

On the Ground | 00:30 GMT 20 October 2011

Vietnam – Confronting the same old problems

- **Headline growth has held up despite higher lending rates; inflation has peaked, as expected**
- **VND depreciation pressure requires central bank to keep monetary policy tight**
- **Tight bank liquidity is preventing local government bonds from benefiting from lower inflation**

Summary

In 2012, the authorities in Vietnam will face a similar set of challenges to previous years: depreciation pressure on the Vietnamese dong (VND), and the need to manage credit and money growth while facilitating economic activity. These efforts could be complicated by the more difficult global environment and its impact on export performance.

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Q3 economic growth accelerated to 6.1% y/y, defying the surge in borrowing costs in Q2 and Q3. This was consistent with industrial production and retail sales data. However, freight and passenger traffic showed a deceleration in Q3, suggesting that economic activity moderated more than the headline growth number suggested.

Meanwhile, headline inflation has peaked. We expect it to moderate further, albeit gradually, on the correction in global food and energy prices and slower money supply growth. We expect y/y inflation to return to single digits by late Q2 or early Q3-2012. However, slowing inflation may not create room for monetary easing in the near term given renewed depreciation pressure on the VND. The State Bank of Vietnam (SBV) raised its benchmark refinance rate by 100bps to 15% in early October to shore up the VND. Even so, the currency could depreciate further in 2012 given Vietnam's persistent current account deficit and still-low FX reserves.

Domestic factors have turned supportive of the Vietnamese Government Bond (VGB) market, with y/y inflation coming off its peak and rate cuts expected in Q2-2012. However, global financial-market uncertainty is likely to persist near-term, and while the VGB market is relatively insulated, the impact of the global turmoil has been felt indirectly through tighter interbank liquidity. We have a *Neutral* outlook on the VGB market, but we expect the yield curve out to 5Y to stay inverted amid tight liquidity conditions.

Table 1: Standard Chartered forecasts – Vietnam

Previous forecasts in brackets

	Q4-2011	Q1-2012	Q2-2012	Q3-2012	Q4-2012	2011F	2012F	2013F
GDP growth (%)	6.1	6.1	6.2	6.3	6.4	5.8	6.3	6.5
Inflation (%)	21.1	17.0	10.9	8.9	7.9	18.7	11.3	8.0
USD-VND*	21,000	21,400	21,400	22,000	22,000	20,600	22,000	-
Refi rate (%)*	15.0	15.0	14.0	12.0	11.0	15.0	11.0	9.0
2Y bond yield (%)*	12.5 (12.0)	12.0	11.0	11.0	11.0	12.5 (12.0)	11.0	10.0

* End-period; Source: Standard Chartered Research

Official growth remains strong, despite high lending rates

GDP grew 6.1% y/y in Q3

Many corporates we have spoken to on the ground indicate a much tougher operating environment due to the surge in policy rates and, subsequently, lending rates. In Q2 and Q3-2011, lending rates rose to 20-25% as a result of refi rate hikes. The 20% lending growth cap, strictly enforced by the SBV, also created a liquidity squeeze for the business sector.

Vietnam's official economic growth continued to accelerate in Q3, despite tight liquidity conditions

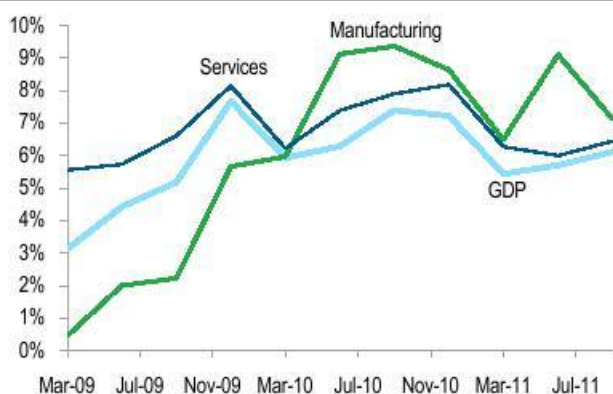
Despite these difficult conditions, Vietnam still managed decent growth in Q3, according to official data. GDP expanded 5.8% y/y for the first three quarters of 2011; according to our calculation, this puts Q3 growth at 6.1% y/y, up from 5.7% in Q2 and 5.4% in Q1. As Chart 1 shows, the growth rates of the manufacturing and services sectors converged to around 7% in Q3. This helped to offset weakness in the agriculture sector, which grew only 3.2% y/y in Q3.

Other underperforming industries included construction (+5.0%) and real estate and renting (+2.2%), reflecting sluggishness in the Vietnamese real estate sector. Meanwhile, electricity, gas and water supply (+9.9%) and education and training (+7.8%) led the pack in terms of growth rates.

Freight and passenger traffic numbers suggest a moderation in logistics activity

The headline growth performance is consistent with industrial production and nominal retail sales data. However, as a reality check on the GDP growth numbers, we look at data on freight and passenger transport (adjusted for distance travelled), and note that both decelerated in Q3. We look at these numbers because logistics data is generally viewed as easier to capture accurately than GDP, which is based on a more abstract value-added calculation. Freight volume, including both domestic and international, actually contracted in Q3 on a y/y basis, after strong growth of 23% in Q2. Passenger traffic is less volatile and moves broadly in line with GDP, but it also pointed to a further moderation in growth, instead of the acceleration shown in the GDP figures.

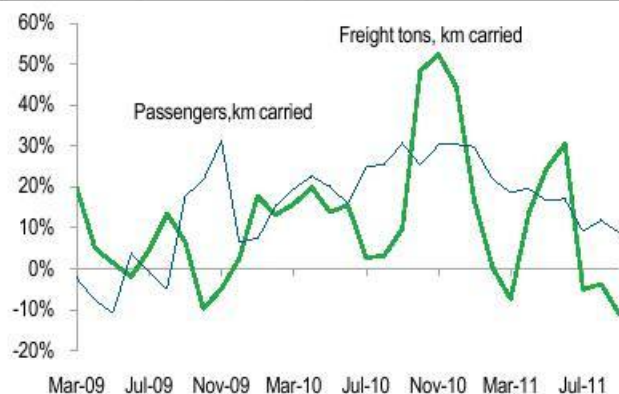
Chart 1: Resilient growth, despite tight policy



Sources: CEIC, Standard Chartered Research

Chart 2: Logistics data paints a more sobering picture

Growth in freight and passenger traffic



Sources: CEIC, Standard Chartered Research



Correction in food and oil prices, as well as lower money supply growth, should help to moderate inflation

Headline inflation to return to single digits by Q2-2012

As expected, y/y inflation peaked in August at 23%, and moderated to 22.4% in September. We forecast that inflation will ease further to 19.7% in December and return to single digits by late Q2-2012, averaging 11.3% in 2012. The outlook for supply-side inflation is positive. The recent correction in global crude oil and food prices will help to tame headline inflation further in the months ahead. The announcement of a reduction in retail prices for diesel (to VND 20,400 from VND 20,800 per litre) and kerosene (to VND 20,200 from VND 20,500) will also help. On the demand side, robust headline GDP growth suggests that overall economic momentum remains intact and that demand pressure is still strong.

The central bank's tight monetary policy should also help to reduce inflationary pressure. As Chart 4 shows, money supply (M2) growth has been leading headline inflation by approximately nine months, and its growth has slowed since late 2010.

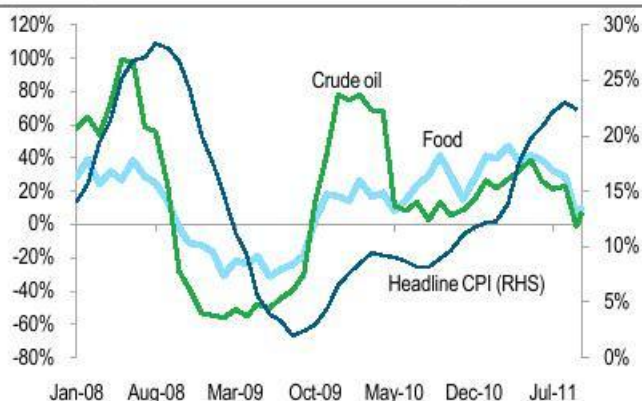
Depreciation pressure on the VND poses a near-term inflation threat. The SBV has gradually pushed the daily USD-VND reference rate higher since late September, to 20,708 from 20,628. While the modest VND weakening so far is likely to have a limited impact on the immediate inflation outlook, further devaluation would create fresh inflationary momentum in the economy.

Market is concerned about renewed demand for USD, as USD loans could be unwound

VND under pressure, despite lower inflation and smaller trade deficit

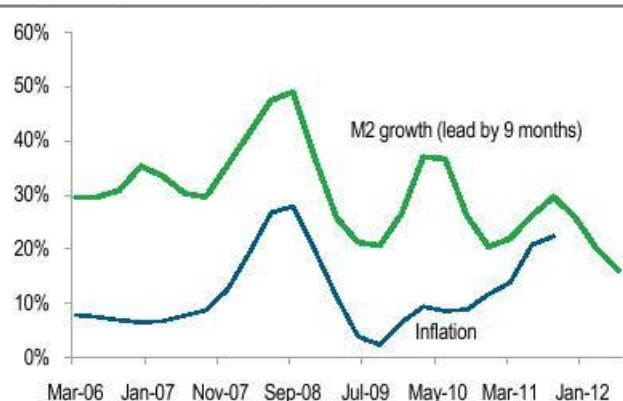
After a period of strength between May and July, the VND has come under renewed pressure. USD-VND in the parallel market, trading at 21,450, has again surged above the official trading band. We believe this is partly driven by market expectations that USD borrowing done earlier in the year will need to be unwound, which could revive USD demand. VND depreciation pressure runs counter to the peaking of headline inflation and the healthier trade deficit. The trade deficit stood at USD 7.6bn for the first nine months of 2011 and is likely to undershoot our full-year forecast of USD 12-15bn.

Chart 3: Lower food and oil prices help to tame inflation
y/y changes in CRB food index, WTI Cushing and CPI



Sources: CEIC, Standard Chartered Research

Chart 4: Slower money growth to help cool inflation
M2 growth (9-month lead) vs. headline inflation



Sources: CEIC, Standard Chartered Research



We expect interest rate cuts once inflationary pressure eases and FX stability is restored

As a result of VND depreciation, the SBV raised the benchmark refinance rate by 100bps to 15% on 7 October, effective on 10 October. This was likely aimed directly at protecting the VND rather than cooling inflationary pressure. Hence, this tightening could be unwound once FX depreciation pressure eases; we expect interest rate cuts to resume in 2012 as the policy emphasis switches back to growth from inflation. We expect loosening to start in Q2-2012, when headline inflation is likely to slow visibly. But a stable FX market will be a pre-condition for such a move. On the other hand, a worse-than-expected deterioration in the global economy – to which Vietnam is increasingly exposed, and which could have a direct impact on supply-side inflationary pressure – could prompt the central bank to ease sooner than expected.

We have predicted for some time that USD-VND would remain relatively stable for the rest of 2011, followed by renewed one-off devaluations in 2012 as concerns about a widening trade deficit, low FX reserves and the risk of new policy mistakes re-emerge (see **On the Ground, 21 June 2011, 'Vietnam – Trip notes from Hanoi and Ho Chi Minh'**). Recent CPI inflation data and the hike in the refinance rate to 15% from 14% are supportive of the VND near-term. However, the September trade deficit was revised higher to USD 1.5bn, which may signal widening trade deficits in the coming months. At the end of June, Vietnam's FX reserves were reportedly USD 15.2bn – around two months of imports, up from 1.42 months of imports in May.

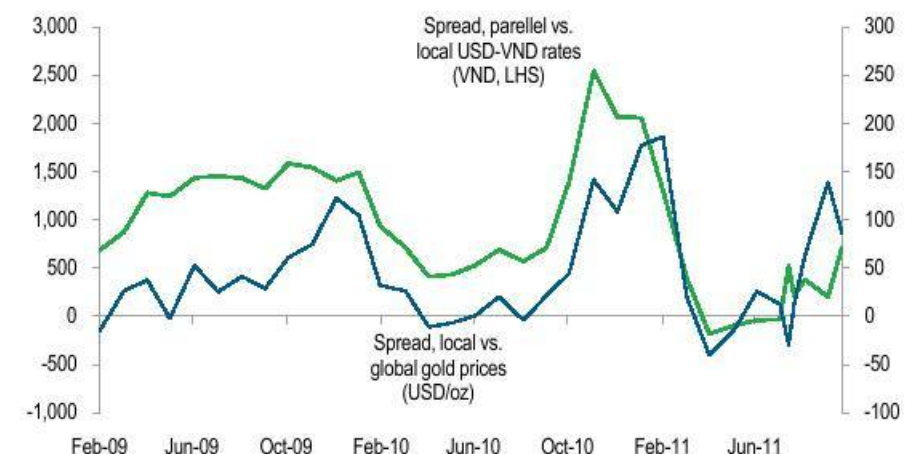
The spread between the official and parallel USD-VND rates has widened recently, and is currently at around VND 400. The widening of the spread in H2-2009 and late 2010 eventually triggered devaluations in late 2009/early 2010 and early 2011, respectively. The current spread of around VND 400 is relatively modest by historical standards.

Further devaluations are likely in 2012 due to a widening trade deficit, low FX reserves and the risk of policy mistakes

On balance, we believe that the Vietnamese authorities may be able to keep USD-VND relatively stable for the rest of 2011, but further devaluations are likely in 2012. Hence, we adjust our end-2011 USD-VND forecast to 21,000 from 20,600. We maintain our 2012 forecasts of 21,400 at end-Q1, 21,400 at end-Q2, 22,000 at end-Q3, and 22,000 at end-Q4.

Chart 5: High local gold prices unsettle the VND

Demand for the USD rises in tandem with gold



Sources: Reuters, SJC, Standard Chartered Research



Short-term government bonds underperform

Domestic factors have turned supportive of the VGB market, with y/y inflation coming off its peak and interest rate cuts expected in Q2-2012. However, global financial-market uncertainty is likely to persist near-term, and while the VGB market is relatively insulated from the global turmoil, the impact is felt indirectly through tighter interbank liquidity. We have a *Neutral* outlook on the VGB market but expect the yield curve out to 5Y to stay inverted amid tight liquidity conditions.

SBV policies aimed at strengthening markets in the medium term have added to the near-term VND liquidity squeeze

Onshore VND liquidity had fallen since the start of September on increased demand for USD and gold (see Chart 5). Liquidity has also been squeezed by the SBV's introduction of interest rate caps on short-term VND deposits (effective 1 October), which has prompted further asset rotation out of the VND into USD and gold. Hikes in rates for the refinance and overnight lending facilities (effective 10 October), the main sources of funding for smaller banks, have further reduced liquidity. Chart 6 shows rising demand for short-term financing in the aftermath of the announcements, and the upward pressure this has put on interbank lending rates and short-term VGB yields.

We expect short-dated yields to underperform near-term. Upcoming tax payments and increased spending during the year-end holiday season are likely to sustain tight liquidity conditions through to January 2012.

Chart 6: SBV liquidity support through OMOs is rising but still at record lows (%)



Sources: Bloomberg, Standard Chartered Research

Chart 7: Yield curve inverts on tight liquidity conditions



Source: Standard Chartered Research



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