2008

Sacombank-SBS SECURITIES COMPANY

VIETNAM
THE TRUE STORY

In the wake of Vietnam's May 2008 CPI and trade deficit data release, such words as out of control, devaluation, even bailout … have appeared ...
In this report, we are going to look at the factual data on Vietnam's inflation, foreign exchange and current account as well as the Government's responsive measures ...
Finally, investors are provided with informative and objective views of a clear picture, a true story ...




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What the numbers say

Monthly CPI the highest level since year beginning

According to the newly released data for May 2008, the CPI index has reached the highest level from the beginning of the year, adding another 3.91% to make the year to date number become 15.96%. This is actually the highest number for any single month in 2008 and also the highest number for a single month in the last 18 years.

This 5 month figure alone is higher than the CPI index of the whole year 2007, which was 12.63%

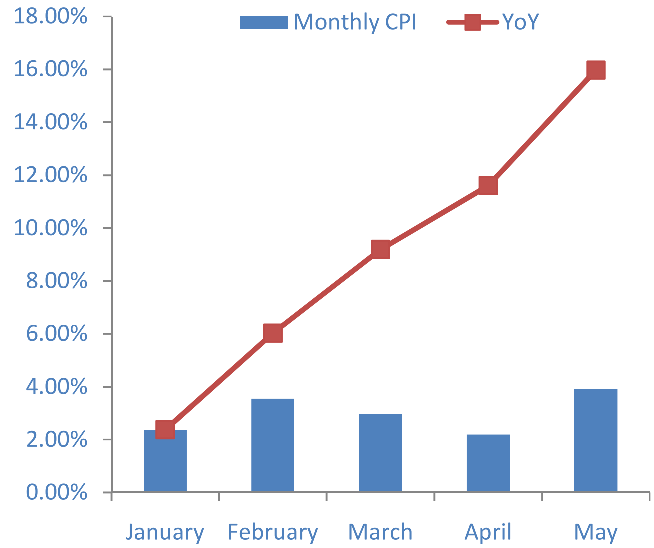
Two major causes of the CPI surge were the prices of foodstuff and housing – construction materials. These two items contribute the biggest part to the increase. While foodstuff accounts for 42.8% of the CPI basket, any movement of this item has a considerable effect on CPI.

As can be seen from chart 2, the CPI indices for these two item kept increasing since the beginning of the year. Starting from 3.8% in January, the foodstuff item kept its rising pace and continuously hit new levels and reached a record number of over 25% in May. The situation with housing and construction materials was similar in terms of trend, however, the number was much lower, this item has gained over 10% compared to December last year. This is in fact a very unprecedented phenomenon and would be dug deeper in the section that follows.

As for other items in the May CPI table, the increase was very moderate, ranging from as low as 1.44%.

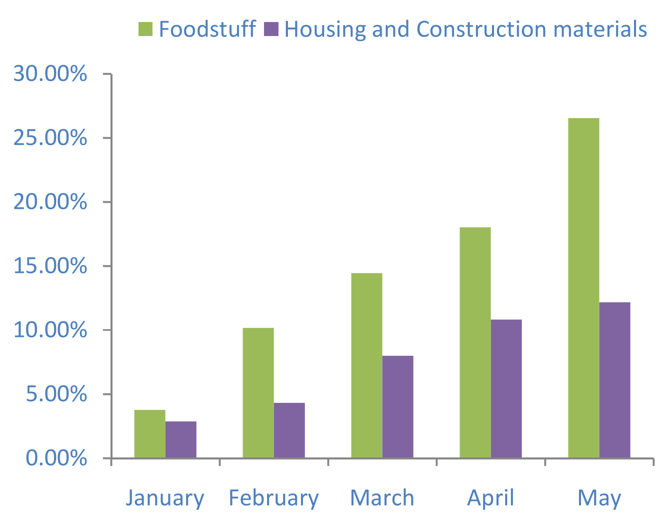
It can be concluded that the main causes for the high CPI as of May were from foodstuff and housing – construction materials.

Chart 1: CPI year to date



Source: GSO

Chart 2: Foodstuff and Housing price



Source: GSO

Table 1: **CPI in May 2008**

	Item	↑*over 12/07*
1	Food and foodstuff services	26,56
2	Drinks and tobacco	07,06
3	Garment, hats, foot-wears	05,69
4	Housing and construction materials	12,17
5	Equipment and home-ware	05,07
6	Pharmacy	03,19
7	Transportation, telecommunications	10,20
8	Education	01,44
9	Culture, sport and recreation	04,87
10	Consumer good and other services	07,11
	CPI	**15,96**

US Dollars appreciates against dong

There have been interesting movements around the VND/USD rate since the beginning of the year. As can be seen from the charts, two major phenomena could be observed.

The VND/USD rate has made a U shape movement since the beginning of the year.

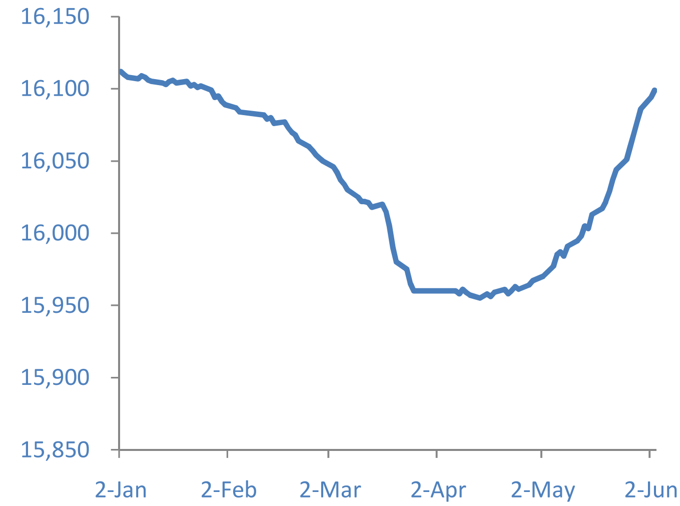
On both of its movement directions, the VND/USD rate on the free market has stepped up and slid more than the official rate.

Starting off in early January, the SBV official rate moved from above 16,100 VND/USD down to as low as 15,955 VND/USD in mid April and then climbed to over 16,000 VND/USD again (Chart 3).

Meanwhile free market has been a lot more volatile. Starting at over 16,500 VND/USD in early January, it then moved all the way down to as low as 15,330 in mid March, then climbed over the official rate again. The record level of 18,000 VND/USD was observed at some points in time on 03 June.

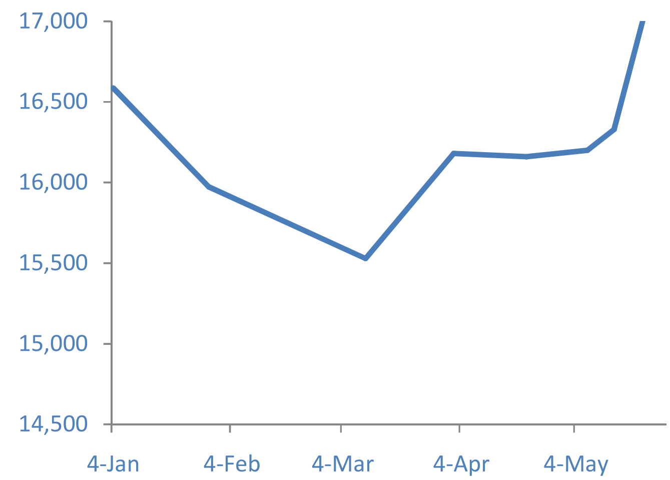
It was at this time that negative reports started appearing and projecting a devaluation of the Vietnam dong.

Chart 3: SBV official rate



Source: SBV

Chart 4: Free market rate



Source: Vneconomy.vn

Some views have even forecast a 30% devaluation of VND as a similar case to Thailand back in 1997.

There have been various views on the rationale of the USD appreciation against Vietnam dong, some claims Vietnam's weakening trade balance as the root, others blamed the deteriorating stock market and the slowing real estate market, the volatility of world gold and oil prices also have been cited. Among those, a cause that has been mentioned by SBV and also domestic scholars was the speculation phenomenon, which was further inflated by the very strong herd mentality of the majority of less informative individual investors in Vietnam.

In the second section of the report, we are going to provide some fundamentals, reasons as well as our views on the path of the currency.

Deficit deepened as import kept exceeding export for the fifth consecutive month

The May data has shaken the statistic number, breaking all previous records on imports and trade deficit. The trade deficit of 2008 has averaged nearly 3% on a m.o.m basis.

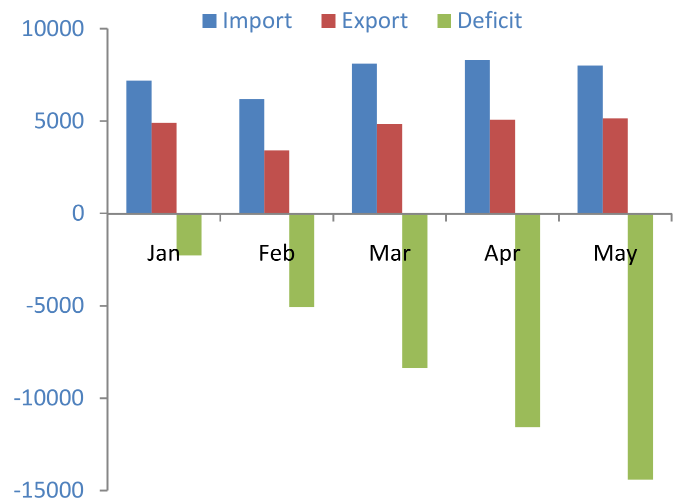
As can be seen in chart 3, the imports figures have risen sharply and been consistently higher than exports every month. On average, imports were recorded at around USD 8 billion a month, while that of export was below USD 5 billion. In May however, export has shown some positive result as the first month to reach over USD 5 billion in export.

After 5 months, the total amount of deficit has reached USD 14.4 billion, this accounts for around 20% of GDP and is already higher than the number for the whole year of 2007, which was USD 12.4 billion.

This rocket boost could be attributed to the sharp rise in some main items of imports such as automobile, gold, machineries, steel, petro (see next table). Also the high import data for several recent months are claimed to be due to many importers accelerating the import pace ahead of tax raises.

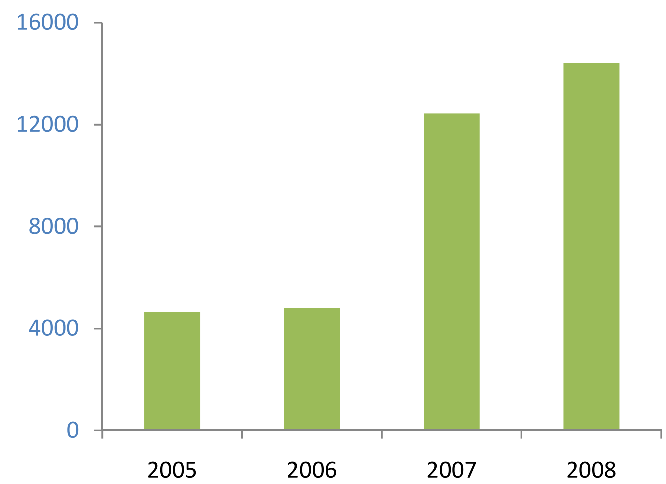
Anyway, this poses a great pressure on boosting export and controlling import for the rest of the year.

Chart 5: Export-Import-Deficit



Source: GSO

Chart 6: Trade deficits



Source: GSO

Table 2: **Proportion of some main imports as of May 2008**

	Value (USD millions)	Percentage
Automobile	1,306	3.45%
Steel	4,150	10.97%
Machinery, equipment	5,715	15.11%
Electronics	1,475	3.90%
Petro	4,855	12.84%
Fabric	1,792	4.74%

Source: GSO

What has been done

Tightening monetary policy: From earlier this year, a number of measures have been applied by the State Bank of Vietnam. In one of the first moves, SBV raised the required reserve ratio three times, from 8% to 10% and then 11% for all deposits under 12 months. After that, a total number of VND 20,300 billion (USD 1.25 billion) were allocated to all banks in the form of compulsory bill which are 6 months in maturity and would not be used for refunding. In the next move, SBV decided to withdraw all the deposits of the treasury system at commercial banks, which would expectedly takes away another VND 52,000 billion (USD 3.2 billion) from circulation. These have been seen as strong measures and showed strong determination from SBV to curb inflation.

Limiting credit growth and improve the loans portfolio: SBV has guided commercial banks to limit credit growth not to exceed 30% in 2008 to prevent the banking industry from getting overheated and enable banks to improve their loans portfolio, clearing their balance sheets from non performance and problem loans. Funds allocation to real estate projects and stock market investment are limited and closely watched.

The ceiling rate has been removed: As a result of funds shrinking and credit growing limit, interest rate at commercial banks have been significantly increased. In a recent move, SBV has raised the VND base rate from 8.75% to 12%. The 12% ceiling on deposit rate set up earlier this year was also removed. This aims at bringing a positive real interest rate in the economy. The popular deposit rate now stands at around 14% to 15%, which is a positive results and actually has created a favorable interest rate scenario which we will mention in the following section of the report.

Raising import tariff: In another firm move to prevent imports from accelerating, Vietnam has significantly raised import taxes on automobile and gold. Tax on imported cars has been lifted from 60% to 83%, and that of gold from 0.5% to 1%, 10% rise is also applied to the import of automobile parts. These items alone have contributed over USD 2.5 billion to the first 5 month deficit and are expected to spend about another USD 5 billion for the rest of the year. However, with these resolutions in place, the number will significantly decrease. Taxes on other consumer imports such as cigarette, alcohol, electronics are also expected to be raised later this year.

Controlling projects: All projects using state budget are to be checked, categorized and decided whether to be delayed, cancelled or continued. Among all, three groups of projects will be considered first: office buildings for the government, party, social organizations; the inefficient, time-delaying, unnecessary projects and those of which investment procedures have yet to be completed. The funds to be cut are targeted at 10% of the total construction investment using state budget, which is about VND 11,200 billion (USD 700 million). As government investment accounts for approximately 50% of total investment in the economy, this, if successful, will help cut down about 5% of the total investment.

Other measures have also been used, such as: Cutting down 10% on ordinary spending of the government budget, pushing up the export of major goods that Vietnam has comparable advantage, limiting the import of consumer goods, which account for a fairly large proportion of the import portfolio. In the longer term, the government is to restructure the economy towards creating more export-supporting industries, creating more value added products, lessening the dependence on importing inputs

The true story

Inflation is a whole world issue: With oil price shooting over the roof, basic materials rocketing and foodstuff shortage becoming a hot issue, the whole world is undergoing an intense pressure of inflation. Concerns have been raised around the increasing price levels in many countries in the world. As for the case of Vietnam, besides the oil and material effects, after the WTO accession, other goods are also adjusting to the general world price level as a form of osmotic effect. Taking this into account, we do not see the current inflation level as a persistent issue and thus will be lessened soon.

Foodstuff security is not an issue for Vietnam: Although contributing the biggest proportion to Vietnam's CPI index, foodstuff has never been and will not be a threat for Vietnam, in the meantime, many countries are facing an issue of foodstuff security. Apparently, the historic prolonged cold weather in northern Vietnam plus livestock diseases earlier this year have brought about certain difficulties for Vietnam's agriculture. The massive death of chicken and pigs, the temporary effect on rice growth have contributed to the increase in foodstuff price from the beginning of the year. Speculation is also a factor to be blame. In a country where people depend heavily on rice, any price movement would result in a more magnified effect. That is what happened in early May, causing the high CPI index as presented in the previous section. In a longer term however, there is no reason for Vietnam to worry about this issue. The current situation has got a lot better and with the Government determining to fight against foodstuff speculation and illegal price-blowing tricks, Vietnamese consumers are assured a stable foodstuff price for the rest of the year. This will also mean inflation will be significantly eased.

Core inflation remain modest: According to a publication by the Faculty of Banking of the Hochiminh city Economics University, Vietnam's core inflation is only 11%, a 4% lower than the inflation index using CPI. This calculation excludes the volatility of oil and food prices and thus reflect a more stable and longer-term movements in the general price levels. With regard to this indicator, Vietnam is actually maintaining a positive real interest rate, given the current level of 14% to 15% in deposit rates, and this is a very positive signal for the economy in the long term.

A main import item this year is for machineries which are crucial for the construction of new factories and production lines. Any country in the early economic expansion period would need to import these major equipment and thus a shortfall is understandable. This trend creates short term pressure but will pay back when these machineries start producing output for the economy, part of which will be exported. One example of this is the huge project of Dung Quat refinery, the massive amount of fund tied to importing equipment for the project as well as half of the country's funds used for importing oil and gas products will be resolved when it come into full operation earlier next year. For other items in the import portfolio, the amount and value are expected to drop strongly from now to the end of the year due to the higher import taxes and other technical measures applied. Another fact which is also worth mentioning is that many of the country's warehouses are filled up, ports are full of unloaded containers as importers tried to front run in anticipation of tax rises. While all necessary actions are taken to boost export, we anticipate a considerable improvement in the current account for the rest of the year.

Current account deficit but not a big concern: The amount of USD 14.4 billion deficit so far is certainly a sizable number for a small economy like Vietnam's. However, with financial account being taken into consideration, this is not a big concern. If FDI, ODA, private remittance kept the pace of 2007, the shortfall in current account will not be a big concern. And this is a firm base as FDI commitment until the end of May has reached a record number of USD 14.7 billion, ODA commitment of USD 5.4 billion, in addition to that, the remittance from Vietnamese overseas is also expected to be over USD 6 billion in 2008. With that being said, we are confident that the 2008 balance of payment will be neat and nice.

The recent increase of US dollars is mainly herd mentality driven: The fact that the free market rate kept deviating from the official SBV rate as shown in chart 3 and 4 has proved one common thesis that herd-mentality is always an issue in Vietnam's US dollar market. The oversold effect could be seen when the US dollar was under the pressure of devaluating earlier this year and at the moment, the overbought sentiment seems to be prevailing. As a matter of fact, a number of small businesses in need of USD for importing also resort to the free market, which pushes up the dollar recently, but this is a very small portion of the market. The main reason comes from individual investors' speculation amid concerns of worsening inflation and trade deficit numbers. At the moment, the State Bank of Vietnam is focusing on informing and educating the people about the economy's fundamentals and the rationale for not risking their money in a herd-mentality styled; speculation-driven dollar appreciation. The possibility of a big devaluation as claimed by some recent reports are very unconvincing. We therefore are against such views as a 20% or 30% devaluation in Vietnam dong NDFs. The fundamentals are still stable and problem free, so there is a little chance of a runaway as the case of Thailand in 1997. Also according to a high ranking officer from SBV who asked to be anonymous, the SBV's current foreign exchange reserve is overwhelming compared to the indirect investments on the Vietnam market should a runaway occurs. Thus we strongly believe Vietnam could very well handle this little hiccup.

It takes time for the policies to take effect: The tightening monetary and fiscal policies have been put in place since the beginning of the year, and in the normal course of policy implementation, it should take some time for the effects to be felt. For the case of Vietnam when the market response to policies has not been very rapid, the impact delay might be slightly longer, but results are expected to be seen very soon.

Differences between Vietnam and 1997 crisis struck countries: There are a lot of dissimilarities between Vietnam and those countries in the 1997 crisis. Such indicators in the banking sector as loan to deposit ratio; loan to real estate sector are very much lower in Vietnam than in Thailand. While Thailand banks had over 20% of their loans allocated to real estate for many years in a row, Vietnam banks only accelerate this type of loans in the last two years and the total balance so far accounts for a rate of well under 10%. If those East Asian countries' banks had their foreign-liability-to-total-liability ratio of over 10%, Vietnam banks have a very modest exposure to foreign currency liability. In terms of debt to foreign partners, Vietnam has got a significantly lower rate than Thailand (over 20% of GDP versus 58%) and the short term debt accounts for only 6.8% of Vietnam's GDP while that was 26.7% of Thailand in 1997. That is not yet to mention the illiquid stock and currency market of Vietnam, which impedes the assumption of a Thailand-style flee.

CONCLUSION

Our views in this report are based on the factual data and the current situation with the consideration of long term fundamentals in the economy of Vietnam. Our conclusion is that there is little evidence of either a balance of payment crisis or a heavy VND devaluation. Of course that is not to say what happened recently could be simply ignored. In a longer term, we show our concerns towards the current account deficit if it is not well handled, and if the unlikely becomes likely, the balance of payment, the flows of FDI, ODA, indirect investments will be at risk. For 2008 however, we do expect the positive results from the Government's policies to come soon as well as other supplementary measures are put in place if necessary.

Our message to investors is to look behind the numbers, into the core issues and fundamentals, be cautious and not to be too extreme. For now, there is not any reason to dread.

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