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Vietnam – Implications of rating downgrade

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- Latest downgrade by Moody's to reinforce market worries over VND depreciation
- Central bank will need to consider hiking rates and to allow orderly VND depreciation
- We do not expect contagion to the rest of the region from Vietnam's financial turbulence
- We expect further VND devaluations on BoP dynamics, rising CPI inflation and policy
- We reiterate our bearish outlook on the local-currency government bond market

Summary

Rating downgrade to reinforce market concerns over VND depreciation

On 15 December, Moody's downgraded Vietnam's foreign-currency rating from Ba3 to B1, with a negative rating outlook. This follows Fitch's downgrade to B+ in July 2010. S&P's foreign-currency rating for Vietnam is now BB, two notches above those of Moody's and Fitch. With S&P's rating outlook at negative, the risk of a downgrade in the near term has risen considerably following Moody's latest action.

The Moody's downgrade is likely to reinforce the prevailing negative sentiment towards the Vietnamese dong (VND). The distressed debt situation at a state-owned enterprise, cited by Moody's as one of the reasons for the downgrade, will also affect market sentiment in the near term. We expect the authorities to continue to opt for further one-off devaluations of the VND over the next 12 months, with the official USD-VND exchange rate reaching 20,800 by end-2011. The latest Moody's action underlines our bearish outlook for VND bonds. Foreign interest in the onshore bond market has waned significantly, and the downgrade underpins our view that foreign demand will remain poor. With inflation on the uptrend and further rate hikes expected in 2011, we expect 2Y yields to climb to 11.25% in Q1-2011 and 12.00% in Q2-2011, from 10.8% currently.

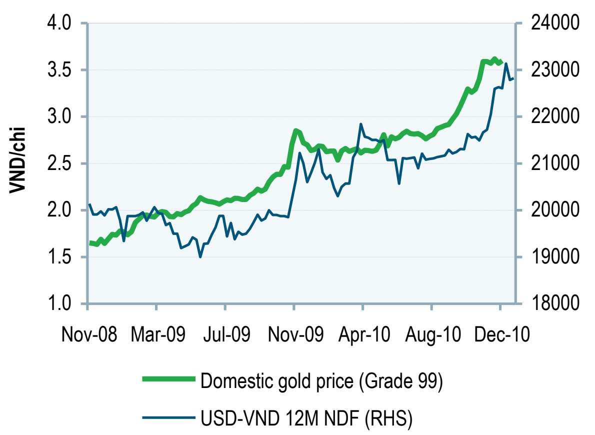
It is important to stress that Vietnam's currency stress is unlikely to spill over to the rest of the region. While Vietnam suffers from a shortage of foreign exchange reserves, other South East Asian economies have a large stock of reserves, at a combined USD 646bn for Singapore, Malaysia, Indonesia, Thailand and the Philippines. In fact, several central banks, including those of Thailand and Indonesia, are trying to manage sizeable foreign inflows and the resulting currency appreciation pressure. These countries are also running healthy current account surpluses, whereas Vietnam has been running a trade deficit to support economic development and rising consumption.

Important disclosures can be found in the Disclosures Appendix

A shortage of foreign-currency reserves and confidence

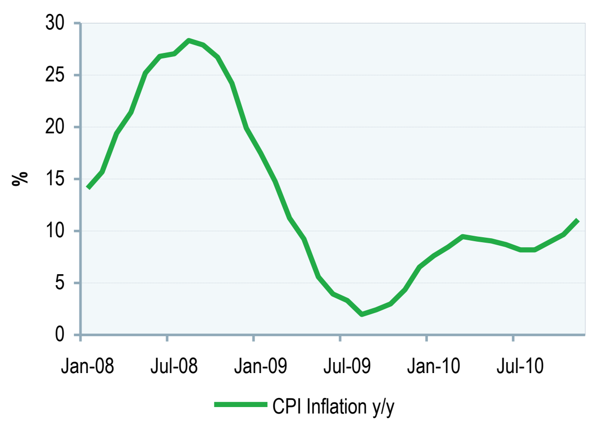
Even before the rating downgrade, the VND was already in a position of weakness in terms of investor confidence. Higher gold prices (Chart 1) and rising inflation, which breached 10% y/y in November (Chart 2), have prompted local investors to switch from the VND to gold and USD. (In the absence of a better reflection of the parallel USD-VND exchange rate, we use the USD-VND 12M non-deliverable forward, or NDF, to illustrate market perceptions; however, we note that the liquidity in this market is thin.) The inflation surge in recent months has been led by food and transportation costs. Due to the erosion of the value of the VND and competition from gold and USD, Vietnam's FX reserves have stabilised at around 1.8 months of imports, according to the IMF. By our calculation, this translates into around USD 12bn of reserves, based on the average monthly import value for the first 11 months of 2010. The low level of FX reserves does little to support confidence in the VND.

Chart 1: Higher local gold price puts downward pressure on VND



Sources: CEIC, Standard Chartered Research

Chart 2: Inflation is on the rise again in Vietnam



Sources: CEIC, Standard Chartered Research

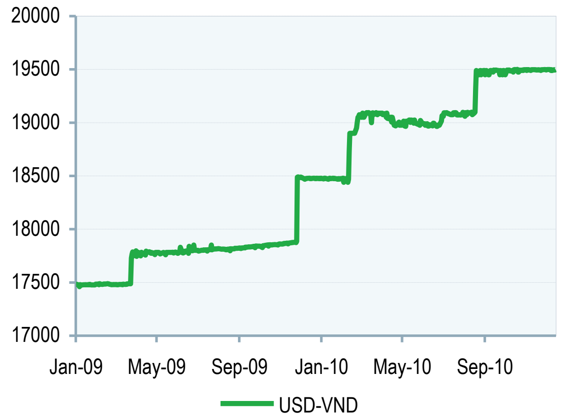
While market sentiment is clearly fragile, one needs to put Vietnam's balance-of-payments position in perspective. The trade deficit is likely to reach USD 12bn in 2010, compared with projected overseas remittance inflows of around USD 7bn. Meanwhile, disbursed foreign direct investment (FDI) was reportedly USD 10bn for the first 11 months of the year, and overseas development assistance (ODA) will total around USD 4.3bn. So while Vietnam's external position is in a delicate balance, it is not necessarily in crisis mode.

The Moody's downgrade is justified by factors beyond the rise in inflation and the country's balance-of-payments position. Rapid lending growth in 2009 and 2010 to support economic expansion has led to a possible deterioration of credit quality in the banking sector. The lack of public data on this front makes assessing such risks a challenge. Meanwhile, Moody's also cited the distressed debt situation at a state-owned enterprise as a factor that could weaken the government's ability to support other SOEs in meeting their external debt obligations. This could in turn undermine international investor confidence in debt raised by the Vietnamese government or SOEs.

Policy response – higher rates and orderly currency depreciation are needed

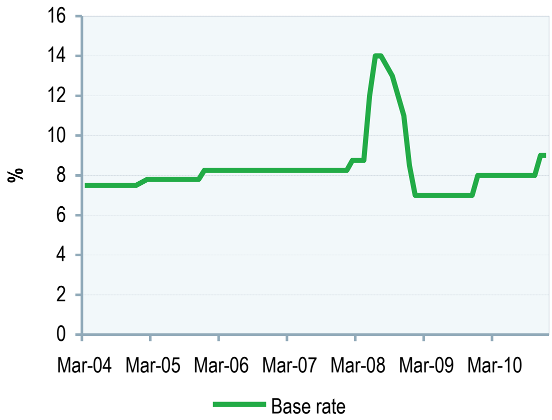
Given that Vietnam's inflation is likely to remain elevated in the short term due to year-end and Tet (Lunar New Year) spending, the VND is likely to remain under pressure. While the easing of gold prices may have provided some relief, this is an exogenous factor rather than a domestically determined one (though the government has tried to cool gold prices by relaxing restrictions on gold imports). The government could allow the currency to depreciate in steps, as it has done in the past 12 months, or raise interest rates to make the VND more attractive to hold. The State Bank of Vietnam (SBV) capped the deposit rate at 14% on 15 December. While this could be adjusted higher, the central bank's action can be interpreted as a desire to keep interest rates at reasonable levels without allowing them to spike.

Chart 3: SBV has devalued the VND in steps



Sources: Bloomberg, Standard Chartered Research

Chart 4: Base rate may need to rise further

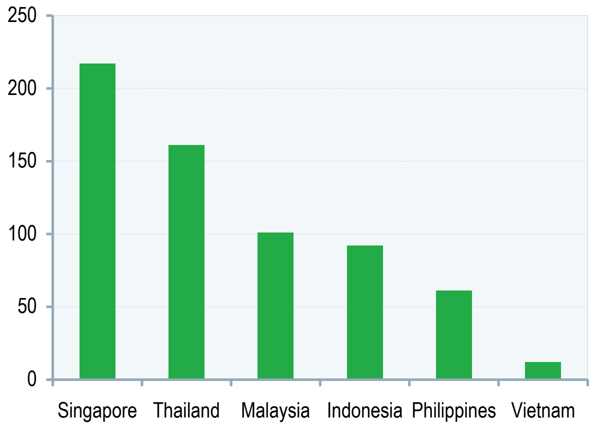


Sources: CEIC, Standard Chartered Research

Implications for the region – an exceptional case

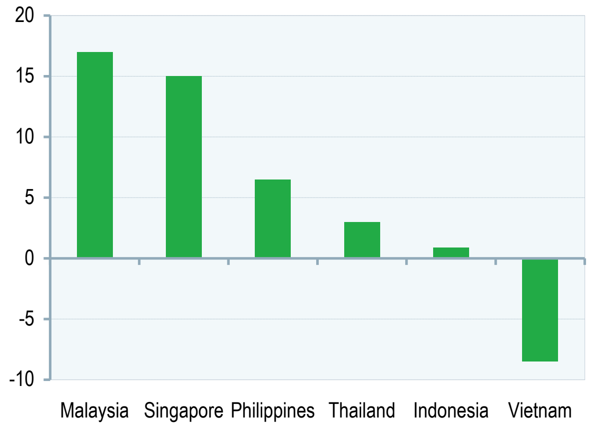
We believe the current financial stress in Vietnam should have a limited impact on the rest of the region. Some of the root causes of Vietnam's problem are unique to the country. Other South East Asian economies have much larger FX reserves (Chart 5) and current account surpluses (Chart 6), while Vietnam has low FX reserves and a current account deficit. Moreover, these economies have seen considerable capital inflows and, subsequently, currency appreciation. In fact, Thailand and Indonesia have implemented measures to stem short-term capital flows and limit currency appreciation, albeit with limited success. International investors are fully aware of these differences. Moreover, foreign participation in local markets has been low in Vietnam since the bond-market crash in 2008, and VND depreciation has been largely driven by domestic investor sentiment, in our view. As such, the risk of contagion to other South East Asian countries from further VND devaluations is limited, in our view.

Chart 5: FX reserves in South East Asia *(USD bn)*



Sources: Bloomberg, Standard Chartered Research

Chart 6: Current account balance in 2010 *(% of GDP)*



Sources: CEIC, Standard Chartered Research

FX economics

We forecast that Vietnam's GDP growth will accelerate to 7.2% in 2011 from 6.7% in 2010 due to robust domestic demand. We expect CPI inflation to rise to 10.5% in 2011 from 8.9% in 2010 on rising commodity prices; the SBV is likely to raise interest rates in Q2, with rates peaking at 11% in Q3 (versus 9% currently). While the trade deficit has stabilised since H1-2008, the risk is that the deficit will widen again in 2011 amid strong domestic demand and higher commodity prices. Inflows from FDI, inward remittances and ODA may cover the shortfall, but overall balance-of-payments dynamics are likely to turn less favourable in 2011 than in 2010. We note that Vietnam's ratio of estimated FX reserves to average monthly imports is very low, at 1.8 months.

FX outlook

We have short- and medium-term *Neutral* FX ratings on the VND; this largely reflects the fact that USD-VND forwards (both deliverable and non-deliverable) already factor in substantial VND depreciation. We forecast further one-off VND devaluations throughout 2011 on deteriorating external balances, higher CPI inflation and FX policy. We see balance-of-payment dynamics turning less favourable for the VND in 2011 than in 2010, which is a concern given the low level of FX reserves. Moreover, there is a substantial risk that the market will perceive the SBV as falling behind the curve in raising interest rates. This recalls the experience of late 2007 and early 2008, when the SBV was slow to react to a sharp rise in CPI inflation, which triggered a sharp sell-off in local asset markets and the VND. Finally, the SBV's credibility is low, as the central bank has on a number of occasions devalued the VND immediately after pledging to keep USD-VND stable. We forecast that the official USD-VND exchange rate will rise to 20,800 at end-2011.

Table 1: Standard Chartered Bank USD-VND forecasts

	End- Q4-10	End- Q1-11	End- Q2-11	End- Q3-11	End- Q4-11
USD-VND	**19,900**	**20,000**	**20,400**	**20,500**	**20,800**
Forward (mid)	*20,974*	*21,600*	*22,147*	*22,620*	*23,185*

Source: Standard Chartered Research

FX strategy – corporates

Transaction risk

USD-VND onshore forwards are currently indicated at 21,600 at end-Q1-2011, 22,147 at end-Q2, 22,620 at end-Q3 and 23,185 at end-Q4 (mid), respectively. These levels are substantially above our USD-VND forecasts, especially for longer tenors. However, risk-averse corporates may want to factor in the risk of sharper VND devaluations than we forecast. As such, risk-averse Vietnamese importers should maintain high hedge ratios on USD payables. The same is the case for euro (EUR) and Japanese yen (JPY) payables. For Vietnamese exporters, the opposite conclusions apply.

Translation risk

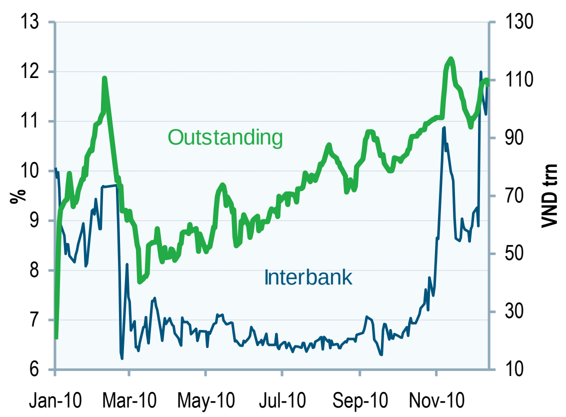
With respect to translation risk, we expect the VND to continue to depreciate versus the USD over the coming year, and the risk is for sharper depreciation than we anticipate. As such, we advise USD-based clients to maintain high hedge ratios for VND-denominated assets. EUR-, GBP-, AUD-, NZD- and JPY-based corporates should also maintain high balance-sheet hedges of VND-denominated assets. Only when Vietnam's balance of payments has become more favourable and the SBV has stopped repeated devaluations will we advise global corporates to lower their VND balance-sheet hedges. Similarly, Vietnamese corporates with G10 subsidiaries should maintain low balance-sheet hedges on G10 currencies.

Rates – Upward pressure on government bond yields to continue through H1-2011

We reiterate our bearish outlook for the VND government bond market through H1-2011. We expect heightened market expectations of further rate hikes (on the pick-up in inflation, the widening trade deficit and increasing pressure on the currency) to undermine the local-currency bond market. The Moody's rating downgrade will not have a direct impact on bonds, as foreign participation in the market has been minimal since 2008. The market reaction was similarly muted following Fitch's rating downgrade in July 2010, although domestic sentiment then was well supported by the SBV's accommodative monetary policy, still-benign inflation, and the strong economic growth outlook. The impact of the Moody's downgrade on the bond market will instead take the form of heightened pressure on the VND, leading to a greater pick-up in imported inflation. The SBV is already at risk of falling behind the curve, as CPI inflation has gained pace in Q4-2010.

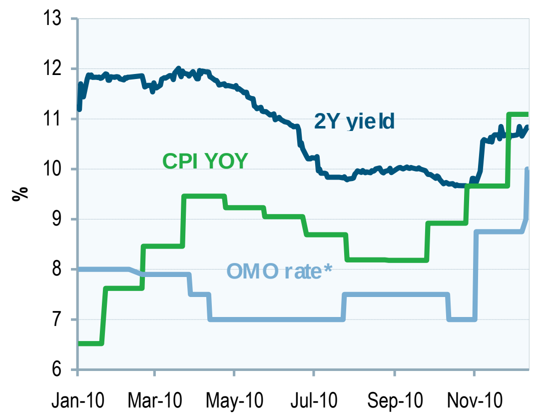
Further rate hikes by the SBV will add upward pressure on bond yields and money market rates. Against its earlier rhetoric, the SBV hiked the base policy rate in November 2010, triggering a rise in bond yields across the curve and a spike in interbank overnight rates. Liquidity conditions have remained tight, with the SBV having to push the outstanding open-market operations (OMO) amount to above VND 100trn (see Chart 7). The SBV also increased the 7-day OMO funding rate to 10% from 7% in October. While the requirement for banks to hold government bonds as the underlying asset for repos with the central bank is providing support to the bond market, the pick-up in the OMO rate has narrowed spreads between bond yields and the OMO rate. To illustrate, the 2Y bond yield to the 7-day OMO rate is now only 80bps, versus 320bps in June (see Chart 8). Money market rates may remain elevated until the Tet holiday in early February 2011. With CPI inflation on the uptrend, further rate hikes expected, and tight liquidity, we forecast that 2Y yields will rise to 11.25% in Q1-2011 and 12.00% in Q2-2011, from 10.8% currently.

Chart 7: SBV has provided liquidity through OMOs



Sources: Bloomberg, Standard Chartered Research

Chart 8: Upward pressure on VGB yield



* This rate is constructed from both 7-day and 14-day OMO rates; Source: Bloomberg

Disclosures Appendix

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