

On the Ground | 02:15 GMT 21 June 2011

## Vietnam – Trip notes from Hanoi and Ho Chi Minh

- Inflation fight is the main focus; interest rates are likely to remain high in H2-2011
- Austerity measures are leading to slowing activity in the banking sector and the real economy
- We have pushed back our call for VND devaluation to 2012 from Q3-2011 previously
- We are mildly bullish on the government bond-market outlook in H2-2011 on robust domestic demand

### Summary

In a recent report, we discussed the initial success of the government's monetary policy tightening and de-dollarisation measures in stabilising the economy and financial markets (**On the Ground, 25 May 2011, 'Vietnam – Looking for the right entry point'**). However, slowing growth is challenging the government's resolve to implement and maintain these measures. We visited Hanoi and Ho Chi Minh from 13-16 June to meet with government officials, state-owned banks, and local and multinational corporate clients. We saw signs of slowing activity on the ground. Members of the banking and business communities voiced concerns over slower credit disbursement and high interest rates. Nonetheless, the government indicated its commitment to maintaining its austerity measures in H2-2011.

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We have pushed back our call for further Vietnamese dong (VND) devaluation to 2012 from Q3-2011. We view de-dollarisation measures as essential to anchoring demand for US dollars (USD) and gold, and are confident that the government will maintain its current monetary stabilisation measures through H2-2011. That said, we are not yet confident enough to call the bottom of the VND at this stage. The authorities' austerity measures so far have been appropriate and have helped to provide stability. However, we will closely watch how this tightening is unwound in 2012 as inflation eases. The unwinding of tight monetary policy could induce more volatility in 2012. In addition, balance-of-payments (BoP) dynamics and low FX reserves remain significant medium-term challenges.

We switch to a mildly bullish stance on the government bond market (from a bearish stance), as yields appear to have peaked in early May. Demand from domestic banks will remain strong, easily absorbing the limited supply slated for the rest of 2011. Meanwhile, high bond returns (just above 12% for the 2-5Y tenors) and expectations of USD-VND stabilisation are reviving foreign investors' interest in the local-currency bond market. We expect inflows to the market to spark a further fall in yields.

**Table 1: Standard Chartered quarterly and annual forecasts for Vietnam**

	Q4-10A	Q1-11A	Q2-11	Q3-11	Q4-11	2010A	2011	2012
Real GDP (% y/y)	7.7	5.4	6.2	6.4	6.5	6.8	6.3	7.0
Inflation (% y/y)	10.8	12.8	19.2	22.1	20.7	9.2	18.7	8.5
Refinance rate (% end-period)	9.0	12.0	14.0	14.0 (16.0)	14.0 (16.0)	9.0	14.0 (16.0)	10.0 (14.0)
USD-VND (end-period)	19,500	20,900	20,600 (20,900)	20,600 (21,800)	20,600 (21,800)	19,500	20,600 (21,800)	22,000
2Y VGB yield (% end-period)	10.70	12.35	12.35 (14.0)	12.00 (14.3)	12.00 (13.5)	10.70	12.00 (13.5)	-

Source: Standard Chartered Research



*The SBV has the government's support to maintain tight monetary policy in H2-2011*

## Economic stability, not growth

The State Bank of Vietnam (SBV) has a clear objective this year: to facilitate economic stability, not growth. With y/y inflation at 19.8% in May and still rising, the SBV's key challenge in H2-2011 will be to reduce inflation to its target of 15% y/y (average for the year). Meanwhile, the government has cut its 2011 GDP growth target to 6.0% from 7.5%.

To recap, the SBV has introduced the following measures this year: it instructed banks to limit credit growth to 20% y/y (applicable to all banks at all times); hiked the benchmark refinance ('refi') rate by 500bps to 14% from 9% at the beginning of the year; and lowered interest rate caps on USD corporate and individual deposits to curb demand for USD, in an effort to support the VND and reduce imported inflationary pressure.

We expect m/m inflation to have peaked in May, thanks to tightening measures and stabilising global food and oil prices. On a y/y basis, inflation could surge further to 22% in Q3-2011 before easing towards 20% in Q4. Given concerns about growth and the business environment, we have revised our refi rate forecast and now expect the rate to remain at 14% for the rest of 2011. However, we do not expect interest rates to be reduced materially until inflation eases significantly. We expect inflation to return to single digits in Q2-2012.

*There is a growing understanding within the government that it should distinguish between saving the economy from a hard landing and allowing inefficient companies to survive*

## Bad debt and weak business sentiment weigh

The government's push to stabilise prices is drawing close scrutiny as the banking and business communities raise concerns about high borrowing costs. As tighter monetary policy translates into higher lending rates and lower loan availability for corporations, banks' non-performing loans are growing at an alarmingly high rate of 1-2% m/m. The SBV's latest banking-industry report on 10 June indicated that YTD aggregate credit growth was on track at 7.05%, but that credit growth at the country's 14 banks had exceeded the 20% limit in May, and that these banks would need to reduce their outstanding loans.

While monetary austerity measures may cool growth in the near term, low inflation and FX stability are critical to attracting FDI. Short-term weakness in growth is therefore probably a price worth paying, and could help to build the authorities' credibility in ensuring macroeconomic stability rather than pursuing growth at all costs.

There is a growing understanding among technocrats and leaders of state-owned banks that lower credit growth can still sustain healthy GDP growth if more credit is channelled to productive sectors such as agriculture and manufacturing, and less goes towards non-productive sectors and speculative assets. Furthermore, complaints about hardships faced by the business community need to be assessed further to determine whether the government needs to step in to save the economy from a hard landing, or if it should allow less competitive companies to fail or be restructured.

## FX economics

On the ground in Hanoi and Ho Chi Minh City, there is an expectation that de-dollarisation measures will stabilise the USD-VND exchange rate, at least until the end of 2011. The key drivers of VND depreciation since April 2008 have been: (1) negative BoP dynamics and low FX reserves; (2) high CPI inflation and loose monetary policy; and (3) low policy credibility. Below, we assess whether these factors have turned more constructive for the VND.

### Balance of payments

Vietnam's BoP deficit narrowed to USD 35.8mn in Q3-2010 from USD 351.6mn in Q2-2010. This compares with the record BoP deficit of USD 4.165bn in Q2-2008 (see Chart 1). The improvement in Vietnam's deficit largely reflects an improvement in the current account (C/A) goods deficit to USD 733mn in Q3-2010 from USD 7bn in Q1-2008. The trade deficit stands at USD 6.59bn year-to-date (as of May 2011) – in line with our full-year forecast of USD 12-15bn, or around 13% of GDP.

The monthly trade deficit has increased in recent months, reaching a three-month moving average of USD 1.50bn in May. This is by no means alarming compared with the monthly average deficit of USD 2.5-3bn in H1-2008, but it should be monitored closely, as there is a risk of further widening given strong domestic demand and high energy prices. The overall BoP may improve in 2011, as a larger C/A deficit should be balanced by rising C/A transfers and FDI (see Table 2). In addition, portfolio inflows to Vietnam may pick up given monetary tightening and peaking CPI inflation.

*The BoP is less of a negative now than in H1-2008, but a widening trade deficit and low FX reserves remain medium-term challenges*

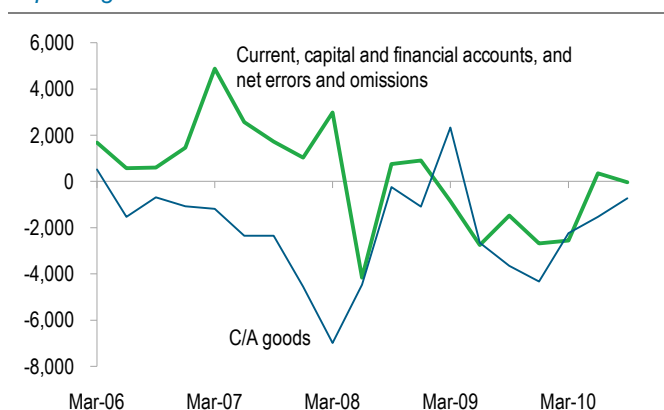
The level of FX reserves is a key factor in assessing the VND. According to the IMF, Vietnam's FX reserves rose by USD 0.9bn in May to 13.5bn (see 'Vietnam – Informal Mid-Year Consultative Group Meeting, 8-9 June 2011', IMF). Recent appreciation pressure on the VND is an encouraging sign, as it implies that the authorities have been able to replenish the FX reserves. However, as of May 2011, the FX reserves amounted to only 1.42 months of imports. In sum, the BoP appears to be less of a VND negative than it was in H1-2008 and 2009, but is a more significant concern than in Q4-2008 and H1-2010, when the VND was also devalued despite the fact that the BoP was in surplus. Overall, we believe Vietnam's BoP remains a significant concern given the risk of a further widening of the trade deficit and low FX reserves.

### Inflation and monetary policy

May CPI inflation came was 2.21% m/m and 19.8% y/y, versus 3.32% m/m and 17.5% y/y in April. This was the highest y/y reading since December 2008. The three- and six-month moving averages for the m/m rate now stand at 2.25% and 2.57%, respectively. Since January, the SBV has raised the refi rate to 14% from 9%. More importantly, since February, the authorities have imposed caps on USD deposit rates of 2% for individuals and 0.5% for non-credit institutions. (At the beginning of the year, there was no cap on deposit rates for individuals, and the limit was 1% for non-credit institutions.) The SBV's latest banking operations bulletin for April 2011 put the

**Chart 1: Current and capital account (USD mn)**

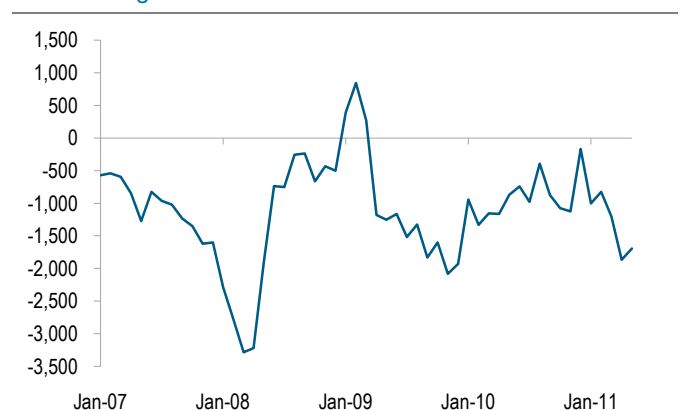
*Improving*



Sources: IMF, Standard Chartered Research

**Chart 2: Monthly trade deficit (USD mn)**

*Deteriorating*



Sources: Bloomberg, Standard Chartered Research



average VND deposit rate at 13.41%, below the SBV's recommended ceiling of 14%, although there are reports of banks paying more to attract deposits. In addition, the authorities have imposed limits on gold trading and the use of gold in financial transactions in order to mitigate the use of gold as medium of exchange.

*Widening USD-VND deposit rates and restrictions on gold trading have reduced incentives to hoard USD and gold, curbing VND depreciation pressure*

The combination of widening VND-USD deposit rates and restrictions on gold trading has reduced incentives to hoard USD and gold, countering depreciation pressure on the VND. This is evident in the spread between the formal and informal USD-VND rates, which has been positive since end-April (see Chart 3). Based on month-end levels, this is the first time since late 2009 that the USD-VND informal exchange rate has traded below the official rate. This is encouraging, and is a clear sign of rising confidence in the authorities' ability to maintain a stable USD-VND rate.

However, we note that the spread between the formal and informal USD-VND rates was also below 100 from April 2010 to June 2010; it then widened again, eventually triggering the VND devaluations in August 2010 and February 2011 (see Appendix). This was at a time when the trade deficit was still relatively narrow, the BoP was in surplus, and CPI inflation was muted compared to current levels. Hence, the spread between the formal and informal USD-VND rates only gives an indication of the current state of market pressure, not future developments. Based on the experience in 2010, as long as the spread between the official and parallel USD-VND rates is below 100, depreciation pressure is likely to be manageable.

We forecast that the SBV will keep the refi rate at 14% through the end of 2011. Meanwhile, we expect CPI inflation to peak at 22.1% y/y in Q3 before easing to 20.7% y/y by Q4. We see Vietnam's inflation and monetary policy dynamics as a short-term negative for the VND, but this factor may turn neutral in Q3, when CPI inflation peaks. Recent steps by the authorities to widen the interest rate differential between USD and VND deposits should also support near-term USD-VND stability.

### **FX policy – Near-term stability**

*Repeated VND devaluations over the past three years are part of a vicious cycle*

Over the last three years, Vietnam has repeatedly devalued the VND, at times shortly after having committed to the market to keep the currency stable (see Appendix). Most recently, on 11 February 2011, the SBV effectively devalued the VND by 7%. In our view, this policy of repeated devaluations partly reflects a desire to narrow the trade deficit, but is also a response to market pressures for further devaluation. This has created a vicious cycle where market players hoard USD and gold in anticipation of further devaluations, which in turn creates the conditions for further devaluations.

A key question is whether the Vietnamese authorities now have the willingness and the ability to maintain a stable exchange rate. The low credibility of their exchange rate policy over the last three years has been closely linked to the low credibility of monetary policy. As such, a key factor for the exchange rate is whether the authorities are committed to maintaining the current relatively tight monetary policy for an extended period. Our on-the-ground impression is that they are committed to keeping the current interest rate policy in place for the rest of the year, and to maintaining a stable USD-VND exchange rate as long as depreciation pressures do not re-emerge. As such, Vietnam's monetary and exchange rate policies currently appear to be less of a VND negative than they have been for the last three years.

## FX outlook

*We are pushing back our call for further VND devaluations to 2012 from Q3-2011 to reflect recent monetary stabilisation measures*

In light of the government's resolve to maintain monetary stabilisation measures in H2-2011, we revise our USD-VND forecast, pushing back our expectations of a further devaluation to 2012 from Q3-2011. We now forecast USD-VND at 20,600 at end-Q3-2011, 20,600 at end-Q4-2011, 21,400 at end-Q1-2012, 21,400 at end-Q2-2012, 22,000 at end-Q3-2012, and 22,000 at end-Q4-2012. The change in our FX forecasts reflects encouraging steps by the Vietnamese authorities to tighten monetary policy and their commitment to maintaining a stable exchange rate. However, significant risks remain, including rising CPI inflation, a widening trade deficit, low FX reserves, and the risk of new policy mistakes. Hence, we maintain our view that depreciation pressure will resume in 2012, when we factor in VND devaluations of 6.8%. This is comparable to the magnitude of average yearly VND devaluation from 2008-10.

## FX strategy

### Real money funds

*Real money funds should keep VND exposures unhedged*

Offshore investors can only access the onshore USD-VND spot market, not the forward market. Hence, they have to hedge VND risk through the non-deliverable forward (NDF) market. The USD-VND NDF market is highly illiquid. In addition, the USD-VND 3M, 6M and 12M NDFs (mid-level) are currently indicated at 20,925, 21,445 and 23,125, respectively – significantly above our forecasts. Hence, real money fund investors, which invest in (for example) Vietnamese government bonds, should keep their currency exposure unhedged.

### Corporates – Transaction risk

USD-VND 3M, 6M and 12M end-Q3-2011 onshore forwards are currently indicated above our USD-VND forecasts. However, we acknowledge the risk that the VND may depreciate more than is priced into our forecasts. Hence, we recommend that risk-averse Vietnamese importers 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.

**Table 2: Vietnam's external balances\***

*Inflows should balance rising trade deficits*

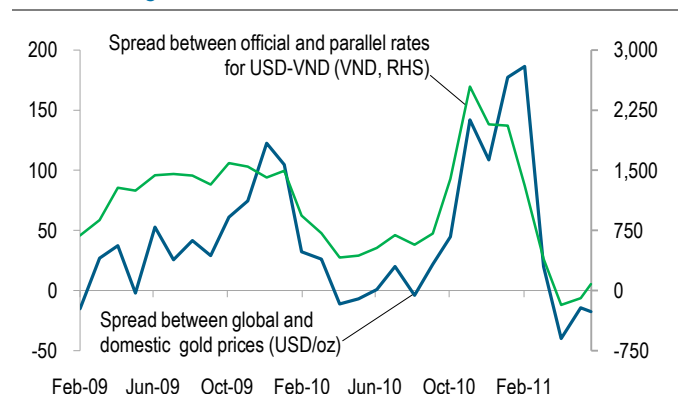
	C/A	C/A transfers	FDI
2007	-6,953	6,430	6,700
2008	-10,787	7,311	9,579
2009	-6,116	6,448	7,600
2010	-4,000	7,800	8,000
2011	-5,500	8,000	9,500

\* 2010 and 2011 numbers are our forecasts

Source: Standard Chartered Research:

**Chart 3: Confidence in the VND is stable for now**

*Demand for gold and USD eases*



Sources: Reuters, Saigon Jewellery Company



### Corporates – Translation risk

With respect to translation risk, we expect the VND to depreciate again in 2012, and the risk is for a 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 BoP has become more favourable and the FX reserves have reached a more comfortable level 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.

### Government bond yields look to have peaked this year

We switch to a mildly bullish stance on the government bond market, from a bearish stance. We believe yields have peaked for this year, and robust domestic demand will stabilise bond yields ahead of the peak in y/y inflation in Q3-2011. Rough estimates suggest that domestic demand is sufficient to absorb supply in 2011, and constructive supply dynamics will lend support to the bond market if inflation surprises to the upside.

*Constructive demand-and-supply dynamics support the bond-market outlook*

Expectations of a peaking in the policy rate and flush liquidity, along with policies to limit the loan-to-deposit ratio to below 80%, cap credit growth at 20% y/y, and impose a minimum quick ratio (the ratio of total liquid assets over total liabilities) of 15% have been constructive for the local government bond market. Strong demand from banks has driven 2-5Y yields 150bps lower since early May, despite the hike in the refi rate in May (to 14% from 13%).

Banks need to buy VND 36trn worth of VGBs and T-bills to replace maturing inventory. Besides replacing maturing inventory, we analyse potential new demand for bonds brought by the above-mentioned changes in the SBV's banking regulations. A 20% y/y increase in commercial banks' bond portfolio this year (including corporate and government bonds), to match the growth in asset and client loans, would translate into VND 40trn of new demand for bonds. Meanwhile, the loan-to-deposit ratio of the banking industry stood at 107.5% in August 2010, according to a Business Monitor International report. Every 1ppt reduction in this ratio is equal to VND 20trn of demand for other assets, including government bonds.

On the supply side, we estimate total planned 2011 issuance of VGBs and T-bills at VND 65trn (about 70% of domestic financing requirements); this number is likely to be lower if the budget deficit is cut from 5.3% to 5.0% of GDP as a result of fiscal consolidation efforts. Year-to-date issuance has amounted to VND 31.2trn.

*Without offshore inflows, the extent of any further rally in bonds will be limited*

In the current tightening cycle, we expect 1-3Y yields to find a floor at around 12% in Q3-2011. While demand is robust, the high-interest-rate environment will limit the scope of the rally in government bonds. We do not expect government bonds to rally strongly going forward, or negative returns relative to funding rates to widen much further in the absence of offshore inflows. To illustrate, the 2Y VGB yield is currently at 12.35%, while the refi rate is at 14%, the reverse repo rate (with the SBV) is at 15%, and the VND official deposit rate cap is 14%. Liquidity in the interbank market has markedly dropped in the past month, with the overnight lending rate now at 11-12%.



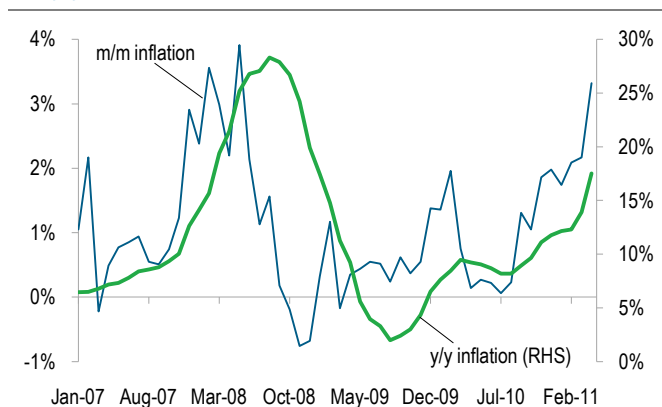
## Entry opportunities for offshore investors

We outlined four investment entry conditions for offshore investors in our recent report (**On the Ground, 25 May 2011, 'Vietnam – Looking for the right entry point'**): (1) the SBV maintains tight monetary policy to control inflation; (2) global food and oil prices are stable; (3) confidence in the VND persists; and (4) inflation starts to fall on a m/m basis in June 2011.

As we turn mildly bullish on the government bond market, and all of our entry market conditions look to hold in H2-11, we recommend foreign investors to enter the 1-3Y VGBs. The government has indicated its commitment to maintaining tight monetary policy in 2011, and this should sustain economic stability over the next six months. Early indications are that the m/m inflation rate should start to fall in June (from 3.3% in May), and y/y inflation should peak in Q3-2011. We have pushed back our call for another one-off 4% VND devaluation to 2012 (with a possible review depending on macroeconomic conditions). Besides the cash bond market, offshore investors may wish to take a position via access trades, such as the funded Total Return Credit Linked Notes, or the unfunded Total Return Swap, with the VGBs as the underlying asset.

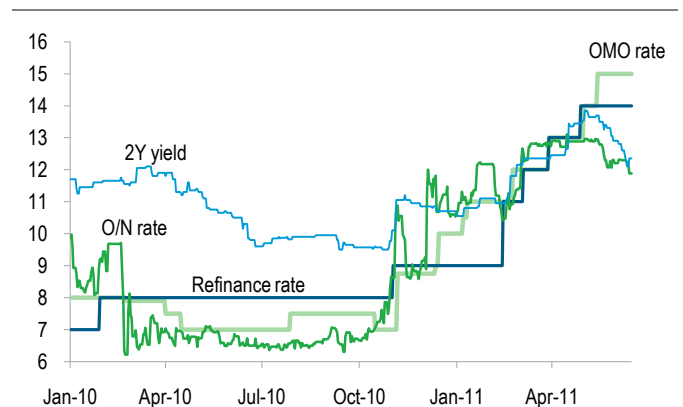
While we are encouraged by government policies to improve macroeconomic and financial-market stability, we see two key risks to investment in the local-currency bond market, and we expect them to remain high over the medium term (beyond six months): (1) High inflation, weak BoP position, low FX reserves, or a reversal of the current austerity and de-dollarisation policies could revive upside pressure on USD-VND. (2) Low trading liquidity, resulting in a high bid/ask spread, could make exit strategies prior to bond maturity costly.

**Chart 4: The fall in m/m inflation will signal the coming of the y/y inflation peak (headline inflation)**



Source: Bloomberg

**Chart 5: Bonds benefit from flush liquidity and bullish outlook (%)**



Sources: Bloomberg, Standard Chartered Research

## Appendix – Vietnam's exchange rate policy since December 2007

Date	Policy
24 December 2007	SBV widens the daily USD-VND daily trading band to +/-0.75% from +/-0.5%. USD-VND moves towards the floor of the new trading band.
10 March 2008	SBV widens the daily USD-VND trading band to +/-1% from +/- 0.75%. Initially, USD-VND moves towards the floor of the new daily trading band.
11 June 2008	SBV devalues the VND by 2% versus the USD. USD-VND immediately moves towards the ceiling of the daily trading band.
26 June 2008	SBV widens the daily USD-VND trading band to +/-2% from +/-1% with effect from 27 June 2008. USD-VND immediately moves towards the ceiling of the new daily trading band.
7 November 2008	SBV widens the daily USD-VND trading band to +/-3% from +/-2%. USD-VND immediately moves towards the ceiling of the daily trading band.
25 December 2008	SBV devalues the VND by 3% versus the USD. USD-VND immediately moves towards the ceiling of the daily trading band.
23 March 2009	SBV widens the daily USD-VND trading band to +/-5% from +/-3% with effect from 24 March 2009. Over the next three sessions, USD-VND moves towards the ceiling of the new daily trading band.
25 November 2009	SBV devalues the VND by 5.44% versus the USD and narrows the daily USD-VND trading band to +/- 3% from +/- 5%, effective from 26 November. This effectively devalues the VND by 3.44%. USD-VND immediately moves towards the ceiling of the new daily trading band.
10 February 2010	SBV devalues the VND by 3.25% versus the USD with effect from 11 February 2010. Over the following weeks, USD-VND moves towards the ceiling of the daily trading band.
17 August 2010	SBV devalues the VND by 2% versus the USD. USD-VND immediately moves towards the ceiling of the new daily trading band.
11 February 2011	SBV devalues the VND by 8.5% versus the USD and narrows the daily USD-VND trading band to +/- 1% from +/- 3%. This effectively devalues the VND by around 7%.

Sources: Reuters, State Bank of Vietnam, Standard Chartered Research





## Disclosures Appendix

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