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Vietnam – What a difference a year makes

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- 12 months ago, Vietnam faced an unsustainable trade deficit and surging inflation
- Both challenges have now subsided, replaced by concerns about global growth
- We expect further rate cuts and a weaker VND to support growth
- Structural positives are expected to underpin the medium-term growth outlook

From trade deficit and inflation to global slowdown

12 months ago, the Vietnamese economy was in trouble on two fronts. First, it was running a massive trade deficit due to both cyclical factors (economic overheating) and structural deficiencies (a heavy reliance on imports of refined petroleum products and processed metals). The trade deficit in Q1-2008 reached a run rate of 9% of GDP, and this triggered concerns about the risk of a balance-of-payments crisis. Second, inflation accelerated sharply, from 14% y/y in January 2008 to 21.4% by April and ultimately 28.3% in August. It was calmed only by aggressive rate hikes by State Bank of Vietnam (SBV) and a dramatic collapse in global energy and food prices.

By late 2008, it was apparent that both of these problems had been brought under control, but the challenges facing the economy shifted from domestic issues to external ones. The global financial and economic crisis has threatened this frontier economy in more ways than one. First, the export sector is being tested as global demand for Asian exports collapses. While exports posted positive year-on-year growth in February and March 2009, we remain cautious on the outlook for overall 2009 export performance. Second, we expect foreign investment inflows, both direct investments by overseas businesses and portfolio investments, to shrink this year and possibly in 2010.

Table 1: SCB's macroeconomic, exchange rate, and policy rate forecasts for Vietnam

	Q1-09	Q2-09	Q3-09	Q4-09	2009	2010	2011
Real GDP growth	3.10	4.20	4.50	5.00	4.20	5.00	5.50
Inflation	14.40	7.00	2.50	2.00	6.50	7.00	8.00
Current account balance (% of GDP)	-	-	-	-	-7.00	-5.00	-5.00
Base rate (period-end, %)	7.00	5.00	5.00	5.00	5.00	5.00	7.50
USD-VND (period-end)	17,484	18,000	18,500	18,500	18,500	17,800	17,400

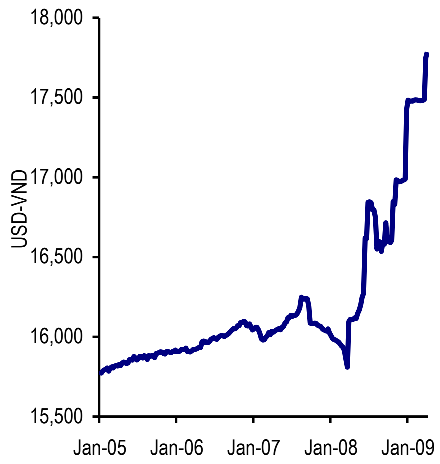
Source: SCB Global Research

In response to the challenging external environment, SBV has already unwound all of the interest rate hikes it implemented in 2008, and further cuts are on the cards, in our view. The authorities have also employed currency devaluation to boost exports, although we have strong reservations about whether this will support export performance. The government has announced various fiscal measures to support economic growth, including interest subsidies and tax deferrals, although the overall size of the stimulus package has yet to be clarified.

An early victim of risk aversion

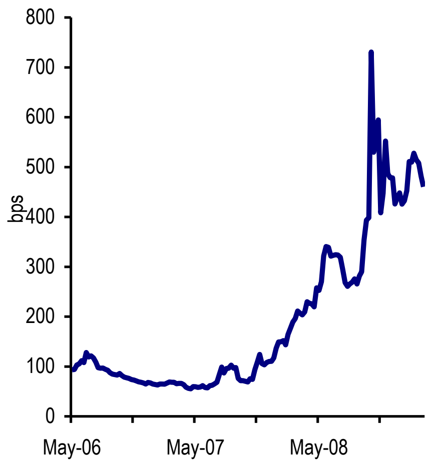
Market sentiment towards Vietnam took a turn for the worse in Q1-2008, when the trade deficit and inflation came under the spotlight. Speculation that Vietnam could face a balance-of-payments crisis prompted a reversal of the brief strengthening trend of the Vietnamese dong (VND) against the USD (see Chart 1), a spike in government bond yields, and a rise in the CDS spread (Chart 2). The local stock market also reacted to these concerns, declining ahead of regional equity markets before the global financial crisis took over (Chart 3).

Chart 1: USD-VND exchange rate



Source: Bloomberg

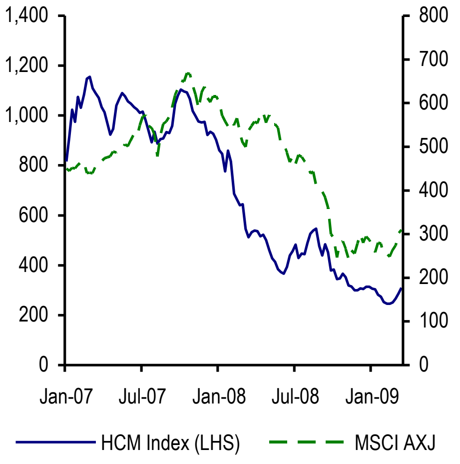
Chart 2: Vietnam 5Y CDS spread



Source: Bloomberg

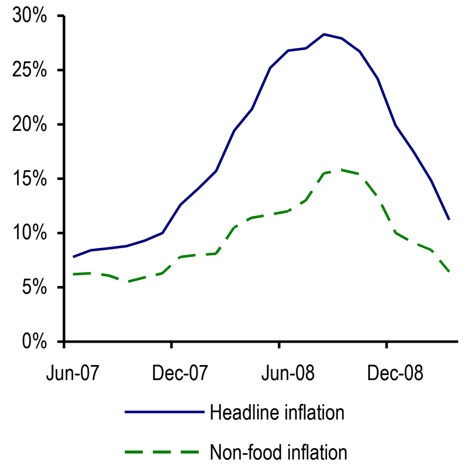
We believe that domestic concerns caused Vietnam's financial markets to correct and its domestic economy to decelerate before the rest of the region experienced similar declines. In response to capital outflows and rising inflation, SBV raised its base rate aggressively in 2008, to 14% by the end of Q2-2008 from 8.75% at the start of the quarter. The shortage of both USD and VND liquidity during this period also put the brakes on domestic economic activity, especially in the real-estate sector. By Q3-2008, the trade deficit seemed to have come under control, and inflation also showed signs of peaking as m/m increases in the consumer price index slowed. Both of these developments eased investor concerns. Yet this period of calm was relatively short-lived, as the market's focus soon turned from domestic issues to the global financial turmoil.

Chart 3: Ho Chi Minh Index vs. MSCI Asia ex-Japan



Source: Bloomberg

Chart 4: Inflation on a downtrend

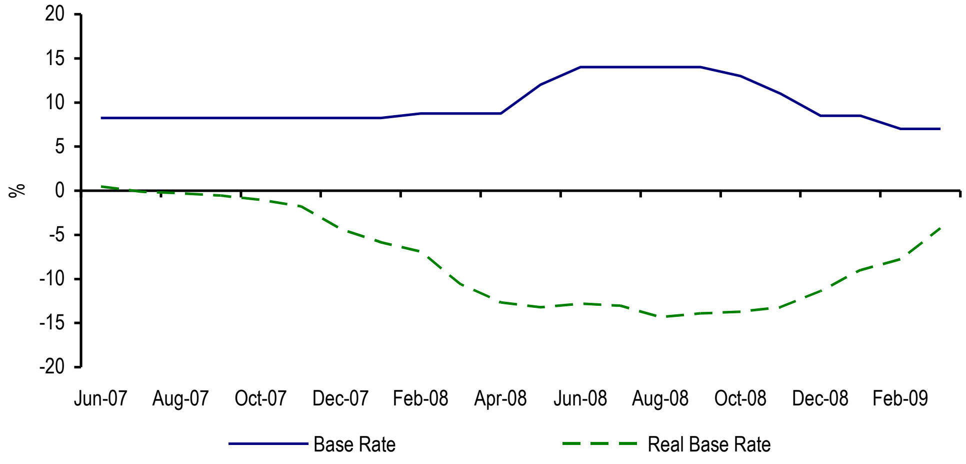


Sources: CEIC, SCB Global Research

Confronting the global financial crisis

With the collapse of Lehman Brothers and the subsequent surge in risk aversion, Vietnam experienced further upward pressure on its CDS spread (Chart 2) and the USD-VND exchange rate. While inflation was still high, at above 25% y/y (Chart 4), the government was quick to reverse its monetary tightening, reducing the base rate to 7% as of early April 2009 from 14% in September 2008 (Chart 5). Meanwhile, the authorities also permitted the VND to weaken further against the USD, in line with regional currencies. Since the end of September 2008, the VND has weakened by 7%, from 16,600 to its current level of 17,800. This was achieved through a combination of an outright upward shift in the official daily USD-VND fixing and a widening of the USD-VND trading band – a de facto devaluation, as the market regularly trades at the upper end of this band.

Chart 5: Policy base rate is falling, but real policy rate is on the rise

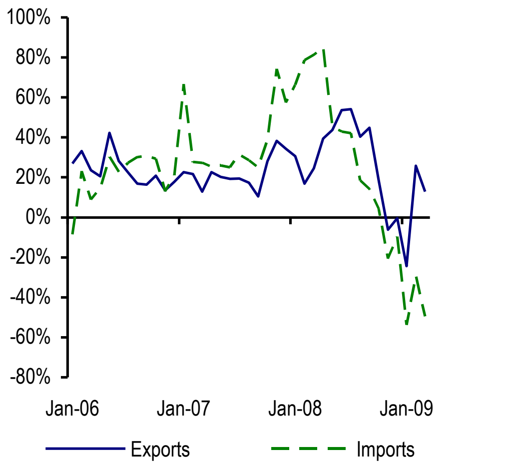


Sources: CEIC, SCB Global Research

The global economic turmoil started to impact Vietnam's export performance in October 2008. Our calculation of monthly export growth (as opposed to the official year-to-date figures) puts y/y export growth at 18.4% in October, compared with 44.8% the previous month (Chart 6). Exports turned to a contraction of 6.2% y/y in November. Looking at the breakdown, the decline in crude oil exports weighed significantly on overall export performance. Meanwhile, growth in exports of manufactured goods, such as textiles/garments, footwear, and electrical components, also decelerated sharply during these months. Demand from China and Japan for Vietnamese exports also contracted, by 27% and 30% respectively, in the first two months of 2009.

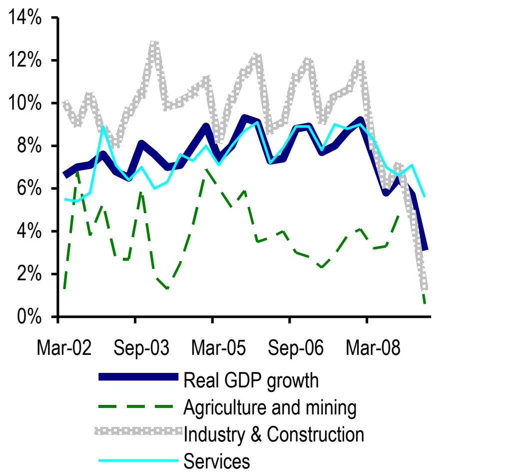
As a result of the global slowdown, as well as the lagged effect of tight monetary policy in 2008, Vietnam's economic growth slowed to an estimated 3.1% in Q1-2009 from 5.7% in Q4-2008 (again using single-quarter data rather than the year-to-date figure). The breakdown by sector (Chart 7) suggests that both the agriculture and industry/construction sectors ground to a halt in the quarter, with only 0.6% and 1.4% y/y growth, respectively. The services sector also decelerated but managed to maintain a more respectable 5.6% expansion.

Chart 6: Export growth has rebounded temporarily, while imports continue to collapse



Sources: CEIC, SCB Global Research

Chart 7: Q1 GDP growth slowdown led by agriculture and industry



Sources: CEIC, SCB Global Research

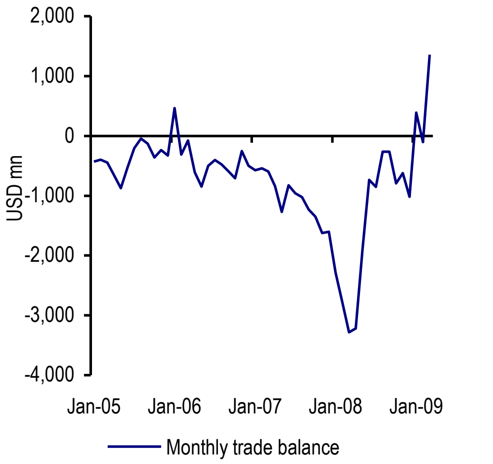
Surprisingly, the global economic slowdown has yet to hurt foreign direct investment (FDI). Official figures show that the country attracted USD 6bn of pledged FDI in Q1-2009, slightly higher than the USD 5.2bn reported in the same period in 2008. That said, we remain cautious towards such data, since pledged investment figures do not automatically translate into actual inflows. While pledged FDI in 2008 amounted to USD 60bn, actual inflows were about a quarter of that amount given the time lag between the signing of contracts and the implementation of projects. Nonetheless, the headline FDI figures are still a pleasant surprise amidst this challenging environment. Remittance inflows from overseas Vietnamese workers, for which reliable data is more difficult to come by, are expected to decline this year as the global labour market contracts.

What are the positive signs?

In addition to the resilient FDI data, the Vietnamese economy is showing several other positive signs.

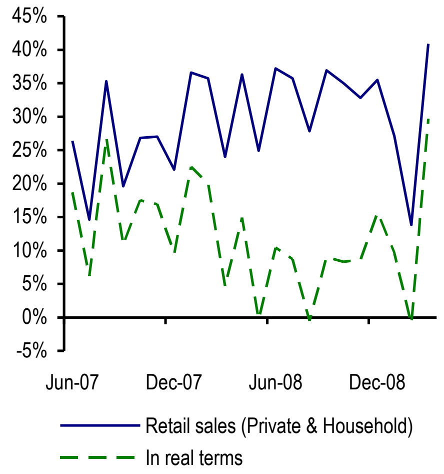
1) **Trade balance is swinging from deficit to surplus.** For the first quarter of 2009, Vietnam ran a trade surplus of USD 1.6bn, compared with a deficit of USD 8.4bn in the same period in 2008 (Chart 8). This was the result of the collapse in imports, which was partly driven by a rapid decline in commodity prices, in particular of steel and petroleum products. Imports of machinery and spare parts also slowed markedly, partly reflecting more cautious business sentiment. With Vietnam's first oil refinery starting production this year, the country should be better protected from high oil prices, which are widening the country's trade deficit in energy products. Even as we continue to expect the trade balance to turn back to a deficit in the coming months, the size of the shortfall is likely to be a fraction of last year's USD 18bn deficit.
2) **Exports returned to growth in February and March after three months of contraction.** Although Vietnam's exports contracted in the three months between November 2009 and January 2009, they have returned to growth, according to our calculations. Exports expanded by 25.9% y/y in February and 12.9% in March. Still, we remain relatively cautious, since the export boost seems to have come from one-off policy-induced orders (such as sizeable rice exports in March), while exports of manufactured goods (textiles/garments, footwear, and electrical components) have yet to show a convincing stabilisation.
3) **Inflation remains on a downtrend.** After peaking in August 2008 at 28.3%, inflation has trended lower as quickly as it trended up. March headline inflation was 11.2% y/y, the lowest since December 2007. Provided that oil and food prices sustain their stable trend this year, Vietnam's inflation could drop to the low single digits in H2-2009 (2%, according to our forecast). This would give SBV further room to cut interest rates.
4) **Retail sales are holding up.** The gloomy sentiment globally has yet to be seen in local consumption. As shown in Chart 9, retail sales to households have maintained decent momentum in recent months. Even adjusting for inflation, real retail sales have been broadly expanding.

Chart 8: Monthly trade balance now in surplus



Sources: CEIC, SCB Global Research

Chart 9: Retail sales surprisingly resilient



Sources: CEIC, SCB Global Research

Policy options – more of the same

The National Assembly has 'approved' a reduction in the official 2009 growth forecast to 5% from the previous target of 6.5%. This remains above our expectation of 4.2%, and further stimulus would likely be required to achieve it. The Vietnamese authorities have relied on three key policies to support the economy, and we believe the same strategies will be employed in the months ahead.

1) **Monetary policy.** As the base rate has been reduced from a high of 14% to the current level of 7%, the case for further reductions has become less clear-cut. There are worries that if VND interest rates are reduced too much, local depositors may choose to switch their savings into foreign currencies or even gold. However, we believe that with inflation set to fall rapidly in the months ahead and the real base rate set to rise again as a result, there is room for the central bank to cut the base rate further. The government has commented that the base rate should be reduced further as inflation slows. Hence, we retain our view that the base rate will reach 5% by the end of Q2-2009, with two cuts of 100bps before then.
2) **Exchange rate policy.** As mentioned above, the authorities have resorted to de facto depreciation of the VND in recent months in the face of weakening Asian currencies. We expect more of the same to take place for the rest of the year, albeit in an orderly manner. As Vietnamese exporters are focussed more on the labour-intensive end of the manufacturing spectrum and are hence more price-sensitive, a modest depreciation of the VND would offer some help to local producers.
3) **Fiscal policy.** According to Prime Minister Nguyen Tan Dung, VND 300trn (USD 17bn) of the budgeted government spending of VND 491trn (USD 28bn) will be spent on measures to bolster the economy, including new infrastructure and social welfare projects. While further details on these measures are yet to be revealed, the government has already deferred payment of personal income tax and corporate profit tax for selected sectors, and has provided subsidies to businesses (importers, exporters, and SMEs) for their interest payments. This interest subsidy programme is being expanded to a broader spectrum of businesses and to individuals to ensure the availability of affordable credit.

Anticipating the future growth drivers

While 2009 will be a year of great challenges for the domestic and regional economy, we remain constructive in our medium-term outlook for Vietnam. Several structural factors will drive the country's development, some of which will still be at work even as growth in the advanced economies weakens. (We discussed many of these structural factors in detail in our 'Eight reasons to be bullish' series published in Q1-2008.)

Favourable demographics. UN projections suggest that Vietnam's population will grow from 85mn currently to 110mn by 2035, with two-thirds of the population being economically active. This represents a formidable force in supporting labour-intensive manufacturing and domestic consumption. Based on the development experiences of other Asian economies, Vietnam's purchasing power could double in the next six to seven years.

Regional trade patterns. Risk diversification and China's move up the manufacturing value chain imply that international businesses will increasingly look for a second manufacturing base. Vietnam, due to its stable political environment and low cost of production, is often regarded by Asian businesses (especially those from Japan, Korea, Taiwan, and increasingly China) as a good alternative. Interest from the West is also on the rise. However, a crucial hurdle faced by Vietnam in the coming years will be to improve its infrastructure to meet foreign investors' expectations. The current state of the country's physical infrastructure is unlikely to be sufficient to accommodate the rapid growth anticipated ahead, or supply chain management that increasingly demands seamless connections between producers and consumers. In addition to manufacturing, agriculture is another industry where Vietnam has a competitive advantage, and this is expected to be a key driver of growth.

Learning from your neighbours. The experiences of other Asian economies often serve as an example to policy makers in Vietnam as they determine the most appropriate approach to facilitating growth. These include the execution of monetary policy, development of financial markets, and how to balance economic development and sustainability. The domestic market turmoil in Q2 and Q3-2008, as well as the global financial crisis, demonstrated that the authorities are quick to learn and adapt, in our view.

Taking into account these structural developments, as well as the cyclical aspects of the global environment, we expect Vietnam's economy to grow by 4.2% in 2009 and 5% in 2010. While this may be low from a domestic standpoint, it is a respectable performance from a regional perspective. We expect 2009 growth to be led by domestic demand and government spending, with exports playing a larger role in 2010. In our view, a return to economic growth above 6% will require a combination of a global economic recovery, domestic financial stability, and ongoing reinforcement of foreign investor confidence, especially among business investors.

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