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Vietnam's central bank hiked the benchmark interest rate, devalued the official exchange rate and narrowed the daily currency trading band

What happened:

The State Bank of Vietnam (SBV) has announced on November 25 that 1) it will raise the benchmark base rate to 8.00% p.a. from 7.00% p.a. [effective from December 1]; 2) reset the official VND mid-point exchange rate to 17,961 from around 17,034 against the USD, with the ceiling rate at 18,500 [effective from November 26]; and 3) narrow the trading band to 3% from 5%. In addition, the prime minister is reported to have requested some major exporters to sell their FX receipts to the central bank.

Our interpretation:

1. We believe **the rate hike by the SBV is a necessary move to help contain the emerging overheating and inflationary risks in the economy.** While we still hear ministries continue to debate over whether the growth recovery is sustainable or not, this gesture by the central bank confirms that policymakers in Vietnam are 1) vigilant about such risks and 2) determined to keep policies close to the curve. In addition, raising the VND interest rate also helps increase the attractiveness of the local currency to help stabilize the exchange rate.

2. **The currency devaluation is due to concerns on the weak external position and low FX reserves.** The trade deficits have increased to US$2.2 billion per month, a level still lower than the peak level of above US$3 billion per month in 1Q2008, but not by much. In addition, the significant decline in foreign direct investment this year combined with short-term capital outflows has put Vietnam's balance of payment position under stress again, when its official FX reserves have been drawn down to US$17–19 billion.

3. **Tightening the daily USD/VND trading band is seen as part of the efforts to slow down the VND's depreciation against the USD during intra-day trading.** In our view, the SBV attempts to prevent any further snowballing effect by conducting this one-off adjustment in the central parity and narrowing the band. In addition, the threat on SOEs to turn in their export receipts to the central bank also helps with SBV's credibility on defending the exchange rate from further depreciation.

Any implications on China?

1. **Any interest rate hike?** We believe China's government has already implemented policy measures (such as the credit controls and investment restrictions in certain sectors) to limit the overheating risks in the Chinese economy. The possibility of the People's Bank of China launching an interest rate hike before the end of this year is quite low, in our view. However, when growth strengthens further for a few more quarters and CPI inflation becomes more apparent, the central bank could resort to a combination of monetary policy tightening measures next spring, with a bias on quantitative control over rate hikes.

2. **Any CNY move?** In our view, Vietnam and China are at very different economic stages and will make their own independent currency policies. The case for Vietnam to depreciate its currency is strong because of its weak external position and low reserves, which is not shared by China. In contrast, China's trade surplus has declined but still remains well above US$10 billion per month on average. In addition, capital inflows into China seemed to have grown and caused policymakers' concern for hot money inflows. With a large official FX reserve of US$2.3 trillion, the need for a CNY devaluation is highly limited, even if a further strengthening in domestic demand pushes its trade balance into a deficit. The possibility for the Chinese policy makers to make such a conscious decision in the near future is extremely low.

On the other hand, we do not believe Chinese policymakers will choose to appreciate its currency in the near future due to concerns on export weakness (for details on "why we do not expect CNY appreciation soon", see *China: Backdoor tightening to continue, before more meaningful tightening comes in 2Q2010*, China Views, October 29, 2009).

I, Helen (Hong) Qiao, hereby certify that all of the views expressed in this report accurately reflect personal views, which have not been influenced by considerations of the firm's business or client relationships.