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Vietnam – A good H1 report card

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- The economy grew 6.2-6.4% in Q2-2010, and inflation has calmed in recent months
- Trade deficit is stable, and FDI and remittances are increasing again
- Risk of inflation remains, but we lower our 2010 forecast to reflect benign H1 price movement

A healthier-looking H1-2010

Although we have been optimistic since the start of the year about Vietnam's growth outlook, we have been more cautious about inflation and the external payment position, two issues that have challenged the economy in recent years. Growth has been on track with our expectation, with 6.2%-6.4% growth in Q2-2010 estimated by the government, after reaching 5.8% in Q1. We are pleasantly surprised by the tame inflation thus far in H1-2010, with month-on-month inflation staying between a very benign range of 0.1% to 0.3% for the past three months.

The trade deficit, which registered USD 6.5bn in H1-2010, is also moving in line with our full-year forecast of USD 13bn. A moderation in import growth and acceleration of export growth is helping to keep the trade deficit in check. Meanwhile, growth in disbursed (actual inflow instead of pledged amount) foreign direct investment (FDI) and remittance flows are also conducive to the country's external payment position.

Table 1: Standard Chartered Economic and market forecasts for Vietnam

	Q1-2010A	Q2-2010A	Q3-2010F	Q4-2010F	2010F	2011F
Real GDP	5.8%	6.3%	6.9%	7.5%	6.7%	7.2%
Inflation (y/y)	8.5%	9.0%	9.6% (13.1%)	10.7% (13.9%)	9.5% (11.5%)	8.5%
USD-VND	19,085	18,990	19,600	20,000	20,000	19,800
Base rate	8.0%	8.0%	8.0%	9.0%	8.0%	10.0%

Note: Numbers in brackets denote previous forecasts; Source: Standard Chartered Research

As Table 2 shows, industrial production (presented in real terms by the government) and retail sales data reflect firm domestic fundamentals. The improvement in the monthly export growth figures – from zero in the first two months of the year to an average of 30% y/y in Q2-2010 – is also encouraging. This reflects a robust domestic economy and income rises across the country, as well as a gradual recovery in Vietnam's export markets, especially in ASEAN and China.

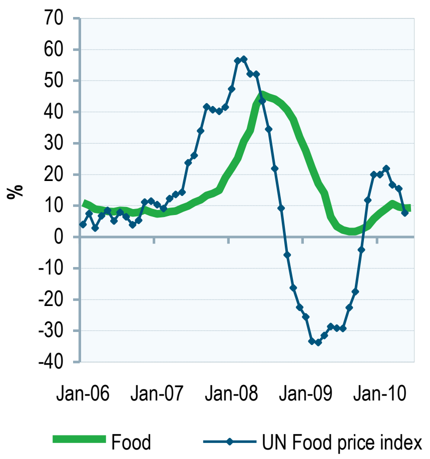
Table 2: Recent macroeconomic indicators

	Jan-2010	Feb-2010	Mar-2010	Apr-2010	May-2010	Jun-2010
Real GDP			5.8%			6.3%
Inflation - m/m	1.4%	2.0%	0.7%	0.1%	0.3%	0.2%
- y/y	7.6%	8.5%	9.5%	9.2%	9.1%	8.7%
Industrial production	14.1%	14.1%	12.0%	13.4%	14.0%	14.6%
Retail sales	29.6%	45.2%	31.0%	42.9%	39.2%	32.3%
Exports, y/y	0.1%	0.1%	5.3%	24.6%	38.2%	26.7%
Imports, y/y	46.7%	46.7%	33.8%	19.0%	20.8%	22.0%
Trade balance (USD mn)	-945	-1,330	-1,155	-1,162	-750	-1,200

Note: instead of year-to-date figures, we have estimated the monthly data. For Jan-Feb trade and industrial data, the growth represented is the average of the two months to remove Tet holiday distortions; Sources: CEIC, Standard Chartered Research

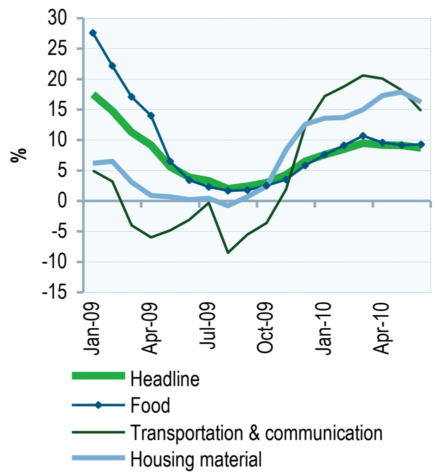
The decline in year-on-year inflation in recent months has been a pleasant surprise. Easing of food, housing and transportation prices, which make up almost 60% of the CPI weighting, have directly contributed to the lower headline figures (see Chart 2). The moderation in global commodity prices has been helpful. As Chart 1 shows, global food prices, using the UN food price index as a proxy, have eased in recent months and this has correlated well with the slowdown in food price inflation in Vietnam. The fuel price reductions on 27 May and 8 June have also helped to keep a lid on transportation costs.

Chart 1: Vietnam's food prices vs. global prices



Sources: IMF, Standard Chartered Research

Chart 2: Key inflation components are edging down



Sources: IMF, Standard Chartered Research

As a result of the benign inflation in recent months, we have revised our inflation forecast for 2010 from 11.5% to 9.5%. Reduced pressure on the Vietnamese dong (VND) to depreciate also bodes well for managing imported inflation. However, we remain watchful for signs of two sources of inflation. First is domestic inflation – strong retail sales and industrial production could fuel inflationary pressure in the months ahead. Second is commodity prices. The current bout of stable commodity prices could disappear if risk appetite returns, driving the USD lower and commodity prices higher. Hence, we acknowledge the current benign inflation environment but remain vigilant for the potential uptick in inflation in H2-2010. After all, Vietnam has the highest inflation volatility in East Asia (see **On the Ground, 23 February 2010, 'Asia – Inflation volatility'**).

As a result of the stable inflation in recent months, the central bank and the government have been working to lower interest rates. The State Bank of Vietnam (SBV) announced that major local banks have agreed to reduce the VND lending rate to between 12% and 12.5% in July, from the current 14%. They also agreed to cut the VND deposit rate to 10.2% in the next three months, from the current 11.5%. As we noted previously (see **On the Ground, 14 June 2010, 'Vietnam – Monetary policy in transition'**), the base rate has lost its purpose as a policy reference rate and the SBV is expected to provide a more market-relevant benchmark rate in the months ahead to indicate policy intentions. Meanwhile, the authorities are still likely to influence lending and deposit direction.

Balance of payment dynamics also improving

The external payment position is a recurring problem of the Vietnamese economy. Vietnam's H1 trade deficit stands at USD 6.5bn compared with a deficit of USD 2.1bn in H1-2009. The dramatic difference was partly due to some large one-off exports of precious metals in 2009. The improvement in export growth and slowdown in import growth have helped to keep the country's deficit position stable. The H1 performance is largely in line with our full-year trade deficit forecast of USD 13bn.

Inflows are also improving steadily. According to the Ministry of Planning and Investment, remittance flows amounted to USD 3.6bn in H1-2010, versus USD 2.8bn in H1-2009. Disbursed FDI is USD 5.4bn for H1-2010, 6% higher than a year ago. The combination of stable trade deficit and improving inflow should bode well for currency stability.

Comments by the IMF that the level of the country's foreign exchange reserve had fallen to 7 weeks-worth of imports have shocked the market. Vietnam 5yr-CDS spread surged to 276bps from 251bps following the comments, subsequently returning to 236bps. The central bank later clarified that the FX reserve should be 9 weeks-worth of imports and that they are aiming to raise this to 12 weeks by the end of the year. With the government not disclosing reserve data, it is difficult to pinpoint the exact trend, but the improvement in the balance of payments dynamics should help to increase the country's resilience to external payment stress. As we highlighted in our recent report (see **Special Report, 31 May 2010, 'Vietnam – Rediscovering the frontier'**), much of Vietnam's external liabilities are with governments or international organisations such as the Asian Development Bank and the World Bank, debtors that are likely to be more willing to provide lending conditions that will not add stress to the balance of payment situation relative to private-sector lenders.

Disclosures Appendix

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