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Vietnam: Not home free for a soft landing yet

- Despite the recently improving market sentiment, we believe it is too early to dismiss the macro instability risks and conclude that Vietnam is home free for a soft landing this year.
- CPI inflation will likely be pushed up further by higher food prices in the upcoming months.
- Meanwhile, growth has slowed and could moderate further on the back of monetary tightening and the cutting of fiscal expenditures and public investments.
- In view of such risks, we adjust our forecasts for real GDP growth to 6.9% yoy for 2008 and 7.2% for 2009, down from 7.3% yoy and 7.8%, respectively. Our new annual average CPI inflation forecasts are 22.0% yoy and 14.0% yoy for 2008 and 2009, respectively, compared with 19% yoy and 10.0% previously.
- To avoid a boom-and-bust scenario, we believe the Vietnamese government will need to strike a delicate balance between tightening policies to curb inflationary pressures and not over-tighten, choking growth.

Investor sentiment on Vietnam seems to have bounced back from a recent bottom these days. After a 60% drop in the Vietnam Index (VNI) level by mid-June, Vietnam's stock market has started to normalize after macro data signaled moderating inflationary pressures and decelerating imports growth in late June. Meanwhile, the central bank's expansion of the official daily USD/VND trading band and greater supply of USD liquidity helped narrow the gap between the official and market exchange rates, while the non-deliverable forward (NDF) market has been pricing in a smaller depreciation in the VND against the dollar than before (see Exhibit 1).

However, in our view, it is probably too early to dismiss the macro instability risks and conclude that Vietnam is home free for a soft landing this year. In addition to persistent inflationary pressures, especially in food prices, we see further downside risks to growth, which we believe will require economic policies that strike a balance between being tight enough to rein in overheating pressures and not being too tight, choking growth. We believe the government will have to watch macro and micro data vigilantly and make timely adjustments in economic policies to prevent a boom-and-bust situation.

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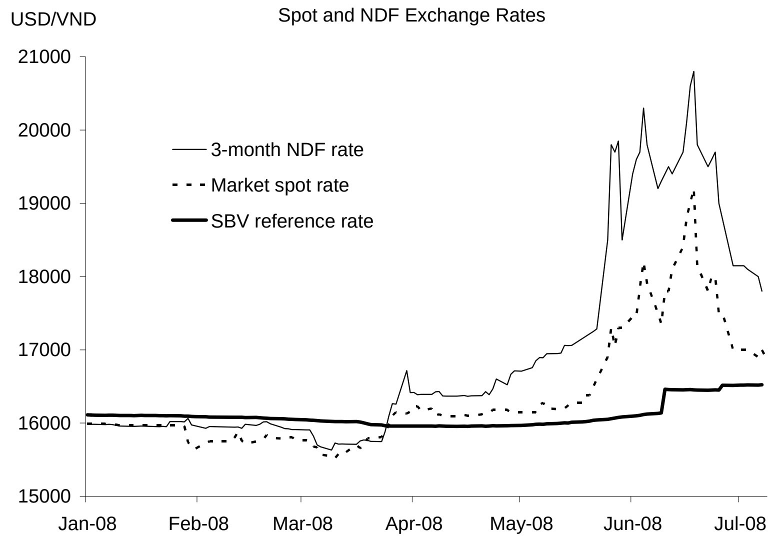
Exhibit 1: Spot and forward exchange rates have come down from their peaks



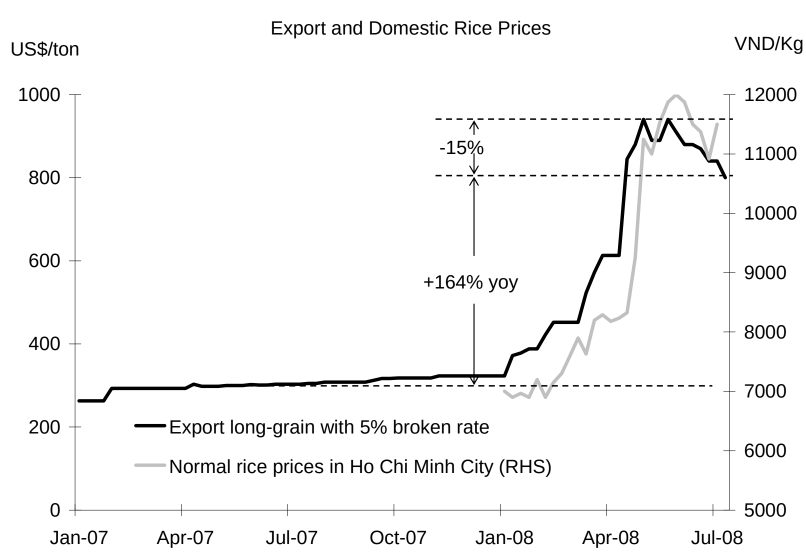
Source: CEIC, Reuters, Goldman Sachs Economics Research.

Inflation probably has not peaked yet

First, despite an evident decline in sequential non-food price inflation in June, headline CPI inflation in year-on-year (yoy) terms will likely be pushed up further by higher food prices in the coming months.

In Vietnam’s CPI basket, rice is a major element in the food component (9.9% weight) and to a certain extent in the food stuff component (25.2% weight). Although rice prices have come down from their highest levels in May, they are still much higher compared to their levels a year ago (see Exhibit 2). Despite the bumper winter-spring crop, we believe the probability of rice prices staying around current levels outweighs the moderate risk of a significant decline in the near term, especially considering the price pressures in the international rice market and rising production costs.

Exhibit 2: Rice prices declined, but still remain much higher than a year ago



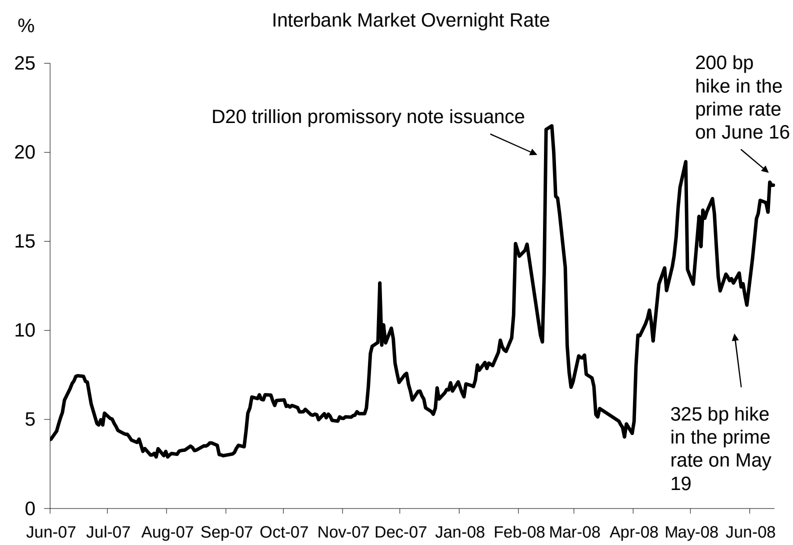
Source: Reuters, DC Research, Goldman Sachs Economics Research.

Meanwhile, the government may find it more difficult to maintain the price caps on essential goods, given surging commodity prices in the international markets and distortions in demand and supply that the price controls effectively created. While the government has vowed to keep the control on utility and fuel prices until the end of 2008, the Health Ministry approved medicine price increases by 5%–10% on July 1 to prevent a shortage in supply. However, pharmacies in Ho Chi Minh City were reported to have hiked prices by 20%-50% in response, which again showed a restricted price increase was difficult to implement.

Growth has slowed and could moderate further

The tightening measures the State Bank of Vietnam (SBV) have undertaken so far have tightened financial conditions and helped cool down the red-hot economy. Since the liquidity withdrawal in March, the central bank has hiked the prime interest rate twice by 525 bp accumulatively, which left liquidity in the interbank money market still at a relatively tight level (see Exhibit 3).

Exhibit 3: Money market remains tight after interest rate hikes



Source: CEIC, Goldman Sachs Economics Research.

Restrictive financial conditions have affected borrowing costs and funding availability for a broad range of state-owned and private firms reliant on bank loans. Commercial banks are reported to charge lending rates and fees as high as 22%-24% p.a. for short-term borrowing, with additional requirements on security deposit payments of more than 20% of the loan value as well as early loan repayments.[1] Over time, more firms and individuals will likely face heavier burdens of financial costs, when commercial banks reprice loans and apply new interest rates for the next 6-month interval. In addition, due to the equity market underperformance, raising capital through IPOs and issuing shares have not been the best financing option for businesses either this year, which has seen a decline by 76% yoy so far. For private firms in particular, which tend to be small in scale and less diversified in business areas in Vietnam, the negative impact of monetary tightening and high inflation on their business could be difficult to offset.

Consequently, real economic growth has slowed down, after months of monetary tightening and reductions in fiscal expenditures and public investment projects. For example, GDP growth in 1H2008 decelerated to 6.5% yoy, down from 7.5% yoy in 1Q2008, while imports growth declined to 54% yoy in 2Q2008, down from 75% yoy in 1Q2008.

[1] See *Borrowers suffer as banks race to boost deposit interest rates*, Thanh Nien News, June 13.

Going forward, growth will likely come under further pressure in 3Q2008, with no monetary policy loosening or fiscal stimulant in sight. Given persistent inflationary pressures, it is unlikely that the Vietnamese government will loosen monetary policy or halt the fiscal expenditure cut before a clear downward trend in CPI inflation is in place. Since we identified the main cause for the recent inflation surge in Vietnam as the excessive monetary expansion during most of 2007,[2] keeping the prime interest rate high and retaining the credit controls under the current circumstances are both necessary and preferable measures to reduce inflationary pressures and stabilize the economy, in our view.

Given the risks from tight financial conditions and more aggressive fiscal contraction,[3] we adjust our forecasts for real GDP growth to 6.9% yoy for 2008 and 7.2% for 2009, down from 7.3% yoy and 7.8%, respectively. In addition, our new annual average CPI inflation forecasts are 22.0% yoy and 14.0% yoy for 2008 and 2009, respectively, compared with 19% yoy and 10.0% previously.

Challenges for policymakers

We believe further signs of growth weakness will put policymakers' cyclical management capabilities to the test. The Vietnamese government will need to walk a fine line between tightening policies to curb inflationary pressures and inadvertent over-tightening to choke growth. So far, the Vietnamese government appears to have largely ignored firms' complaints on higher interest rates[4] and has remained adamant about prioritizing inflation control measures over growth.

However, if inflationary pressures leave no room for the central bank to cut interest rates for a sustained period of time, the risks of non-performing loans will likely rise in the medium term, which could potentially cause the merger and acquisition of banks to take place sooner than expected and complicate the future equitization agenda of the banking sector in Vietnam.

If inflation climbs up from the current level, the government will have to carefully weigh the costs and benefits of interest rate hikes in view of the risks of liquidity fleeing from the domestic currency into gold and the USD, as well as the risks of suffocating business expansion and growth. At a certain stage, the monetary authority may consider introducing government-subsidized inflation-indexed saving instruments (see details in Box 1 on next page) to anchor domestic citizens' long-term inflation expectations. Although this measure helps secure liquidity within the banking system and preserve growth, it will require the government to make a commitment over fiscal resources beyond 3-year terms and remove institutional obstacles on bond yield regulations, which will become more likely only if the situation deteriorates further from here.

[2] See *Vietnam: Rising inflation, growth setback and a likely roadmap of policy response*, Asia Economic Flash, May 19.

[3] Dow Jones reported the Ministry of Finance increased the cut on government projects to more than D17.7 trillion (equivalent to roughly 8.5% of annual state investment in 2007) to tame inflation by the end of June, of which D9.3 trillion was from government-bond-financed projects.

[4] Recent reports on Reuters suggested the government has used administrative measures to guide state-owned banks to support critical investment projects on an ad-hoc basis. See *Vietnam Bank BIDV to cut loan rates to boost economy*, July 8, Reuters.

Box 1: Government-subsidized inflation-indexed saving instruments

This is a measure that entitles long-term depositors or bond holders (with maturities of 3 years and above) to be paid at a return rate that is equal to price inflation or nominal interest rate within that period, whichever is highest. The purpose of introducing these securities is to ensure long-term deposit returns without increasing nominal deposit and lending interest rates. It could potentially help attract more local-currency deposits back into the banking system without adding the burden on loan borrowers.

In contrast to inflation-protected bonds that are commonly traded in many markets, these instruments will have to be subsidized by the government if introduced in Vietnam soon. This is because in a highly inflationary environment, no private financial firm is likely to take up the risk to become the seller of such instruments.

Under this arrangement, when inflation runs above nominal interest rates, the government will be responsible for paying the difference in the interim period. This subsidy can also serve as a penalty on the government for being unable to rein in inflation and eliminate any incentive to “inflate away” the government debt. As a result, it could help re-establish confidence in the local currency and help anchor people’s inflation expectations in the long term.

During the implementation in 1988–1990 and 1994–1996 in China, inflation-indexed deposit saving effectively reduced inflation expectations and restored financial order. As we see it, this measure achieves the goal of keeping liquidity within the banking system without overstretching economic growth.

As a temporary measure that can be removed when inflation comes down, we do not think it should be viewed as providing a subsidy to commercial banks. More importantly, banks will still be paying the legal deposit rate to depositors and charging certain lending rates to borrowers with their operation costs priced in. Meanwhile, sectoral competition should eliminate any excessive profits within the sector.

In our view, the chief obstacles of implementing these policies are the government’s commitment to the deposit subsidy and the current regulations on bond yields. However, compared to the potential benefits that can be reaped from this measure, these institutional challenges should be relatively easy to overcome if the inflation problem deteriorates from here. Lastly, it is worth noting that temporarily introducing inflation-protected instruments will receive the desired outcome on inflation reduction only if it is packaged with a macroeconomic stabilization program featuring fiscal reform.