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VND raised to Neutral from Underweight*

08:15 GMT 24 August 2009

- We are raising our short-term FX rating on the VND to *Neutral* from *Underweight*
- Risks of further one-off devaluations have moderated as the economy picks up
- BoP dynamics and widening fiscal deficits remains medium-term concerns
- Most FX models have a *Sell* signal on the VND

* = For the next 3-6 months against key trade currencies:
Leveraged funds: Neutral VND
Real money funds: neutral vs. standard FX benchmarks
Corporates: neutral vs. forwards

Summary

We are raising our short-term FX rating on the Vietnamese dong (VND) to *Neutral* from *Underweight.* This primarily reflects the fact that onshore forwards already price in further depreciations of the VND, which are in line with our forecast. We believe that risks of further sharp one-off devaluations have moderated, as the trade deficit has narrowed and the economy is picking up. However, near-term balance-of-payments dynamics are likely to continue to put upward pressure on USD-VND as weaker inflows from FDI and inward remittances are unlikely to cover the trade deficit. Moreover, we expect Vietnam's fiscal deficit to widen to 10% of GDP in 2009 from 5.2% in 2008 which raise the risk of a foreign-currency credit rating downgrade. Finally, most FX models give a *Sell* rating on the VND. We have adjusted our USD-VND forecasts modestly.

Table 1: SCB revised VND forecasts

	End Q3-09	End Q4-09	End Q1-10	End Q2-10
USD-VND (old forecasts are in brackets)	**17,900** (18,500)	**18,200** (18,500)	**18,200** (18,600)	**18,400** (18,100)
Forward (mid-indication)	17,985	18,390	18,740	19,310
EUR-VND	**26,850** (27,750)	**28,210** (28,675)	**27,300** (27,900)	**26,864** (26,426)
Forward	25,412	25,697	26,459	27,270
JPY-VND	**195** (201)	**207** (210)	**192** (196)	**182** (179)
Forward	189	193	197	203
CNY-VND	**2,606** (2,693)	**2,653** (2,697)	**2,657** (2,715)	**2,698** (2,654)
Forward	2,629	2,685	2,735	2,818

Sources: SCB Global Research, Bloomberg

FX economics

Growth: picking up

Vietnam's Q2 GDP growth accelerated to 3.9% y/y from 3.1% y/y in Q1. As we have highlighted previously, Q1 growth was driven by relatively strong domestic demand, while external weakness persists (for more details see **OTG, 1 June 2009, 'Vietnam – External weakness, domestic strength'**). In line with this, July exports contracted by 24.00% y/y, versus a 13.87% y/y decline in June. However, exports have begun to rebound on a m/m basis, with positive growth recorded for the past three months. The relative strength of the domestic economy is evident in retail sales, which grew by 19.97% y/y in July, following a 21.44% y/y increase in June. Vietnamese consumers appear to be benefiting from the sharp slowdown in CPI inflation and accommodative monetary policy. This is likely to be a key pillar of Vietnam's growth in coming quarters. We expect Vietnam to report GDP growth of 4.2% for 2009 and 5% for 2010. We see current growth dynamics in Vietnam as a modest positive for the VND, as it should stimulate capital inflows.

Inflation and monetary policy: decelerating

July CPI rose by 0.52% m/m and 3.31% y/y, compared with 0.55% m/m and 3.94% y/y in June. The sharp fall in the y/y figure compared to H1-2008 largely reflects the high base effect from 2008, as m/m CPI averaged 0.47% from April to July. While y/y CPI is likely to pick up towards year-end as the high base effect fades, we expect it to remain modest, within a range of 5-6%. Given the improvement in domestic activity and the still-benign inflationary outlook, we expect the State Bank of Vietnam (SBV) to keep the base rate at 7% in H2-2008 and H1-2010 before starting to raise it in H2-2010. We see low market interest rates – especially low borrowing rates – as a modest negative for the VND, as they raise the incentive for onshore market players to borrow in VND, thereby increasing the supply of the local currency relative to the USD. This has been one important factor behind the endemic shortage of USD in the financial system.

Balance of payments: downside risks

Vietnam's balance of payments (BoP) came under severe pressure in 2008, when the trade deficit widened sharply and capital inflows from FDI and inward remittances from overseas Vietnamese were unable to cover the shortfall. The 2008 BoP dropped to a deficit of USD 162mn from a surplus of USD 10.2bn in 2007. At a glance, 2009 looks better, given that the monthly trade balance deficit narrowed to around USD 1bn in April-June 2009 from USD 3bn in January-April 2008. The government expects the trade deficit to narrow to USD 10bn in 2009 from USD 18bn in 2008. However, given the global recession, it estimates that FDI and inward remittances will drop to USD 8bn and USD 6bn, respectively, from USD 11.5bn and USD 7.2bn in 2008.

In H1-2009, the trade deficit was only USD 2.1bn, while FDI inflows and inward remittances amounted to USD 4bn and USD 2.8bn respectively. On balance, this raises the risk of a modest deterioration in the BoP in H2-2009. Short-term capital inflows and loans from official institutions are unlikely to cover this shortfall. As such, we see developments in Vietnam's BoP as a modest negative for the VND.

Fiscal balance: rising concerns

We expect Vietnam's fiscal deficit to rise to 10% of GDP in 2009 and 8% in 2010 (from 5.2% in 2008) due to the additional fiscal stimulus measures implemented by the authorities, including interest subsidies and an income tax holiday. Moody's and S&P currently have Vietnam foreign-currency credit ratings of Ba3 and BB, respectively, both with a negative outlook; Fitch has a BB- rating with a stable outlook. From an FX perspective, we see the widening fiscal deficit as a negative for the VND, as it raises the risk of a further foreign-currency credit rating downgrade.

Table 2: SCB economic forecasts for Vietnam

%	2009	2010	2011
Real GDP growth	4.2	5.0	6.5
CPI (yearly average %)	6.5	7.0	8.0
C/A balance (% of GDP)	-7.0	-5.0	-5.0
Fiscal deficit (% of GDP)	-5.2	-10.0	-8.0

Sources: Bloomberg, SCB Global Research

Table 3: C/A, trade balance, and FDI (USD mn)

	C/A	C/A transfers	Trade balance	FDI
2003	-1,931	2,239	-5,106.5	1,450
2004	-957	3,093	-5,483.8	1,610
2005	-560	3,380	-4,314	1,954
2006	-164	4,049	-5,064.9	2,400
2007	-6,992	6,430	-14,203.3	6,700
2008	-9,238	7,330	-18,028.7	11,500
2009F	-6,205*	5,900***	-7,000*	**8,000

** SCB forecasts, ** Government estimates; ***Government estimates of inward remittances;*

Sources: Bloomberg, Reuters, CEIC, SCB Global Research

Exchange rate policy: devaluation risk has decreased

Since March 2008, the SBV has initiated a series of one-off devaluations and it has widened the daily trading band on several occasions. (See Appendix for details). The SBV's moves to widen the daily trading band have effectively functioned as one-off devaluations, as USD-VND traded at the top end of the band ahead of the changes. The rationale for the currency adjustments has been to support growth and contain the trade deficit by helping exporters. The natural side effect has been an increased incentive for onshore market players to hoard USD. In recent months, the government and the SBV have repeatedly stated that they will not devalue the VND again. Given that the trade balance deficit has narrowed somewhat and that the economy is picking up, we believe the risk of further one-off devaluations has decreased. However, policy makers' bias remains to allow for a modest weakening of the VND over the medium term.

FX model valuation

As a reality check, we examine exchange rate valuation from the perspective of traditional FX fair value equilibrium models. On their own, these models provide little short-term prescriptive power. However, they may give a clearer picture of whether a currency should appreciate or depreciate over the medium to long term.

REER Approach: NEUTRAL

The real effective exchange rate (REER) is a function of the price, or inflation, differential and the nominal effective exchange rate (NEER). The relationship between Purchasing Power Parity (PPP) and REER is a close and important one. The core idea is that if PPP is seen to hold over the long term, the REER should remain constant. That said, over the short term, the REER can fluctuate significantly.

Since 1998, the VND has been on a gradual depreciation trend versus the USD, and this accelerated from March 2008 to March 2009. This contrasts with the currencies of some of Vietnam's key trading partners, such as the Chinese yuan (CNY), Singapore dollar (SGD), Malaysian ringgit (MYR), Thai baht (THB), and euro (EUR), which appreciated versus the USD during this period. Vietnam has experienced higher inflation rates than its competitors, eroding some of the nominal currency depreciation. Still, on a REER basis, the VND has depreciated versus its main competitors since 2001. Overall, we believe the REER Approach is giving a *Neutral* signal on the VND.

Monetary Approach: SELL

Linked in with PPP is the Monetary Approach to exchange rates. According to this, a change in money supply growth results in a change in price, which leads to a change in the exchange rate via PPP. Higher money supply growth would be presumed to lead to higher price growth, which should be offset by exchange rate depreciation to maintain PPP.

As of end-2008, Vietnam M2 growth had slowed to 20.32% y/y from 46.11% y/y at end-2007. This compares to y/y M2 growth of 9.0% in the US, 4.8% in the Eurozone, 2.5% in Japan, and 28.46% in China. On balance, Vietnam's money supply growth is higher than that of its trading partners. The Monetary Approach to exchange rates states that higher monetary growth will lead to higher assumed inflation, which will in turn require exchange rate depreciation to offset it. With Vietnam's monetary growth higher than that of most of its key trading partners, this gives a clear *Sell* signal from the monetary perspective.

Mundell-Fleming Approach: SELL

Thanks to the work of Robert Mundell and J. Marcus Fleming, we know that certain combinations of monetary and fiscal policy create specific exchange rate conditions. The Mundell-Fleming model illustrates how combinations of monetary and fiscal policy changes can cause temporary changes in the balance of payments relative to an equilibrium level. The exchange rate therefore becomes the transmission mechanism by which equilibrium is restored to the balance of payments.

The Vietnamese authorities have enacted both monetary and fiscal easing in response to the global crisis. The SBV, for its part, has cut the base rate to 7.00% from 14% in Q4-2008. Meanwhile, we expect the government to mobilise a massive fiscal stimulus programme which will raise the fiscal deficit to 10% of GDP in 2010 from 5.2% in 2009. In an environment of free capital mobility, monetary and fiscal easing has ambiguous implications for local interest rates and thereby for the exchange rate. Obviously, Vietnam does not have free capital mobility. In a scenario of low capital mobility, one has to assume that trade flows will outweigh capital flows. As such, the Mundell-Fleming model of exchange rates gives a *Sell* signal for the VND.

Interest Rate Approach: SELL

Thanks to the work of the economist Irving Fisher, we have the Interest Rate Approach to exchange rates, which focuses on interest rate and inflation differentials. Under the International Fisher Effect, the difference in interest rates should equate to the expected change in the spot exchange rate. Thus, a currency with a higher interest rate should depreciate proportionally relative to another with a lower interest rate. Proponents of 'forward-rate bias theory' rightly question the Interest Rate Approach to exchange rates, suggesting that higher-yielding currencies rarely depreciate to the extent that interest rates suggest – if at all. However, for this purpose, we use the Interest Rate Approach in its pure – if flawed – form for the sake of consistency.

Vietnam's key policy interest rate is currently 7.00%. This compares with 0.-0.25% in the US, 1.00% in the Eurozone, 0.10% in Japan, and 5.31% in China. Vietnam's interest rates are higher than those of its key trading partners. The Interest Rate Approach to exchange rates assumes that a higher interest rate is the result of higher expected inflation. This in turn requires exchange rate depreciation relative to trading partners' currencies. As a result, the Interest Rate Approach gives a *Sell* signal for the VND.

Balance-of-Payments Approach: SELL

Under the Balance-of-Payments Approach, changes in national income affect both the current and capital account, causing a predictable reaction in the exchange rate to restore balance-of-payments equilibrium. A change in national income results in a change in the current account balance, leading to a change in real interest rates and capital flows. As national income rises, import demand increases, causing the current account balance to deteriorate, all else being equal. On the capital account side, a rise in national income must be accompanied by a rise in real interest rates. If the current account dominates, the currency should depreciate, while if the capital account dominates the currency should appreciate.

We expect the Vietnamese economy to have bottomed in Q1and to pick up speed in H2 and 2010, supported by a stabilisation in global growth and relatively strong domestic demand. This should lead to a widening of the trade deficit in H2 compared to H2-2008 and H1-2009, as imports are expected to pick up, while global demand is likely to remain relatively weak. As such, we expect the trade deficit to widen to USD 7bn for all of 2009 from USD 2.1bn in H1-2009. This may also lead to a deterioration in the current account (C/A) deficit compared to H1. From a balance-of-payments perspective, a deterioration in the current account should lead to higher real yields. If the current account dominates, the VND should weaken. However, if the capital account dominates, the VND should gain. In the context of Vietnam, where capital mobility is relatively low, the C/A balance is likely to dominate. Overall, we think the Balance-of-Payments Approach to exchange rates currently gives a *Sell* signal for the VND.

Table 4: FX model valuation signals

FX model approach	VND Buy/Sell Signal
REER	Neutral
Monetary Approach	Sell
Mundell-Fleming	Sell
Interest Rate	Sell
Balance of Payments	Sell
Overall signal	**Sell**

Source: SCB Global Research

FX outlook

Short term (3-6 months): NEUTRAL

We are raising our short-term FX rating on the VND to *Neutral* from *Underweight*. The rating change primarily reflects the fact that onshore forwards continue to price in further VND depreciation, whereas we believe the risk of one-off devaluations has diminished somewhat. As such, we expect the VND to outperform the CNY and the USD relative to forwards, and to underperform the EUR and JPY relative to forwards. Below, we list the key factors behind our rating change:

- **Exchange rate policy:** Since March 2008, the SBV has initiated a series of one-off devaluations and has widened the daily trading band on several occasions. This has created incentives for onshore market players to hoard USD in anticipation of further devaluations. In recent months, the Vietnamese authorities have repeatedly said that they see no need for further devaluations. Given that the trade deficit has narrowed somewhat and that the economy is picking up, the risk of further one-off devaluations has likely decreased. Moreover, we doubt that the authorities will go back to the crawling USD peg which was in place from 2002 to Q3-2007, as this would create incentives for onshore market players to continue to hoard USD. On balance, we see current exchange rate policy as less of a negative for the VND than it has been for the last 1.5 years.

- **Balance of payments:** Since H1-2008, Vietnam's BoP has improved as the trade balance has stabilised. However, we remain cautious on the near-term outlook for the BoP. As the economy picks up, we expect the trade deficit to widen to USD 7bn for all of 2009 from USD 2.1bn in H1. Meanwhile, inflows from FDI, inward remittances, and portfolio flows are unlikely to cover the deterioration in the trade balance. This is in line with the government's estimate that the BoP deficit will widen to USD 1bn in 2009 from USD 162mn in 2008. As such, we see Vietnam's near-term BoP dynamics continuing to create upward pressures on USD-VND.

- **Fiscal balances:** We expect Vietnam's fiscal deficit to widen to 10% of GDP in 2009 and 8.0% in 2010, from 5.2% in 2008. Vietnam has foreign-currency credit ratings of Ba3 from Moody's, BB from S&P, and BB- from Fitch; both Moody's and S&P have a negative outlook. We see the rising fiscal deficit as a negative for the VND, as it raises the risk that Vietnam will face a foreign-currency credit rating downgrade.

Medium term (6+ months): NEUTRAL

We are raising our medium-term FX rating on the VND to *Neutral* from *Overweight.* While we expect the VND to weaken broadly over the medium term, current forward rates are pricing this in. In addition, the VND has depreciated by 12.66% versus the USD since its low on 21 March 2008. As such, we believe that the VND is now more fairly priced than it was in Q1-2008. From a structural perspective, long-term prospects look relatively bright. Political stability, a sizeable population, and the fact that many Asian corporates are still looking at using Vietnam as a manufacturing base offer a promising outlook.

FX strategy

Leveraged funds

Although liquidity has improved somewhat recently, it remains very poor compared to most other Asia ex. Japan (AXJ) markets. The key concern is to unwind short USD-VND positions given the shortage of USD. As such, we see limited potential for leverage market players to position themselves in USD-VND until liquidity has improved substantially.

Real money funds

Asset managers who manage their currency risk actively and separately from their underlying exposure tend to use a more qualitative, or 'fundamental', rather than a quantitative/technical approach. The same concern that applies for leveraged funds regarding illiquidity in USD-VND applies to real money funds. However, we suggest that asset managers investing in Vietnam shift to a *Neutral* position on the VND. On balance, downside risks to the VND have diminished, as the economy is picking up and the trade balance has improved somewhat. As such, we expect the VND to perform broadly in line with forwards.

Currency overlay managers, by contrast, tend to take a more quantitative, or technical, approach. Granted, this is a generalisation, but it does seem that a majority of currency overlay managers adopt a quantitative approach to currency management. All of the key moving averages are still pointing up for USD-VND, suggesting that currency overlay managers are still *Underweight* VND. We suggest that currency overlay managers with positions in Vietnam gradually move to a *Neutral* position, as further VND depreciation is already priced in by the forwards.

Corporates

Transaction risk

Vietnamese exporters have faced a collapse in external demand. Our VND forecasts anticipate VND outperformance versus the USD and CNY over the next three to six months, and underperformance versus the EUR and JPY. This suggests that Vietnamese exporters should raise their hedge ratios modestly against the USD and CNY and lower them versus the EUR and JPY. However, given the endemic shortage of USD in the financial system, corporates should only do this when they are confident that they have enough USD to cover future USD payables.

Translation risk

Over the medium term, we expect the VND to weaken further versus the USD, although the risk of sharp devaluations has diminished somewhat. This is likely to remain the case as long as BoP dynamics remains unfavorable for the VND. Hence, we see no reason for Vietnamese corporates to hedge balance-sheet risks. On the contrary, European or Japanese-based corporates may consider hedging their balance-sheet risks in Vietnam, given the chance of further JPY and EUR outperformance relative to the VND.

Appendix – Vietnam's exchange rate policy since December 2007

- 23 March 2009 – SBV widens the daily USD-VND trading band to +/-5% from +/-3%, with effect from 24 March 2008. Over the next three sessions, USD-VND moves towards the ceiling of the new daily trading band.

- 25 December 2008 – SBV devalues the VND by 3% versus the USD with immediate effect. USD-VND immediately moves towards the ceiling of the daily trading band.

- 7 November 2008 – SBV widens the daily USD-VND trading band to +/-3% from +/-2% with immediate effect. 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.

- 11 June 2008 – SBV devalues the VND by 2% versus the USD with immediate effect. USD-VND immediately moves towards the ceiling of the daily trading band.

- 10 March 2008 – SBV widens the daily USD-VND trading band to +/-1% from +/- 0.75% with immediate effect. Initially, USD-VND moves towards the floor of the new daily trading band.

- 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 policy band.

Sources: Reuters, State Bank of Vietnam, SCB Global Research

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Data available as of 08:15 GMT 24 August 2009. This document is released at 08:15 GMT 24 August 2009.

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