Standard Chartered

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Vietnam – Vietnamese dong devalued

- **The Vietnamese dong is effectively devalued by 7.2%, with trading band narrowed to +/-1%**
- **Timing of the move is in line with our expectations; our end-2011 VND forecast has been reached**
- **Higher interest rates are still needed to maintain price stability and prevent further VND sell-offs**

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The State Bank of Vietnam announced on 11 February that the official USD-VND rate will be devalued from 18,932 to 20,693, with the trading band narrowed from +/-3% to +/-1%. This implies that the new official USD-VND ceiling is 20,900, up from 19,500.

The timing of the devaluation is in line with our expectations (see **On the Ground, 27 January 2011, 'Vietnam – Time to act'**), although the magnitude is greater that forecast. Today's devaluation implies that our previous end-2011 USD-VND forecast of 20,800 has been reached. Table 1 shows our revised FX forecasts, along with our economic and government bond yield forecasts. In our view, the Vietnamese dong (VND) will remain under pressure throughout 2011 given the delicate balance of the country's balance of payments, rising CPI inflation and the growth bias of the Vietnamese authorities.

The credibility of the State Bank of Vietnam (SBV) needs improvement given repeated one-off devaluations. Following today's large move, which effectively takes USD-VND close to where the parallel market was trading before the devaluation, we expect the authorities to keep USD-VND roughly stable near-term. However, we continue to expect one more devaluation in H2-2011 as rising CPI inflation, a widening trade deficit and low exchange rate credibility continue to put weakening pressure on the VND. In line with this, we have adjusted our USD-VND forecasts modestly higher, while maintaining the same profile. We now forecast USD-VND at 20,900 at end-Q1, 20,900 at end-Q2, 21,800 at end-Q3 and 21,800 at end-Q4. The latest devaluation has had little direct impact on government bonds, as offshore involvement has been marginal and demand from domestic banks remains robust.

Table 1: Standard Chartered quarterly and annual forecasts for Vietnam

Forecasts (end-period)	Q4-10A	Q1-11	Q2-11	Q3-11	Q4-11	2010A	2011	2012	2013
Real GDP (%, y/y)	7.7	6.9	7.5	7.2	7.1	6.8	7.2	7.0	6.5
Inflation (%, y/y)	10.8	11.8	12.6	14.3	12.9	9.2	12.9	9.5	8.0
Base Rate (%, year-end)	9.0	10.0	11.0	12.0	12.0	9.0	12.0	12.0	10.0
USD-VND (end-period)	19,500	20,900 (20,000)	20,900 (20,400)	21,800 (20,500)	21,800 (20,800)	19,500	21,800 (20,800)	22,000 (21,800)	21,500 (20,500)
2Y VGB yield (%,end-period)	10.7	11.75	12.25	12.50	12.50	10.70	12.50	-	-
5Y VGB yield ((%, period end)	11.3	12.00	12.5	12.75	12.75	11.3	12.75	-	-

Sources: CEIC, Standard Chartered Research

We warned in late January that a devaluation could come after Tet; the authorities will now need to tighten monetary policy to anchor inflation expectations and protect the VND

The latest devaluation should calm the market, for now

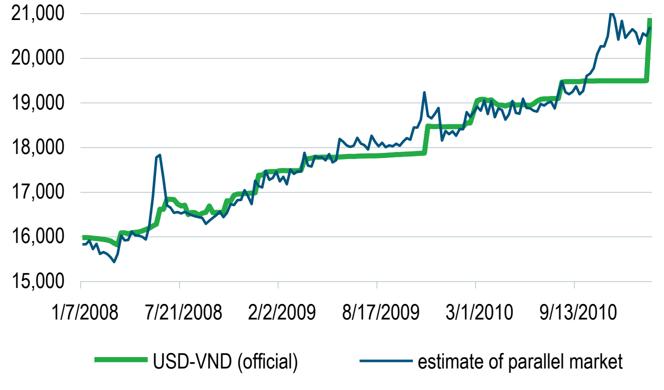
The latest devaluation implies that the official ceiling has moved much closer to the market clearing level seen in the parallel market. Ahead of the announcement, USD-VND was trading at around 21,300 in the parallel market. We predicted in late January that a devaluation could take place after Tet (the Lunar New Year), but the magnitude of the move – with the exchange rate ceiling rising by 7.2% – was larger than expected. Subsequently, the USD-VND official exchange rate has already exceeded our 2011 year-end forecast of 20,800.

The latest policy announcement should provide further relief to the balance of payments, and ease downward pressure on the foreign exchange reserves. Local media reported on 9 February that foreign exchange reserves had declined to around USD 10bn from USD 16bn at the end of 2009. However, the latest devaluation could also lead to higher imported inflation in the months ahead, especially when combined with rising global commodity prices. While the central bank remains comfortable with the current level of interest rates, we see a need for higher rates in order to pre-empt economic overheating risks. After all, one of the reasons why local investors have switched from VND into USD and gold is to protect themselves from inflation. Without credible actions to maintain price stability, local investors may continue to switch out of VND assets into other currencies and assets.

Government bond market – strong demand from banks

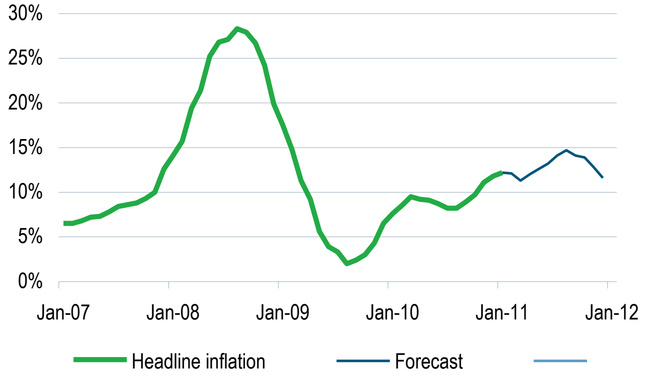
VND devaluation has had little direct impact on the local-currency government bond market. Offshore involvement is marginal, and demand from domestic banks remains strong as tight liquidity conditions begin to soften after Tet. The SBV has maintained liquidity injections into the market via open-market operations, and interbank funding rates – which edged up in January – are beginning to ease. We expect strong demand from banks to support yields in the near term; however, risks are to the upside if a weaker VND adds to imported inflation. Overall, in line with our forecasts of high inflation and 300bps of rate hikes in 2011, we maintain our bearish view on the government bond market.

Chart 1: Latest devaluation matches expectation in parallel market



Sources: CEIC, Standard Chartered Research

Chart 2: Vietnam headline inflation to rise further



Sources: CEIC, Standard Chartered Research

Disclosures Appendix

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