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Vietnam: Rising cyclical risks

- More signs of deteriorating macro dynamics in Vietnam have clearly raised systematic risk in the short term.
- However, given current and potential future foreign direct investment and portfolio investment inflows, limited short-term overseas borrowing, and onshore USD demand mainly driven by imports, we still believe that the probability of a balance of payment crisis is not large enough to make it our baseline scenario yet.
- To reduce inflationary pressures, we believe the Vietnamese government will likely have to extend price controls after they expire in June and undertake more austere fiscal measures by cutting expenditure and public investment projects to stabilize the economy.
- In addition, the central bank will likely tighten credit controls, especially after commercial banks attracted more deposits after the deposit rate ceiling was removed two weeks ago.
- We also believe it has become more likely for the monetary authority to consider the option of an accelerated pace of devaluation against the USD, to prevent the VND from being excessively overvalued in real terms.

In the past few days, record-high CPI inflation in May, a widening trade deficit and the central bank's hint of a dong (VND) trading band expansion have coincided with a temporary suspension of the Ho Chi Minh City Stock Exchange (HCMCSE). These developments have aggravated international investors' fears that macro instability risks in Vietnam will translate into a balance of payments (BOP) crisis or a significant currency devaluation in the near term. As a result, in the offshore non-deliverable forward (NDF) market, the 1-year USD/VND moved to trade around 22000, effectively pricing in a nearly 30% depreciation of the VND in 12 months. At the same time, the price of Vietnam's 5-year sovereign debt credit default swaps has jumped by almost 100 bp from last Friday's (May 30) closing level.

We agree that these signs of deteriorating macro dynamics have clearly raised systematic risk in the short term, which has also imposed a real threat to Vietnam's growth outlook. As we highlighted in previous articles,[1] it is crucial for the Vietnamese government to control inflation and engineer a soft landing of the economy. If the government fails to bring down inflation to a more manageable level, macro stability in Vietnam would be subject to great risk if liquidity flees into USD and gold, which would freeze up the domestic economy.

Nonetheless, we also see some mitigating factors that could help reduce the probability of an imminent BOP crisis. Given current and potential future foreign direct investment (FDI) and portfolio investment inflows, limited short-term overseas borrowing, and onshore USD demand mainly driven by imports, we still believe that the probability of a BOP crisis is not large enough to make it our baseline scenario yet.

On the currency front, our current assessment is that the likelihood of the central bank being forced into taking an abrupt and sharp nominal devaluation in the near term remains small. However, we believe it has become more likely for the monetary authority to consider the option of an accelerated pace of devaluation against the USD, to prevent the VND from being excessively overvalued in real terms.

Worsening macro risks

In the near term, we believe inflation risks continue to impose the greatest threat to macro stability in Vietnam. The acceleration of headline CPI inflation to 25.2% in May was mainly driven by rapidly rising food prices (67.8% yoy), especially the price of rice (see Exhibit 1). Without a further decline of 30%-40% in the price of rice from its current levels, which we deem unlikely given the price pressures in the international market, headline CPI inflation will likely climb higher in the near term and stay at elevated levels in the coming months.

Exhibit 1: Food price increases have contributed the most to the headline CPI increase

Vietnam CPI

	Headline	Food	Foodstuffs	Housing & House Maintenance	Transport & Communications
	% yoy	% yoy	% yoy	% yoy	% yoy
Mar-08	19.4	30.1	31.6	20.6	14.3
Apr-08	21.4	38.2	33.6	22.6	15.8
May-08	25.2	67.8	35.4	23.0	15.5

	Headline	Food	Foodstuffs	Housing & House Maintenance	Transport & Communications
	ppt	ppt	ppt	ppt	ppt
Mar-08	19.4	3.0	8.0	2.1	1.3
Apr-08	21.4	3.8	8.5	2.3	1.4
May-08	25.2	6.7	8.9	2.3	1.4

Source: CEIC, Goldman Sachs Economics Research.

Meanwhile, the trade deficit in the first five months of this year widened to US$14.4 billion, which is US$2 billion more than the total deficit for the whole of 2007. The extraordinarily rapid growth of imports at 70% yoy in January-May (driven by strong investment demand and higher international commodity prices) has raised serious concerns on Vietnam's capability to finance imports when FDI inflows decline. Given Vietnam's heavy reliance on refined oil[2] and raw materials such as steel and fertilizers, its official foreign exchange (FX) reserves (at approximately US$20 billion) seem to be low with barely three months of imports coverage.

[1] See *Vietnam: Rising inflation, growth setback and a likely roadmap of policy response*, Asia Economics Flash, May 19 and *Vietnam: The next Asian tiger in the making*, Global Economics Paper No: 165, April 17.

[2] Vietnam is an importer of refined oil and an exporter of crude oil. Despite the rising prices in crude oil recently, Vietnam has begun to see growing deficits in the oil trade due to the greater price increases in refined oil than in crude oil.

Although the Vietnamese government has implemented tightening policies through public spending reduction, price controls, higher interest rates, and credit controls, the jury is still out for whether such measures will be sufficient in bringing down inflation to a more manageable level, or more tightening is needed in the near future.

Still with some silver lining

Despite a worsening inflation-growth tradeoff in Vietnam, there are also some factors that could help counterbalance the risk of an imminent BOP crisis such as the kind Thailand suffered from in 1997.

1) FDI strength likely to continue and portfolio investment still trickling in

Vietnam has been and will likely continue to finance its trade deficit with FDI inflows, official development assistance (ODA), and private remittances. While the trade deficit widened in the first five months of this year, FDI inflows have more than doubled from the level of a year ago to US$14.7 billion with healthy disbursement inflows. We also expect forthcoming FDI inflows to hold up in the rest of 2008, considering concomitant capital in large projects initiated in the recent past and a stable flow of investment in the petroleum-related industries and IT manufacturing. Anecdotal evidence also suggests remittance inflows from overseas Viet Kiaus have remained strong.

In addition to steady FDI inflows, portfolio investments coming into Vietnam have remained positive, and those who chose to stay until now seem unlikely to leave unless they lose confidence over the medium-term growth outlook. During the sharp decline of 56% in Vietnam's equity index since the beginning of this year, foreign investors have been net buyers (while domestic retail investors were the sellers) throughout the period. Still, even during the past two days of HCMCSE suspension, foreign investors remained net buyers in the Hanoi stock exchange (albeit at a much smaller position).[3]

2) Short-term overseas borrowing is limited

In contrast to Thailand in its pre-Asian crisis period, Vietnam has a much smaller position in overseas short-term borrowing and has never relied on it to finance its trade deficits. The World Development Indicators show Vietnam's short-term debt outstanding as only approximately 8.6% of GDP in 2006, in contrast to Thailand's 26.3% in 1996. Given the central bank's tight regulations on overseas borrowing,[4] Vietnam's short-term loans have been small in size and mostly related to trade credit,[5] and there is little evidence that this has changed dramatically in the past 12–18 months. In addition, Vietnam's total external debt (US$22 billion) is slightly larger than its official FX reserves in size, but most of it is medium-to-long term debt is on highly concessional terms.[6]

[3] May 29, Viet Nam News.

[4] Vietnam's capital account regulation on foreign borrowing is "*Enterprises are subject to annual overall external borrowing ceilings and the fulfillment of certain other conditions. For short-term credit, borrowing enterprise must comply with the required conditions of the SBV. ...borrowing enterprises must report the borrowing and repayment schedules to the SBV. SBV approval is required for state-owned enterprises to borrow abroad under guarantees.*"

[5] *Vietnam's Economy in 2006*, Central Institute for Economic Management, Finance Publishing House, Vietnam.

[6] *Taking stock: an update on Vietnam's recent Economic Development*, World Bank, December 2007.

3) The increase in onshore USD demand has mainly come from imports, so far

The unusual jump in imports growth driven by stronger investment demand in recent months will likely normalize soon on the back of the monetary tightening through credit control, especially at a time when ports are running out of capacity for further import storage. Meanwhile, although it is possible that some imports over-invoicing could have been used to disguise capital flight, our discussions with local business contacts on the ground have offered little support of this being a widespread practice.

In the offshore market, VND NDF rates have been pushed up by traders unwinding long positions in the VND and adding positions to hedge against currency risk in VND sovereign/commercial bond holdings. Despite the large volatilities and pessimism priced in the NDF prices, its dynamics have remained relatively isolated from onshore USD demand so far.

With the existing FX controls under the capital account in Vietnam, the likelihood of an outright currency attack on the VND initiated by international speculators remains limited, in our view. However, if inflation deteriorates further for a sustained period of time, local capital might flee into gold and the USD, putting the domestic monetary system under stress.

The likely policy responses

To reduce inflationary pressures, we believe the Vietnamese government will likely have to extend price controls after they expire in June and undertake more austere fiscal measures by cutting expenditure and public investment projects to stabilize the economy. The current plan of cutting public spending by D2-4 trillion (compared to D112 trillion of government spending last year) does not seem to be sufficient to curb inflationary pressures effectively. In addition, the central bank will likely tighten credit controls, especially after commercial banks attracted more deposits after the deposit rate ceiling was removed two weeks ago. Although these measures should help contain inflationary pressures, they may tend to weigh on domestic equity prices (especially financial and property names) in the near term.

On the currency front, our current assessment is that the probability of the central bank being forced into taking an abrupt and sharp nominal devaluation in the near term is still low. In addition, given the potential impact of a large currency devaluation on inflation, the State Bank of Vietnam (SBV) will unlikely propose this option actively, especially when it is hard to determine how much a one-time adjustment in currency value will be needed to balance the mismatch in FX asset/liability positions.

However, we believe it has become more likely for the monetary authority to consider the option of an accelerated devaluation against the USD, to prevent the VND from being excessively overvalued in real terms. In the first four months of this year, although the VND depreciated by 4.1% in nominal terms against its major trading partners, it strengthened by more than 11% in real terms due to its higher inflation level relative to that of other countries. Since we expect CPI inflation (especially in yoy terms) to stay at elevated levels for the next few months, the SBV could risk pushing the VND official exchange rate to its highest level in real terms since 1997 in 4–6 months if it chooses to stick to the current 2%-per-year pace in VND depreciation against the USD in official parity. By then, risks on a currency crisis triggered by BOP difficulties may escalate to a less manageable level, and remedies could also be more painful.

In the upcoming months, we will continue to monitor policymakers' rhetoric closely on future policy directions. Any reversal from the current emphasis on inflation control over growth targets or contemplating with the idea of using a large nominal devaluation to boost export competitiveness would be warning signs of increasing macro risks in Vietnam.

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