ASIA PACIFIC ECONOMICS
VIETNAM UPDATE

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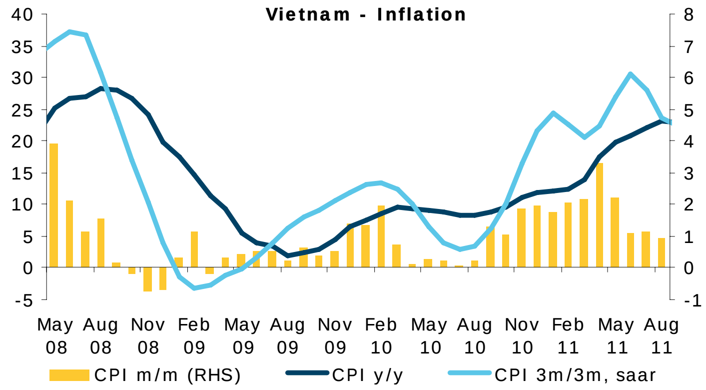
INFLATION HAS PEAKED

We are ready to make the call that Vietnam's inflation has peaked. Although the CPI rose by 23.0% y/y in August, we think that the combination of: (i) policy tightening to date; (ii) slower global and regional growth; and (iii) moderating food price inflation means that the worst is behind us. The main risk to our view is that the central bank declares victory too early and lowers rates too quickly.



Source: CEIC, ANZ Research

HEADLINE INFLATION STILL RISING, BUT MOMENTUM IS CLEARLY EASING

August CPI inflation rose to 23.0% y/y from 22.2% in July, the highest level since November 2008.[1]

- **Inflation rose in nearly all categories**. Food and foodstuff prices surged 34.1% y/y, from 32.6% in July, contributing 13.6ppts to overall inflation. Transportation prices climbed 21.5%, while housing and construction materials rose 23.8%. Non-food/fuel inflation edged up to 11.0% contributing 7.5ppts to the overall inflation.
- **However, monthly inflation eased to 0.9%, the lowest reading since September last year**. Month-on-month inflation fell in all categories bar housing and construction materials and transportation. In particular, food inflation fell by 0.1% m/m, whereas foodstuff inflation declined to 0.2% from 3.2% in the previous month. Core inflation rose 0.5%.
- **Inflation momentum is also declining**. Our measure of inflation momentum fell for the second straight month to 23.6% 3m/3m, saar, from 28.0% in July. Momentum measures are useful for identifying turning points and falling momentum should therefore lower headline inflation going forward.

[1] Recent inflation developments in Vietnam have been in line with our expectations (See "Policy Tightening – Are we done yet?" 27 May 2011).

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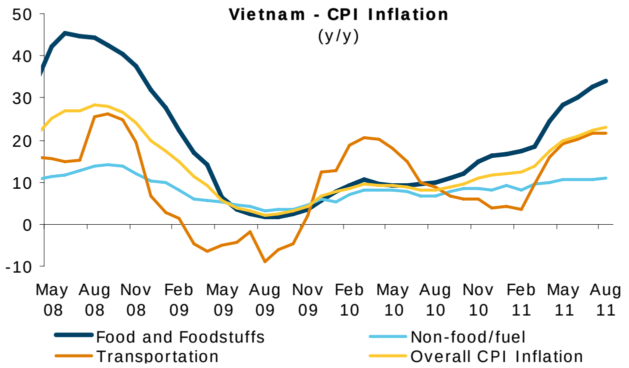

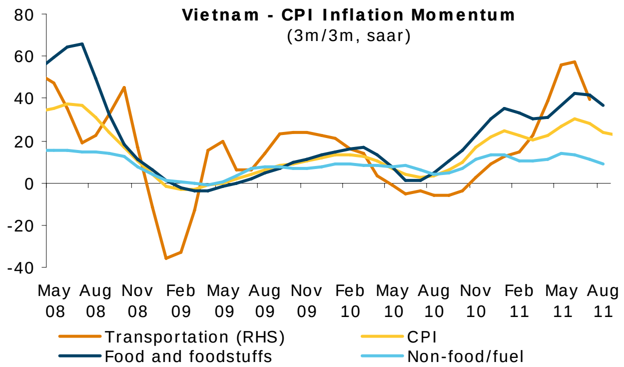

Source: CEIC, ANZ Research

WHY DO WE THINK INFLATION HAS PEAKED?

The main reason for our call is the impact of the government's tightening measures taken since February this year. After key interest rates were hiked by as much as 500bps, credit and broad money growth fell to 28.3% and 17.1% (y/y) in H1 this year, from 31.9% and 29.7% respectively. Our model suggests that 1ppt decrease in the credit growth rate results in a 0.13ppt decrease in inflation (on a quarterly, seasonally adjusted basis), with a one-quarter lag. Recent inflation momentum developments broadly match our modelling result. In addition, relatively flat core inflation in the last few months reflects the fact that underlying demand pressures are easing.

The ongoing global uncertainty may also help Vietnam in its inflation fight. Slower domestic output growth in line with slower global growth will take some pressure off domestic inflation by creating a modest amount of spare capacity (since we estimate potential growth is around 7%). Growth has already moderated to 5.6% in H1 and activity growth momentum is still modest, in line with the regional trend. We expect that full year 2011 GDP growth will moderate to 5.9% from 6.8% last year.

Moreover, easing global commodity inflation will help reduce Vietnam's imported inflation. While price levels remain high, the pace of price increases has declined recently. Food and foodstuffs contribute nearly 40% to Vietnam's CPI weight basket, while transportation costs (a proxy for fuel) contribute about 9%. As we expect food and fuel inflation will continue to moderate, external pressures on domestic inflation will fall further.

Our inflation call hinges on vigilance on the part of the State Bank of Vietnam (SBV). The SBV move to lower its policy rate from 15% to 14% in July (following a soft growth print in Q2) suggests that key policy rates are unlikely to be hiked further. While we think this move was premature, we take note of the SBV's insistance that controlling inflation remains its top priority. Thus, we expect key interest rates will be held at current levels into H1 2012 and will only be cut once inflation momentum falls into single digits. This is necessary for the government to achieve its target of bringing headline inflation back to single digit levels by the end of next year.

Going forward, we see the policy rate falling gradually to 11% by 2012-end. In the very near term, we think it is important to keep the policy rate at its current level of 14% in order to boslter central bank credibility. This profile would be consistent with lowering inflation to single digits by the end of next year. Anchoring inflation expectations in this manner would allow GDP growth of around 7%.

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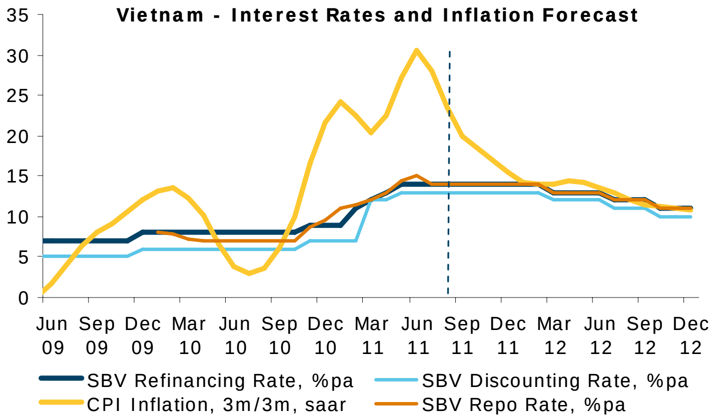

Source: CEIC, ANZ Research

RISKS TO OUR INFLATION CALL (AND WHY MANANGING EXPECTATIONS IS CRITICAL)

The main risk to our forecast is political, or the weight of political factors in setting monetary policy. Mounting domestic pressures on the government to lower nominal interest rates heighten the risk of premature policy loosening that could send inflation momentum (followed by headline inflation) higher again. The unexpected repo rate cut in July is an example, but we think the negative impact was largely neutralised by the slowdown in growth and the effects on commodity prices. However, if lending rates are reduced in September—as the new SBV Governor recently suggested—then higher credit and money growth fuelling higher inflation will ensue. In terms of the magnitude, our modelling suggests that a 1ppt cut of the average real lending rate results in roughly a 1/4 ppt increase in quarterly inflation (or 1ppt annualised). Moreover, any monetary loosening move will undermine the credibility of the government's shift in policy stance. Inflation expectations will stay elevated and it will take much longer for inflation to get back to single-digit levels.

Other risks include:

- **Food prices**. The upside risks from food prices have not abated. The rice-pledging program in Thailand and still rising food inflation in neighbouring China may disrupt the downward trend of food inflation in Vietnam.
- **Minimum wages**. These are to be hiked by 48-69% and may complicate the inflation picture. The government's decision to push ahead with its plan to increase minimum wages for non-state employees in October rather than January 2012 was due to higher-than-expected inflation that negatively affected the average worker's purchasing power. We think wage hikes will not affect our baseline inflation scenario, as most firms are reportedly paying higher wages than the new minimum requirements.
- **Gold**. Higher demand for USD to pay for gold imports will increase depreciating pressures on the dong and drive imported inflation up again. Most recently, surges in onshore gold prices above international prices spurred this demand and disrupted the dong's stability achieved in the previous three months.

Should these risks eventuate, policy rates will need to be held firm for longer so as to keep inflation expectations well anchored. Should expectations become unhinged, the result is likely to be an acceleration of agents shifting from the dong and into gold and US dollars, thereby putting further upward pressure on prices. Re-establishing monetary policy credibility under such circumstances will require tighter monetary conditions for longer, with the correspondingly negative effects on GDP and income growth. Therefore, a key objective of the SBV will be to avoid this spiral effect.

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VIETNAM – ANZ INTEREST RATES AND INFLATION FORECAST PROFILE

		AUG-11	SEP-11	DEC-11	2011	MAR-12	JUN-12	SEP-12	DEC-12	2012
SBV's refinancing rate (%pa)	Prev. Forecast	16	16	16	14.2	15	14	13	12	13.5
	New Forecast	14	14	14	13.1	14	13	12	11	12.5
CPI y/y (eop,%)	Prev. Forecast	-	22-23	16-18	18.7	15-17	12-14	10-12	9-10	12.4
	New Forecast	23.0	22.6	18-19	18.7	17-18	14-15	12-13	10-11	13.8
GDP y/y (eop,%)	Prev. Forecast	-	6.3-6.5	6.3-6.5	6.4	6.2-6.4	6.0-6.5	6.5-7.0	6.5-7.0	6.5
	New Forecast	5.7 (Q2)	6.0	6.2	5.9	6.0-6.5	6.0-6.5	6.5-7.0	6.5-7.0	6.8

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