefit.

Earlier this month, Indonesian leaders travelled to Beijing seeking to tap financing for power and transport projects, notwithstanding the new administration's strong emphasis on both national and maritime security. Chinese companies are challenging Japanese bids for high speed rail contracts in Malaysia and Thailand. This week, a team from Indian Railways flew to Beijing to discuss a potential Delhi-Chennai high speed rail link.

Yet in spite of the huge stashes of money available in Beijing, Chinese financing for existing energy projects in Vietnam – an economy with high dependency on China – has been all but frozen as a result of bilateral tensions over the South China Sea, according to research by Asean Confidential, a research service at the Financial Times.

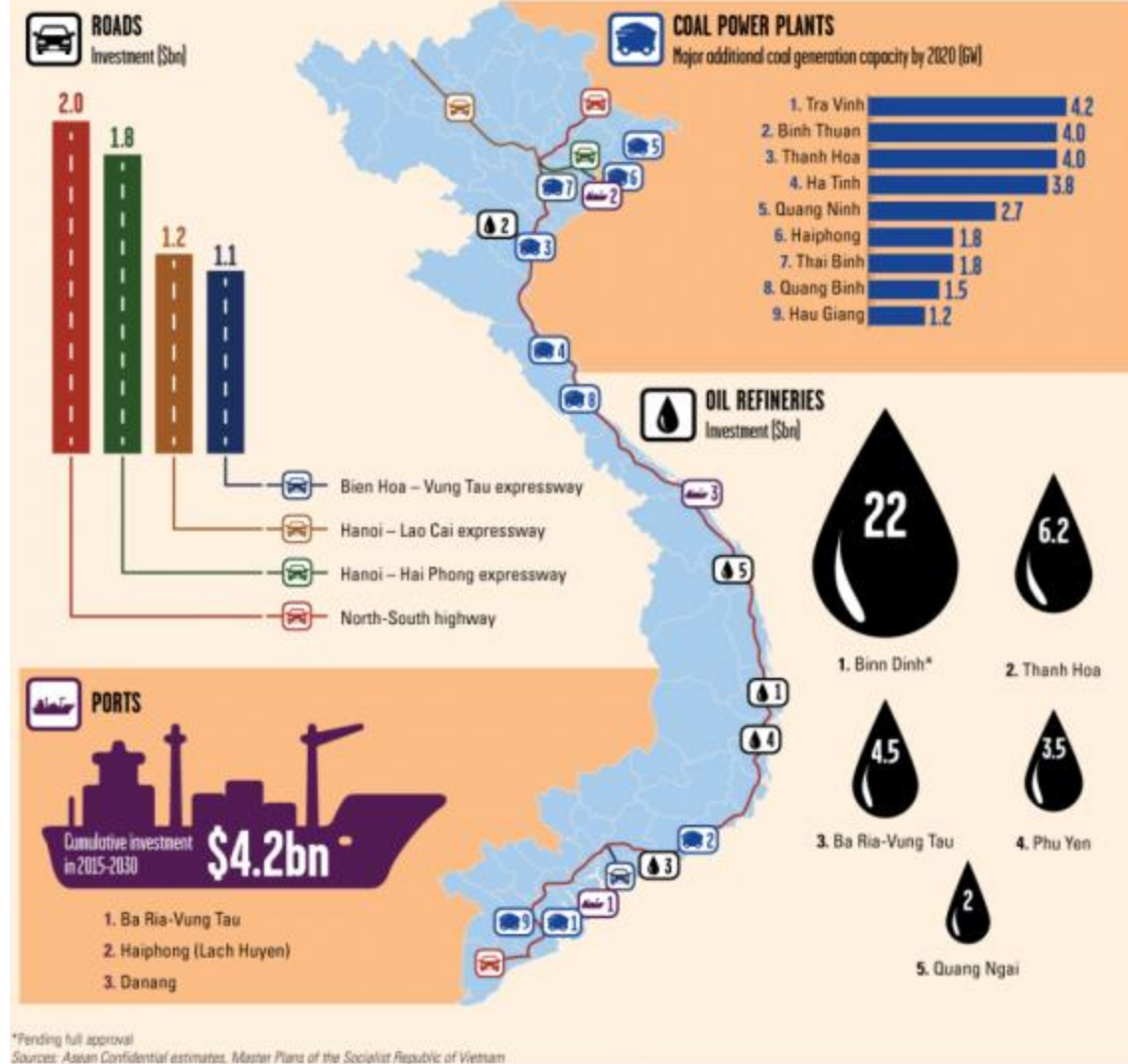
Power grip

Outwardly, tensions have been temporarily patched up. Government officials on both sides have agreed to paper over mutual differences. Official bilateral trade has grown 15 per cent year on year, and in late September a new Asia Development Bank-funded expressway connecting Hanoi, Vietnam's capital, with the Chinese border at Lao Cai was formerly inaugurated.

But since May's anti-China riots, Chinese lenders have effectively frozen credit lines to many Vietnamese engineering, procurement and construction (EPC) contracts, leaving a number of projects in limbo and having forced some into restructuring. Unless this changes, Vietnam will have to rely heavily on South Korean and Japanese financing and subcontracting to fill the void.

What remains unclear, however, is whether South Korea and Japan are either willing or able to finance a planned 55 GW build-out between 2014 and 2030, with 29.5 GW of coal-fired generation targeted by 2020 alone (see map). The exposure of both countries to Vietnam is already high, potentially making them wary of further ratcheting up involvement.

Major ongoing national infrastructure and power projects in Vietnam



Source: Asean Confidential

Many of these projects are already into their first phase of development, and are heavily invested by Japanese and Korean companies ó which account for roughly 60 per cent of cumulative foreign direct investment (FDI) stock, with companies such as Marubeni, Sojitz, Kepco, Daelim, and Hyundai Heavy Industries taking the lead backed by Japanese official development assistance.

The problem, however, is that the EPC contracts for many of these projects have been sub-contracted to state-owned Chinese consortiums, with sometimes up to 95 per cent of the total EPC value going to Chinese firms. These sub-contractors are in turn financed by export credits and concessional loans from Chinese policy lenders such as the China Ex-Im Bank ó thus creating the vulnerability to a freeze in Chinese finance.

How far can diversification go?

In the meantime Vietnam is seeking to rapidly diversify both its investment partners and its energy mix. Recently concluded or announced power deals include participation by not only Japanese and Korean companies, but also those from Thailand, Malaysia, India and Russia.

Perhaps of even greater significance – although still inconclusive – is the revived momentum in negotiations with ExxonMobil over a long-delayed \$10bn gas extraction deal, which would include onshore gas-fired power plants. With Asia's fourth largest reserves of natural gas, independent estimates suggest that gas fields in undisputed waters off south Vietnam alone could generate an additional 20GW in coming decades.

This dovetails with the government's push to reduce its dependency on refined fuel imports, resulting in a recent foreign investment boom in new refineries (on paper, a minimum \$12bn in new investments through 2020), driving the share prices of PetroVietnam Gas – which accounts for almost 20 per cent of the Vietnamese stock market capitalization – to astronomical heights this year. Nuclear plants are also envisioned in the much longer term, attracting interest from Western, Japanese and Korean industry participants.

Nevertheless, while Vietnam could manage to diversify its key investment relationships, it may not be able to substitute for its northern neighbour entirely. As Vietnam gears towards the upcoming Congress of the Communist Party in 2016 – requiring incumbent Prime Minister Nguyen Tan Dung to step down – the issue of how to manage the China relationship and Chinese financing of Vietnam's infrastructure development, will become a paramount issue within Vietnam's political circles.

Similar, different risks in the Philippines

Like Vietnam, the Philippines – which also disputes China's claims in the South China Sea – has largely been left behind by China's international largesse.

Itself witnessing a boom in power generation (an expected power deficit next year notwithstanding), the country has however traditionally been less reliant on Chinese financing, in part due to the lack of government support for infrastructure projects. Its macro economy likewise is less China-centric, and has suffered only marginally as a result of a recent slump in Chinese packaged tours to the island resort of Boracay and imports of key products such as timber and fruit.

Nevertheless, China's State Grid Corp has a 40 per cent equity stake in, and provides technical support and equipment to the Philippines' National Grid Corp (NGCP), the country's sole power grid operator. There are concerns in Manila that a Chinese stake in the country's grid constitutes a risk to its operations and management.

NGCP's cooperation is urgently needed at a time when growing power integration will require greater levels of interconnection across the country's sprawling archipelago, including between Visayas and Mindanao, between Negros Island and Batangas, and an upgrade of the existing Luzon – Visayas grid. Elsewhere, a Chinese quasi-government wealth fund owns a controlling stake in 2GO Group, which operates nationwide ferry services, an expansive network of warehouses, and as a result manages roughly 50 per cent of domestic Philippine freight.

Of course, both are single equity investments by technocratic, commercially driven companies, and have been highly profitable in both cases due to their effective monopolies in respective sectors. In that sense, the levels of attached political risk may to some extent be overblown.

Nevertheless, the Philippines, like Vietnam, is likely to turn towards its other investment partners at a time when Beijing is shunning the two countries in favour of other infrastructure-deficient countries in the region. Indeed, the scale of China's largesse everywhere else in the region serves in part as a subtle reminder that both countries have much to lose by refusing to accept China's new role in regional order