Vietnam
Special Report

Declining Confidence in the Vietnamese Dong

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Related Research

- *Sovereign Rating Methodology (October 2009)*
- *Country Ceilings (September 2008)*
- *Bank Systemic Risk Report (November 2009)*
- *Global Economic Outlook (December 2009)*
- *Vietnam (July 2009)*
- *Fitch Places Vietnam's Ratings on Watch Negative (March 2010)*

Summary

Fitch Ratings has placed Vietnam's Foreign- and Local-Currency Issuer Default Ratings of 'BB–' on Rating Watch Negative. The rating action reflects weakened external finances, manifest in falling international reserves, and a deterioration in public confidence in the Vietnamese dong. The agency is also concerned about reduced data transparency in fluid and potentially volatile circumstances surrounding the sovereign's external finances.

Two policy-related measures — SBV's exchange rate intervention to defend the VND and fiscal-related drawdown of government deposits — as well as wide current account deficits, currency and deposit outflows and abnormally large errors and omissions in the balance of payments (BOP) have weighed down on overall reserves. The steady deterioration in gross international reserves (GIR) during 2009 has been material. Official data show a decline in GIR to USD15.9bn at October 2009, which is one-third lower than the September 2008 high of USD23.6bn. More recent data are not available. However, Fitch estimates that Vietnam's foreign exchange reserves (FXR) cover, international liquidity ratio (adjusting for deposit money banks' foreign exchange deposit liabilities), as well as gross external financing requirements are likely to have worsened. It remains to be seen whether a forecast recovery in private remittances, foreign direct investment and official development assistance will prevent a further slide in FXR levels in the absence of a firm policy response.

The conventional pegged VND/USD exchange rate regime constrains Vietnam's ability to correct increased external imbalances. Ad-hoc currency devaluations (SBV devalued the dong on 26 November 2009 and 10 February 2010) and narrowing of the daily trading-band to ±3% from ±5% risks raising public and investors' expectations of further devaluations to come. Indeed, the market has priced in more VND devaluation in the non-deliverable forward outright curve and VND onshore forwards, although these are poor proxies due to the lack of liquidity in these transactions. A better proxy — the ongoing divergence between the black-market VND and the market clearing spot rate — continues to point to VND depreciation pressures.

Underlying macroeconomic conditions also continue to encourage depreciation pressures on the VND. Underlying price pressures are also clearly building. Sequential seasonally adjusted month-on-month inflation is rising as the negative output gap (real vs. potential GDP) in the economy has disappeared since Q409. A preference for VND devaluation to boost exports and the authorities' pro-growth policy measures in the run-up to the January 2011 national congress of the ruling Communist Party point to risks of further build-up in inflationary pressures and external weakness.

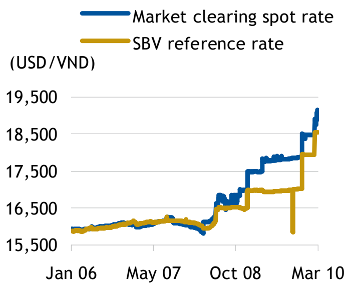
On the public finances front, a series of failed primary auctions by the State Treasury since November flags weakening public confidence in VND-denominated assets and rising USD liquidity constraints within the domestic financial system due to strong USD demand. Without a strong policy tightening backed by significant BOP support, Vietnam's weakened external finance position provides less support to mitigate the sovereign's weak structural fiscal deficit. Key rating drivers include further VND devaluation pressure; rising USD and gold hoarding; lack of an effective policy response; and continued lack of timely FXR data.

Deteriorating External Finances

The strength of Vietnam's external finances has supported the sovereign's overall creditworthiness, but has been sharply eroded as the economy displays signs of domestic overheating and residents' loss of confidence in the local currency. The steady deterioration in GIR during 2009 was material. Based on available but dated Q109-Q309 data, wide current account deficits, currency and deposit outflows and abnormally large errors and omissions in the BOP have weighed down on overall reserves. GIR dropped to USD15.9bn at October 2009 (latest available), which is a decline of one-third from the high of USD23.6bn in September 2008. Fitch estimates GIR may have declined closer to USD14.5bn at end-2009.

Fitch forecasts FXR cover may drop to 2.6 months of imports and 1.6 months of current external payments in 2010, which will be the lowest since 1994 and the weakest amongst 'BB'-range peers (sovereigns rated 'BB+', 'BB' and 'BB−'). The Fitch international liquidity ratio — FXR plus banks' external assets relative to short-term debt and debt service — is forecast at 355% for 2010, compared with the 184% 'BB' median, suggesting a comfortable external liquidity position. However, Fitch believes this ratio underestimates the potential impact of dollarisation risk on external finances. Including deposit money banks' foreign exchange deposit liabilities, Fitch estimates the adjusted liquidity ratio may decline to 55% in 2010, the lowest in a decade. Indeed, the dollarisation ratio of about 24% itself may underestimate the extent of gold- and dollar-hoarding activities outside the banking system.

Spot vrs Reference Rate



Source: Bloomberg, Fitch

On the funding front, Fitch notes that the current account deficit plus net foreign direct investment (FDI) has stayed in deficit since 2007 indicating that FDI, which has been an important source of stable and non-debt-creating flows, has become insufficient to mitigate BOP risks. A USD1bn 10-year global bond issuance in January 2010 was to fund key industrial, energy and shipping projects rather than to boost FXR. The authorities' efforts to expedite disbursements of bilateral and multilateral official development assistance (ODA) worth USD1.35bn in December 2009 may have helped to stem the FXR decline. However, Fitch anticipates stronger ODA backing and FDI funding will be needed in 2010, as Vietnam's gross external financing requirement (GXFR) has risen to 94% of FXR, the highest level since 1997 and the second-highest amongst 'BB'-range peers. Of concern, Fitch forecasts the 2010 GXFR including short-term external debt was over 109% of end-2009 FXR.

Using baseline Fitch forecasts of import and FXR levels for 2010, Fitch estimates that the authorities will need to either compress import growth to less than 10% yoy in 2010 or accumulate a significant 34% yoy rise in FXR to meet its "comfortable level" of FXR import cover of at least 12 weeks. Import compression points to a much needed moderation in domestic demand, contrasting with the authorities' efforts to reach GDP growth of 6.5% in 2010. The alternative of active FXR accumulation may complicate domestic stability if the authorities lean towards incomplete sterilisation of capital inflows (as in past episodes of FXR build-up) which results in a further build-up of inflationary pressures. Both measures require monetary policy restraint, which is not currently on the State Bank of Vietnam's (SBV) cards, as the authorities maintain a pro-growth stance in the run-up to the January 2011 national congress of the ruling Communist Party.

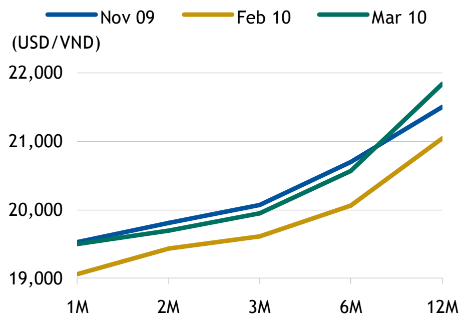
Further Devaluations Possible

The two recent episodes of currency devaluations helped narrow the gap between the market clearing spot rate and the SBV reference rate from 5pp on 24 November 2009 (before the devaluation announcement on the 25th) to about 2pp by early March 2010. Still, the market continues to price in further devaluations.

The non-deliverable forward outright contracts cash settled in USD by counterparties are factoring further VND weakness in the year ahead. At 1 March

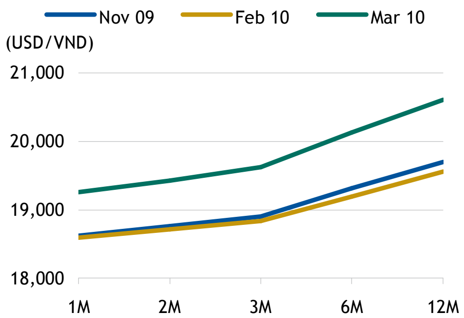
2010, the contracts indicate the currency will decline as much as 14% from the spot rate in 12 months' time, while the VND onshore forward FX transactions priced in a 8% depreciation in a year. Perhaps a more reliable measure of onshore USD demand pressures than the illiquid derivatives market, the gap between the spot rate and the unofficial black-market rate of money changers in Ho Chi Minh City tracked by the state-owned Vietnam Posts & Telecommunications recorded a 5% premium in early March, compared with a high of 13.6% on 24 November 2009.

Non-Deliverable Forward Outright



Source: Bloomberg, Fitch

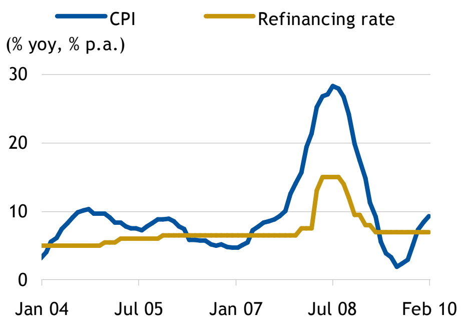
VND Onshore Forward Points



Source: Bloomberg, Fitch

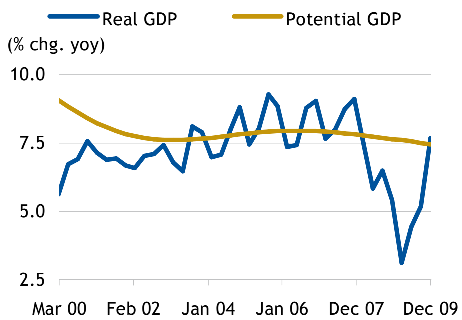
Underlying macroeconomic conditions also suggest continued depreciation pressures. In December 2009, the SBV increased base interest rate from 7% to 8% and the discount rate from 5% to 6%. Still, SBV officials' announced the pro-growth monetary policy stance remains unchanged, keeping the refinancing rate unchanged at 7% since April 2009. The negative real refinancing rate which widened from −0.3% in December 2009 to −2.3% in February 2010 is set to widen further. During the first two months of the year, inflation averaged 8% and will likely on an annual average basis exceed the government's target of 7%. This is particularly so as Fitch estimates that sequential inflation has accelerated on average by 0.7% on a seasonally adjusted month-on-month basis since March 2009.

Inflation and Interest Rate



Source: CEIC, Fitch

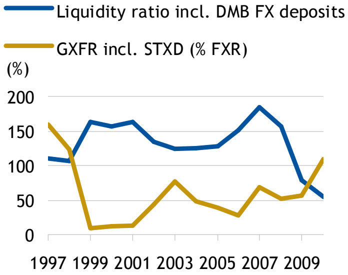
Real GDP and Potential Output



Source: CEIC, Fitch

Following fuel price hikes on 22 February — petrol by 11.5% and diesel and kerosene by 36% — as well as higher electricity costs of 6.8% starting March 2010, the authorities are also stepping up central planning efforts to control prices of rice, gasoline, fertilizer, cement and steel. As the negative output gap between real and potential GDP (estimated using the Hodrick-Prescott filter) has disappeared since Q409, underlying price pressures are clearly building.

Liquidity Ratio and GXFR



Source: Fitch

Recent measures to stem USD demand:

- VND devaluation
- State-owned companies that hold large USD reserves to sell USD to SBV and to the banks
- 1% interest rate cap on companies' USD deposits (approximately USD10.3bn) to encourage switching to VND
- SBV lowered banks' minimum reserve requirements for FX deposits

Recent measures to slow the economy:

- Lower credit growth target from 38% in 2009 to 25% in 2010
- Hike in base rate from 7% to 8% in December 2009

External Finance Strengths Eroding

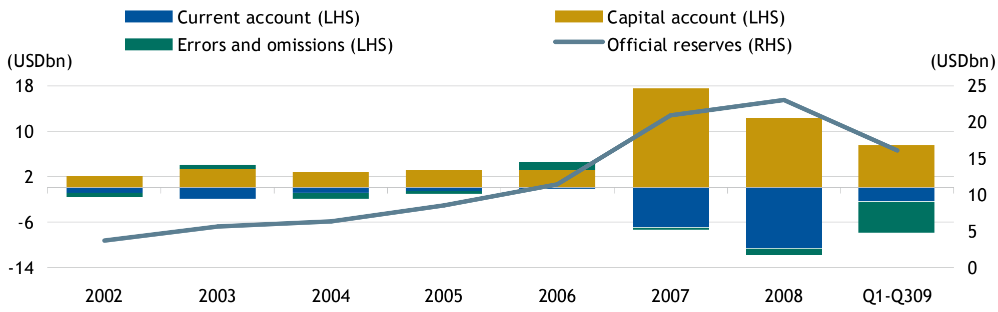
Two policy-related reasons have been publicly cited for the decline in FX reserves during 2009. These were the SBV's exchange rate intervention to defend the VND and a fiscal-related USD1bn drawdown of government deposits (central bank foreign-currency liability) held at the SBV (corresponding central bank foreign-currency asset drawdown) to implement a 4% interest subsidy for short-term corporate borrowings. No official statement has been made on how two more interest-subsidy schemes for medium- and long-term loans issued in 2009 and maturing on or before 2011 (4% subsidy) and medium/long-term loans issued in 2009 and maturing on or before 2012 (2% subsidy) extended by the financial sector will be financed.

Strong pro-growth policy initiatives have compounded the deteriorating external finance position. On a 12-month rolling-sum basis, Vietnam's trade deficit widened to USD13.7bn in February 2010 worth 13% of GDP — close to the last overheating scenario in 2008 of 14% of GDP — as the rise in imports has out-stripped that of exports. On a three-month moving average (3MMA) basis, import growth surged beyond that of exports during August 2009-February 2010. Strong import volume growth of petroleum, steel, automobiles as well as machinery and equipment is likely to have been fuelled by robust economic activity.

Indeed, the SBV attributed an indirect effect of the interest subsidy on heightened pressure to import equipment and consumer goods, such as imported cars, raising the pressures to source USD from the open market and putting pressure on the VND. In addition, Vietnam's commodity dependence is high at 40% of CXR and the trade balance is vulnerable to commodity price shocks, particularly since the country exports most of its crude oil and imports most of its refined petroleum products due to limited refinery facilities.

Apart from the current account deficit, the level of currency and deposit outflows and errors and omissions in the BOP accounts have become abnormally large, indicating possible capital flight by domestic residents. Including deposit money banks' FX deposit liabilities, Fitch estimates the adjusted international liquidity ratio was likely to have declined to 55% in 2009, the lowest in a decade. Fitch forecasts the 2010 GXFR including short-term external debt at over 109% of end-2009 FXR, higher than the 'BB'-range median of 96%.

Balance of Payments



Source: SBV, Fitch

It remains to be seen whether a forecast recovery in private remittances, FDI and ODA will be available at an opportune time to prevent a further slide in FXR levels. On a more positive note, the country has access to an USD120bn ASEAN+3 swap facility that was launched in May 2009.

Difficulties in Local-Currency-Denominated Financing

Primary Market Auctions by State Treasury: Government Bonds

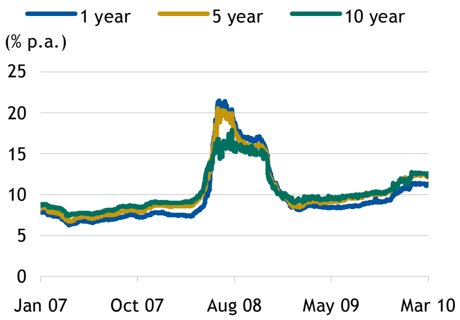
Auction date	Tenor (years)	Winning volume (bn)	Accepted yield	Lowest yield	Highest yield	Ceiling yield to maturity
19 Nov 2009	3	0	0.0	10.9	10.9	9.7
19 Nov 2009	2	0	0.0	10.7	11.2	9.4
16 Dec 2009	3	0	0.0	0.0	0.0	10.8
16 Dec 2009	2	0	0.0	12.5	12.5	10.8
16 Dec 2009	5	10	10.8	10.5	11.0	10.8
21 Jan 2010	5	2	11.0	11.0	14.5	11.0
21 Jan 2010	2	0	0.0	11.8	13.0	10.8
4 Feb 2010	2	0	0.0	11.7	14.5	11.2
4 Feb 2010	5	0	0.0	12.0	12.0	11.3
4 Mar 2010	2	0	0.0	12.0	13.5	11.4
4 Mar 2010	3	0	0.0	13.0	14.0	11.5

Source: Hanoi Stock Exchange, Fitch

The primary government bond market has remained gloomy since 19 November 2009. There have been nine failed auctions by the State Treasury for the first time since available data was listed on the Hanoi Stock Exchange starting July 2004. These auctions failed as the ceiling yield to maturity for two-, three- and five-year bonds set by the Treasury failed to meet investor expectations of lowest and highest yield bids submitted. Gradual hikes in the Treasury's ceiling yield to maturity only secured two successful auctions, on 16 December 2009 and 21 January 2010; but Fitch estimates the winning volumes of 2 billion and 10 billion respectively were significantly lower than volumes recorded during 2004-2008, averaging 280 billion a month.

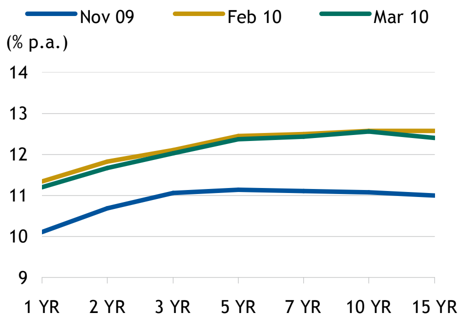
Poor bids in the local markets for VND-denominated government bonds on the back of inflation concerns and an expected rise in loan growth[1] have contributed to higher yields across the tenor of the yield curve, averaging 270-345bp in the first two months of 2010 alone, compared with 20-100bp in the same period a year ago. SBV has reportedly injected more than VND215trn into the money market by buying back government bonds and bills via open market operations from banks using bonds as collateral to borrow money from SBV since the start of the year.

Government Bond Yields



Source: Bloomberg, Fitch

Svrgn Local-Currency Yield Curve



Source: Fitch

Fitch estimates that general government short-term debt falling due will likely rise to 16% of consolidated general government debt in 2010, up from 10% in 2009, as it has become harder for the government to raise longer-dated bonds from the local

[1] The SBV has allowed negotiable rates for certain loans to stimulate production and business activity.

market. In addition, this unfavourable trend points to heavier reliance on onshore USD bond issuance in 2010 to help lower government borrowing costs by offering lower yields. Already, Fitch notes that Vietnam issued USD427m USD-denominated bonds onshore in 2009, higher than the budgeted USD300m intended issuance. Increased reliance on foreign-currency-denominated debt in both 2009 and 2010 raises the sovereign's exposure to foreign-exchange risk.