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Vietnam – Holding the course

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- Inflation and trade balance stable in recent months; inflows also improving
- Authorities have nonetheless devalued the VND and launched new price-control mechanism
- We still expect further VND devaluation in 12-18 month horizon

More of the same as we enter H2 – benign inflation and steady trade deficit

Vietnam's latest economic data for August shows a continuation of the trend we have seen for much of H1-2010. Inflation is relatively calm, at 8.2% y/y or 0.2% m/m. The trade deficit is also steady in August, at USD 900mn, totalling just over USD 8bn for the first eight months. To maintain this stability in both inflation and the trade deficit, the State Bank of Vietnam (SBV) and the Vietnamese government announced two measures in recent weeks. First, the SBV raised the USD-VND reference rate by 2% on 18 August, with the aim of boosting exports and slowing import growth, and subsequently pre-empting the risk of the trade deficit widening. Second, the government announced in Circular 122 that starting from 1 October, it will have the option of imposing price controls on private and foreign companies over essential industrial and consumer products.

The latest policies have several implications. First, inflation in the immediate future should remain under control, especially if global food and energy prices do not surge significantly, although we do not believe price controls will be effective in the event of a sustained surge in input prices. Second, the latest devaluation of the Vietnamese dong (VND) will continue to prevent the authorities from reducing interest rates. Finally, as we expect Vietnam's trade deficit to persist in the medium term, further devaluation of the VND is on the cards in 2010 and 2011. As a result, we have raised our USD-VND forecast modestly, maintaining the overall profile.

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%	8.3%	8.7%	8.5%	9.5%
			(9.6%)	(10.7%)	(11.5%)	
USD-VND			19,500	19,900	19,900	20,800
	19,085	18,990	(19,300)	(19,600)	(19,600)	(19,800)
Base rate	8.0%	8.0%	8.0%	8.0%	8.0%	10.0%
				(9.0%)	(9.0%)	

(Note: Numbers in brackets denote previous forecasts.)

Source: Standard Chartered Research

Important disclosures can be found in the Disclosures Appendix



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Ref: GR10AU

**Table 2: Recent macroeconomic indicators**

	Mar-2010	Apr-2010	May-2010	Jun-2010	Jul-2010	Aug-2010
Real GDP	5.8%			6.3%		
Inflation - m/m	0.7%	0.1%	0.3%	0.2%	0.1%	0.2%
- y/y	9.5%	9.2%	9.1%	8.7%	8.2%	8.2%
Industrial production	12.0%	13.4%	10.8%	14.8%	17.3%	14.4%
Retail sales	31.0%	42.9%	39.2%	32.3%	35.3%	33.0%
Exports, y/y	5.3%	24.6%	43.0%	33.4%	20.7%	32.7%
Imports, y/y	33.8%	19.0%	26.7%	19.6%	9.9%	18.0%
Trade balance (USD mn)	-1,155	-1,162	-870	-741	-1,150	-900

(Note: instead of year-to-date figures, we have estimated the monthly data for industrial production and retail sales.)

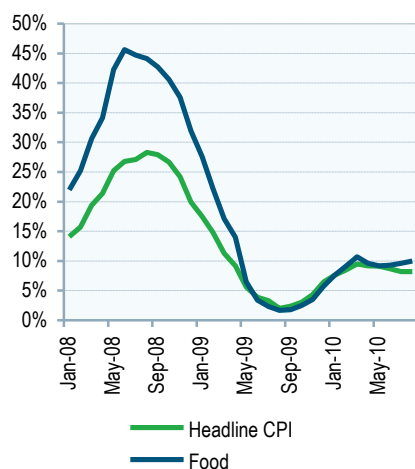
Sources: CEIC, Standard Chartered Research

Global factors are supportive of stable inflation

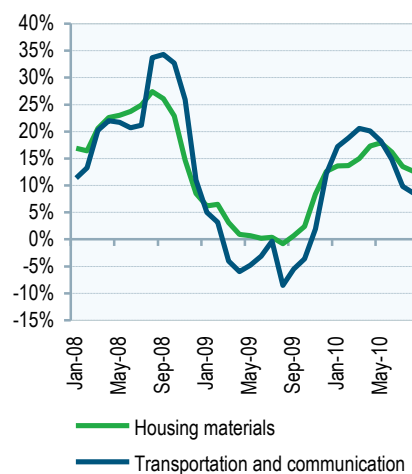
For much of 2010, we have been warning about the risk of a pick-up in inflation in Vietnam, but the contrary has been true for much of the summer. Month-on-month inflation has been tame for the past five months, ranging between 0.1% and 0.3%. This is remarkable, considering that retail sales continue to expand at more than 30% y/y. Looking at the breakdown, inflation in housing materials (10% of the CPI index) and transportation (8.9% of the index) have been steadily decreasing, resulting in stable headline inflation (see Chart 2). Inflation of food, by far the biggest component of the price index basket, with a weighting of 40%, has crept up in the past three months, but not enough to offset the downtrend in other components. Stability in global food and energy prices has been helpful in keeping domestic prices in check.

To assist inflation management, the Vietnamese government announced in Circular 122 that from 1 October, it will be able impose price controls on foreign and private companies on a range of products. This includes industrial inputs such as cement, steel, LPG, fertilisers, animal vaccines, animal feeds, coal and day-to-day necessities such as salt, powdered milk, sugar, rice, paper, textbooks and railway fares. While we do not expect any of these price controls to be implemented in the immediate future, they can be activated if global prices start to surge, and may act as a temporary stabiliser of local prices.

That said, we do not believe such controls would be effective in the event of a sustained rise in global commodity prices, as prolonged market distortions will force adjustments in quantity when market equilibrium cannot be achieved via price adjustment. For example, rising global input prices coupled with fixed domestic output prices will inevitably drive down profit margins, or even incur losses, and could force producers to cut back production to minimise losses. This occurred in China in 2007-2008, when local gasoline prices were controlled by policymakers. A rapid surge in global oil prices seriously undermined the profitability of local petrochemical companies. This led to hoarding of gasoline and other fuels, resulting in long queues of vehicles waiting to be refuelled across the country. This helped prompt the Chinese authorities to engage in price reform later in 2008 to introduce more market forces.

**Chart 1: Headline inflation vs food prices**

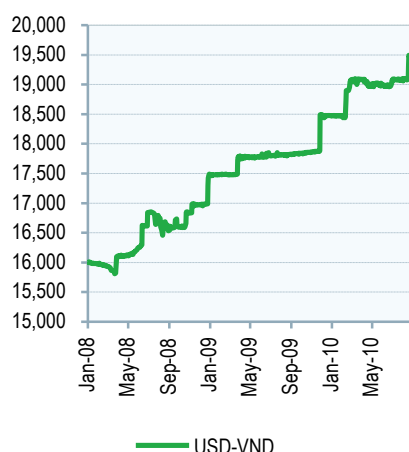
Sources: CEIC, Standard Chartered Research

Chart 2: Lower housing and transportation inflation

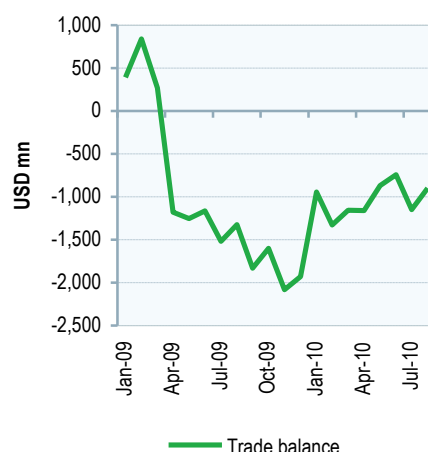
Sources: CEIC, Standard Chartered Research

Trade deficit and currency devaluation

On 18 August, the SBV devalued the VND by revising the USD-VND reference index up by 2.1% to 18,932 from 18,544, while maintaining the daily trading band of +/-3%. Since the devaluation, USD-VND has traded around the strong end of the band at 19,500. The direction and magnitude of the move is largely in line with our forecast, although the timing is ahead of our expectation. After all, the trade deficit has been moving in a stable manner for much of 2010, at around USD 1bn per month, supported by strong export growth and cooling import growth. Meanwhile, disbursed foreign direct investment (FDI), official development assistance (ODA) and remittance flows have been recovering steadily. The Ministry of Planning and Investment stated that disbursed FDI reached USD 7.25bn in the first eight months of 2010, while ODA was USD 1.81bn for the same period. Remittance flows was USD 3.9bn in the January-July period. Hence, the overall depreciation pressure on the VND ought to be lower than in previous years when inflows were waning on the back of the 2008 global financial crisis while firm domestic demand is absorbing imports.

Chart 3: USD-VND exchange rate

Sources: CEIC, Standard Chartered Research

Chart 4: Stable trade deficit

Sources: CEIC, Standard Chartered Research



However, given the Vietnamese authorities' growth bias, we believe that further devaluations are likely in order to support exporters. The timing of further moves will be politically driven but we believe a rise in commodity prices, which would in turn drive inflation and the trade deficit higher, could be a trigger. Sharp rises in gold prices and the US dollar (DXY Index) could also prompt VND depreciation pressure to intensify. In line with this, we have adjusted our USD-VND forecasts modestly higher, keeping the overall profile. We now forecast USD-VND at 19,500 at end-Q3; 19,900 at end-Q4; 20,000 at end-Q1-2011; 20,400 at end-Q2-2011; 20,500 at end-Q3-2011, and 20,800 at end-Q4-2011. This compares with our previous forecasts of 19,300, 19,600, 19,650, 19,725, 19,800 and 19,800, respectively. We maintain our short- and medium-term *Neutral* FX ratings on the VND, given that VND deliverable forwards factor in substantial VND weakness.

Another important implication of the VND devaluation is that the authorities will not be able to push interest rates lower despite the stable inflation. The government has for some months been trying to persuade commercial banks to reduce lending rates in order to promote lending and facilitate growth. This is on the back of the government's lack of a functional benchmark policy rate following the severance of the link between the base rate and commercial lending rates in February 2010. (See **On the Ground, 14 June 2010, 'Vietnam – Monetary policy in transition.'**) While the Base Rate is still announced monthly by the SBV, it is now not much more than a signal to the market of policy intention rather than having the necessary influence over commercial borrowing rates.



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