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Analysts

Tai Hui, +65 6530 3464
Standard Chartered Bank, Singapore
Regional Head of Research, Southeast Asia
Tai.Hui@sc.com

Thomas Harr, +65 6530 3617
Standard Chartered Bank, Singapore
Senior FX Strategist
Thomas.Harr@sc.com

Khalil Belhimeur, +65 6427 5125
Standard Chartered Bank, Singapore
Rates Strategist
Khalil.Belhimeur@sc.com

Vietnam – Further recovery, fresh challenges

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- Vietnam's recovery has been solid and driven by domestic demand
- We revise up our 2009, 2010, and 2011 growth and inflation forecasts
- Trade deficit and hawkish inflation expectations will be the challenges in 2010
- We expect moderate VND depreciation, limited support for bonds

A strong performer during the global crisis

With the help of proactive fiscal measures and resilient domestic demand, Vietnam has weathered the global economic crisis relatively well. Along with China, India, and Indonesia, it is one of the few countries that did not experience a year-on-year contraction in GDP, according to official data. The latest GDP growth data, for Q3-2009, shows that the economy is on a solid recovery track, though the export sector remains sluggish.

To reflect this better-than-expected performance, we have revised up our growth forecasts to 4.9% from 4.2% for 2009; to 6.7% from 5.0% for 2010; and to 7.2% from 6.0% for 2011 (Table 1). We have also revised our inflation forecasts modestly upward in line with the stronger growth projections. We now expect the State Bank of Vietnam (SBV) to start hiking its base rate in Q2-2010 instead of Q3, even though there are other tools available to the SBV to manage lending and contain inflationary pressure.

Notwithstanding our more optimistic assessment of the Vietnamese economy, risks are emerging that are not dissimilar to those encountered in 2008. In particular, the widening of the trade deficit in recent months points to an imbalance between domestic strength and external weakness. And while current inflation readings remain tame both on a year-on-year and a month-on-month basis, aggressive fiscal and monetary stimulus is generating inflation expectations which could be self-fulfilling.

Commodity prices could trigger a further deterioration in both the trade deficit and inflation, as we saw in 2008. The good news is that we do not expect a sharp rise in prices of food, energy, or metals. In recent months, the authorities have resumed the Vietnamese dong's (VND's) 1% per annum decline against the USD, a longstanding policy stance adopted between 2001 and 2007. Given the deterioration in external balances, the bias will be for the government to use the exchange rate more aggressively to narrow the trade deficit.

Table 1: SCB forecasts for growth, inflation, base rate, and VND

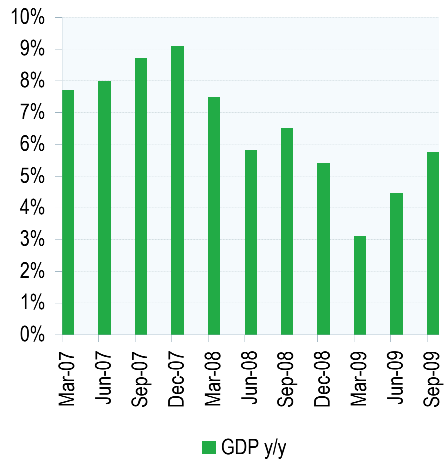
	Q1-09A	Q2-09A	Q3-09A	Q4-09	Q1-10	Q2-10	Q3-10	Q4-10	2009	2010
GDP growth (%)	3.1	4.4	5.8	6.3	7.8	6.9	6.1	6.0	4.9	6.7
Inflation (%)	14.5	6.3	2.7	5.0	7.2	8.6	9.7	10.0	7.1	8.9
Base rate (%)	7.0	7.0	7.0	7.0	7.0	7.5	8.5	9.0	7.0	9.0
USD-VND	17,797	17,801	17,824	18,200	18,200	18,400	18,450	18,500	18,200	18,500

Source: SCB Global Research

Domestic factors drove strong growth in Q3

Vietnam's economic growth continued to rebound from its low of 3.1% in Q1-2009 to 5.8% in Q3 (Chart 1). The recovery was largely driven by domestic demand, with retail sales growing consistently at around 20% between April and August 2009. As Chart 2 illustrates, a rebound in industrial production has also added positive momentum to growth, even though export performance so far this year has been disappointing (Chart 3). In September, industrial production grew by 13.8% y/y.

Chart 1: GDP growth is rebounding nicely



Sources: CEIC, SCB Global Research

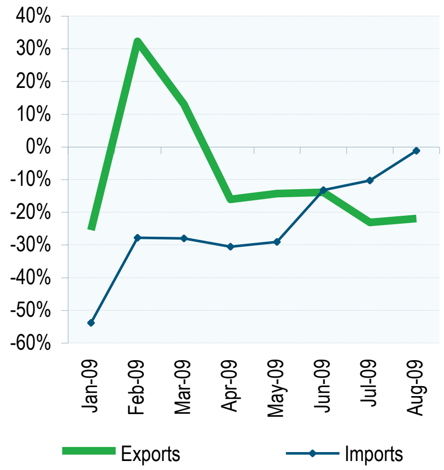
Chart 2: Industrial production is driving GDP growth

Sources: CEIC, SCB Global Research

Could Vietnam face external payments stress and inflation again in 2010?

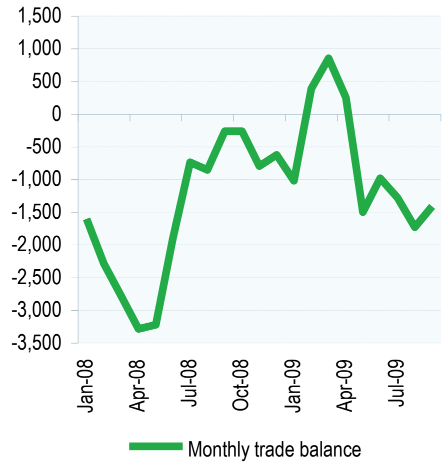
In 2008, Vietnam encountered the twin problems of a massive trade deficit and a surge in inflation. The trade deficit rose to USD 18bn in 2008, and inflation peaked at 28.3% y/y in August 2008. We believe that these problems were caused by a combination of economic overheating and a sharp rise in commodity prices. Many are worried that 2010 could see a return of both problems. In addition to domestic economic policy, we believe that global commodity prices will play a crucial role, as the surge in the trade deficit and high inflation in 2008 were both directly linked to more expensive raw materials.

Chart 3: Import growth boosted by domestic demand



Sources: CEIC, SCB Global Research

Chart 4: Trade deficit trend resumes



Sources: CEIC, SCB Global Research

Challenge 1: trade deficit is widening again

Vietnam's trade deficit (Chart 4) has widened in recent months at the rate of USD 1.5bn per month. Imports of machinery and spare parts, electronic products, and cars have picked up, reflecting robust domestic demand. Meanwhile, exports are showing few signs of improvement. With the cumulative trade deficit for January-September at USD 6.5bn, the current run rate suggests that the full-year trade deficit could reach USD 11bn.

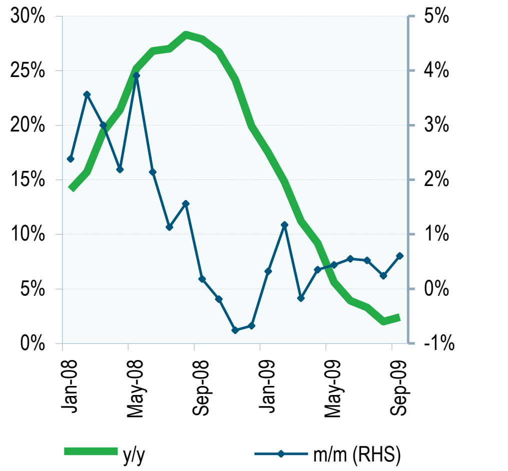
As the domestic economy continues to accelerate, there are concerns that this shortfall could widen further. The average monthly trade deficit for January-May 2008 was USD 2.7bn, and this triggered worries about Vietnam's external-payments position and a potential currency crisis. While foreign direct investment and remittance flows may recover in 2010, renewed concern over the trade balance could again put pressure on the Vietnamese dong.

While this trend is worth monitoring closely, there are mitigating factors that may help to contain the trade deficit. In 2008, manufacturers stockpiled imported steel products in anticipation of further price rises, and this played a huge role in inflating the overall trade deficit. Stable steel prices should help to prevent stockpiling this time around. Rising energy prices, which widened the spread between refined petroleum products and crude oil, also widened the trade deficit, as Vietnam is an exporter of crude oil but an importer of refined products. With the Dung Quat refinery now up and running, the structural cause of the trade deficit has been partly addressed.

Challenge 2: inflation expectations on the rise

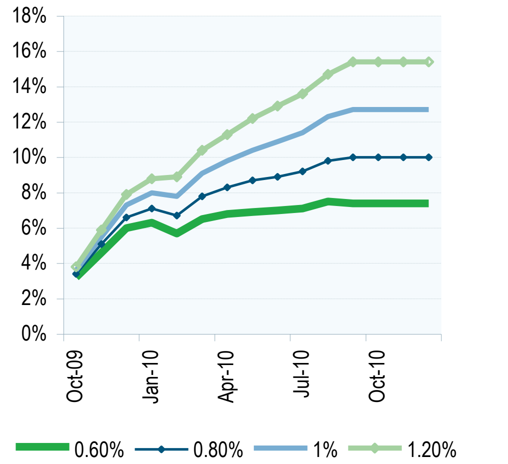
There are considerable concerns about the risk of higher prices due to aggressive monetary expansion by the SBV, even though inflation remains tame. Year-on-year inflation slowed to 2% in August and picked up mildly to 2.4% in September (Chart 5). As last year's high base effect wears off, we expect inflation to accelerate to 6.6% by the end of 2009. Meanwhile, month-on-month inflation is also modest, registering 0.24% in August and 0.62% in September. Looking at the individual components, transport and communications (9% of the CPI basket) have experienced more upward price pressure. Yet the two largest inflation components, food and housing (43% and 10% of the CPI basket, respectively), have exhibited limited upward price momentum.

Chart 5: Inflation is tame, both y/y and m/m



Sources: CEIC, SCB Global Research

Chart 6: Inflation simulation – how m/m inflation could translate into y/y inflation



Sources: CEIC, SCB Global Research

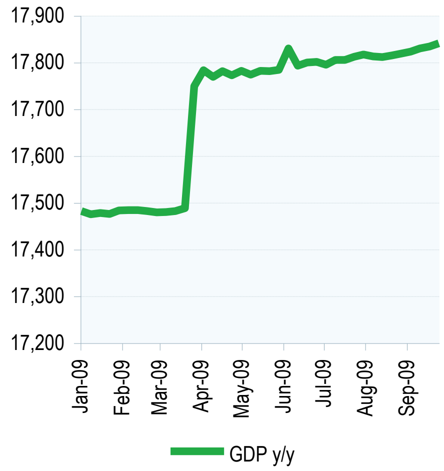
Chart 6 shows a simple simulation of how different levels of m/m inflation could translate into y/y inflation for the rest of 2009 and 2010. For example, if m/m inflation averages 0.6%, year-on-year inflation will reach 6% by end-2009 and 7.4% by end-2010. If m/m inflation averages 1.2%, y/y inflation will hit 7.9% by end-2009 and 15.4% by end-2010. Our core scenario is for m/m inflation to average 0.8%, the average pace of recent years; we assume only a modest increase in commodity prices in 2010, rather than the surge we saw in 2008.

Policy implications – VND and interest rates

What does this mean for the VND and interest rates? We have a short-term *Neutral* FX rating on the VND and expect the VND to move broadly in line with key trading-partner currencies such as the US dollar (USD), Japanese yen (JPY), euro (EUR), and Chinese yuan (CNY) relative to forwards. (For more details, see **FX Alert, 24 August 2009, 'VND raised to Neutral from Underweight'**). While the government has worked on restoring balance to USD demand, the risk is that depreciation pressure on the VND will remain.

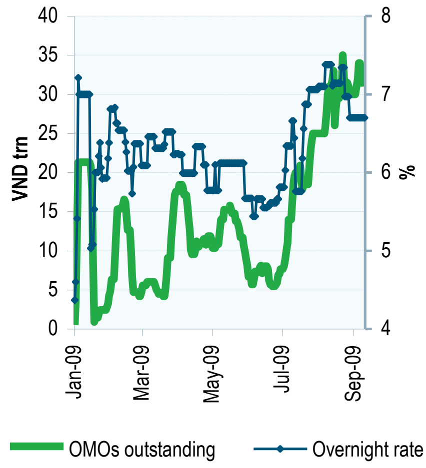
We note that since the widening of the USD-VND trading band on 23 March to +/-5% from +/-3%, USD-VND has returned to its 1% per annum appreciation path against the USD – effectively a crawling peg, and a policy adopted by the authorities between 2001 and 2007. We believe that the risk of further sharp one-off competitive devaluations has moderated as the economy picks up. However, near-term balance-of-payments dynamics are likely to continue to put upward pressure on USD-VND, as weaker inflows from FDI and inward remittances are unlikely to cover the trade deficit. As such, we see near-term upside risks to USD-VND.

Chart 7: USD-VND has returned to its 1% per annum appreciation path



Sources: CEIC, SCB Global Research

Chart 8: Market liquidity remains tight despite SBV support



Sources: Bloomberg, SCB Global Research

On interest rates, while we have pushed forward our expectation of the first SBV rate hike to Q2 from Q3-2010, we remain sceptical about the efficacy of such hikes in controlling economic activity. The central bank has been focusing on controlling the quantity of loans and money supply rather than the cost of borrowing. Furthermore, raising interest rates now would run counter to the interest-rate subsidy scheme the government implemented in early 2009, under which selected borrowers are entitled to a 4ppt interest subsidy on their borrowing. Hence, we expect the SBV to continue to manage liquidity and inflation via the quantity of loans rather than the cost of borrowing.

Local government bonds – limited support from demand and supply

Activity on the local government bond has been quiet so far this year. From the supply side, the government's main focus has remained ensuring the availability of cheap credit to the local economy to cushion the impact of the global economic crisis. The finance minister's latest comments that the government intends to maintain an aggressive ceiling on rates at government bond auctions indicates that the authorities' priorities have not changed materially. Indeed, one can interpret this decision as a means to ensure that government bonds do not crowd out other sectors of the economy. By allowing government bond yields to rise, the appeal of these debt securities would increase, presumably at the expense of commercial loans. Credit could thus become scarce.

The government's desire to keep rates below secondary-market levels should continue to ensure limited uptake at primary auctions. Indeed, this has been a recurring theme throughout the year, with only VND 14trn issued YTD, against a full-year target of VND 55-75trn (some reports have suggested that the initial target was as high as VND 126trn). The lack of primary issuance has plagued the market by reducing price discovery, contributing to its illiquidity. The finance minister's recent comments also suggest that the government is not dependent on bond issuance to finance its deficit this year. While the State Treasury has also issued two three-tranche USD bonds this year, there was a considerable gap between the stated target and the actual amount raised.

Impetus from the demand side has also been lacking. The government's interest rate support programme has resulted in tight market liquidity, with support from the SBV through open-market operations (OMOs) proving crucial (Chart 8). Loan growth has soared this year (to 24.8% in the first eight months of 2009), and banks have found few spare funds to funnel into the government bond market. Moreover, yields on government bonds are currently seen as too low, especially given the recent pickup in inflation to 2.4% y/y in September from 2.0% in August. Furthermore, the use of government bonds is limited to their eligibility for OMOs, and with commercial loans currently offering higher yields, the incentive to purchase government debt securities is relatively weak.

While recent improvements in market liquidity have helped to push government bond yields slightly lower, this should be seen as a temporary development. Given the SBV's explicitly stated concerns about loan growth and the risk of asset bubbles, support from the central bank in terms of market liquidity should not be taken as a certainty (for more details, see **Fixed Income and Rates Strategy, 28 August 2009, 'Asian rates – Impact of exit strategies on VND bonds'**). Meanwhile, the State Treasury has announced that it plans to issue VND 15-20trn of government debt securities in Q4-2009 (with T-bills amounting to VND 7-10trn, bonds ranging between VND 7-8trn, and a potential retail issuance worth VND 1-2trn). While this figure is relatively small, it remains to be seen whether the government will find willing buyers – especially given its stated intention of maintaining low ceiling rates at auctions.

We expect upward pressure on yields to continue in the medium term. While supply concerns are no longer relevant, inflationary pressure, continued aggressive loan growth, and persistently low ceiling rates at primary auctions should continue to plague the local government bond market. Moreover, growing expectations that the SBV will soon initiate its tightening cycle will be of additional concern to the market.

Table 2: SCB forecasts for local government bond yields

%	Current	Q4-09	Q1-10	Q2-10	Q3-10
2Y	9.70	10.00	10.25	11.25	12.50
5Y	10.05	10.50	11.00	12.00	12.75
10Y	10.00	11.00	11.50	12.50	13.00

Source: SCB Global Research

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