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Inflation and trade deficit weigh on sentiment

- Inflation and trade data in May has yet to turnaround
- This is likely to remain a concern on investor sentiment in coming months
- Risk on the upside for interest rates to cool inflation and stabilise currency
- We have revised our GDP growth, inflation and USD-VND forecasts

Vietnam

The latest inflation and trade data from Vietnam have yet to show improvement and this has triggered strong reaction from overseas investors. Sentiment is likely to remain cautious until there are convincing signs of turnaround in both sets of indicators. Meanwhile, the Vietnamese dong (VND) is likely to come under downward pressure as markets remain focused on the country's ability to meet the sizeable trade deficit. **Given the latest set of data, we have revised our growth, inflation and USD-VND exchange rate forecasts to reflect on the challenges and cautious investor sentiment (Table 1).**

Inflation and trade deficit staying high

Consumer price index rose 25.2% in May on the year-on-year basis, or 3.9% month-on-month. Food, which is over 40% of the CPI's weighting, rose 67.8% y/y, or 22.2% m/m. Building materials and transportation also contributed to the high inflation. It is somewhat worrying that the m/m figure has failed to moderate and this suggests the rising trend of the y/y inflation is unlikely to reverse anytime soon. With global oil and commodity prices remain elevated, the risk is that inflation could rise further in coming months. Assuming that consumer price index stop rising in June and stay unchanged for the rest of the year, inflation would average 20% for 2008. Taking this into account, we are revising our full year inflation forecast in 2008 to 23% from 17%. We have also revised lower our GDP forecast for 2008 to 6.7% from 7.5%, and from 8.5% to 6% for 2009, as a result of tighter monetary policy curbing growth.

On trade deficit, trade balance in the first five months of the year reach USD 14.4bn, or USD 2.85bn for the month of May. Hence, trade deficit as a percentage of GDP is likely to stay in the 25-30% range in coming months, implying a full year trade deficit of USD 30bn, if the import growth fails to moderate. Financial markets, especially offshore investors, are particularly concerned that this shortfall will not be sufficiently financed by other capital inflows, such as foreign direct investment (FDI), official development assistance (ODA), and remittances from overseas Vietnamese, which is expected to be around USD 20-25bn this year. This is on top of the estimated foreign exchange reserve of USD 20bn. As result of this development, the Vietnamese dong has come under downward pressure, and such pressure is likely to persist until solid improvement is seen in the trade balance, as indicated by the surge in USD-VND non-deliverable forwards. In the coming months, cautious sentiment on the Vietnamese economic outlook is likely to assert upward



pressure on USD-VND. As a result, we have revised our forecast on the *corporate* rate of USD-VND higher to reflect this sentiment.

Policy response

The State Bank of Vietnam has raised its benchmark base rate to 12%, from 8.75%, effective on May 19, as well as raising discount rate to 11% and rediscount rate to 13%. Given the inflation outlook, which will keep real interest rates significantly negative, we expect further increase in both the money market rates and benchmark interest rates in coming months. This suggests commercial lending rates will also rise. The hike in May should provide a reasonable yardstick of what can be expected in future rate increases. While higher borrowing costs could force the economy to slowdown, and possible lead to rise in default, it would help to provide some stability to exchange rate as well as curb inflation.

Table 1: SCB Forecast on Vietnam GDP, inflation and exchange rate

Vietnam	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	2008	2009
GDP (%, y/y)	7.00 (7.50)	6.50 (7.20)	6.00 (7.20)	6.00 (8.00)	6.00 (8.00)	6.70 (7.50)	6.00 (8.50)
Inflation (%, y/y)	24.00 (20.00)	30.00 (17.50)	22.00 (14.00)	10.00 (7.50)	9.50 (7.50)	23.00 (17.00)	9.50 (8.50)
USD-VND	16,400 (16,300)	16,700 (16,400)	17,000 (16,500)	16,800 (16,300)	16,600 (16,100)	--	--

Previous forecasts in brackets

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