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Global Research

Macro
Vietnam Economics

Vietnam at a Glance

2012 outlook: Some progress, but patience required

- **Inflation is easing and expected to reach single digits by end-2012, giving the SBV room to cut key policy rates**
- **Weaker import demand and a controlled weakening of the exchange rate by the SBV should help stabilise the VND**
- **But even with a more favourable macro environment, we see growth slowing in 2012, due to more cautious spending and weaker exports**

Growth to stay below long-term average

2011 was not an easy year for most economies. Expectations of a robust global recovery were dashed by news of Japan's earthquake, S&P's downgrade of US government debt, Europe's sovereign debt crisis, and China's slowdown. Growth slowed and investors recalibrated their expectations in preparation for a more uncertain future.

Vietnam, a nation with one of the fastest growth rates in the world in the past decade, was no exception. Vietnam's 2011 growth rate, although impressive at 5.9%, stood at a post-2000 low (excluding 2009's financial crisis-related growth of 5.3%). While this partly reflected a weakening global environment, domestic conditions were just as much to blame. Inflation was high, rising 18.6% y-o-y in 2011. Rising prices and measures to curb them took their toll on the economy, both in the short and long term.

However, macroeconomic conditions have stabilised significantly since the turbulent days of early 2011. Inflation decelerated to 17.3% y-o-y in January, and we expect it to hit single digits by the end of 2012. Even the dong (VND) has stabilised and a one-off devaluation is no longer priced-in. This is thanks to efforts by the State Bank of Vietnam (SBV) to gradually weaken the VND and dampen demand for imports. More encouragingly, after much talk, banking reforms are materialising: three banks were merged recently and more are expected to follow in 2012.

Despite this relative stabilisation, both investors and the Vietnamese at large remain cautious. This reflects slower expected domestic demand and weaker exports in 2012. Even with the expected easing of policy interest rates in 2012, consumers and investors are unlikely to accelerate spending significantly, as they have substantially altered their expectations after last year's high inflation. We expect growth to decelerate to 5.7% in 2012 from 5.9% in 2011. As such, although 2012 will likely bring better macroeconomic stability, both weak global economic conditions and cautious sentiment in Vietnam should keep growth below its long-term average.

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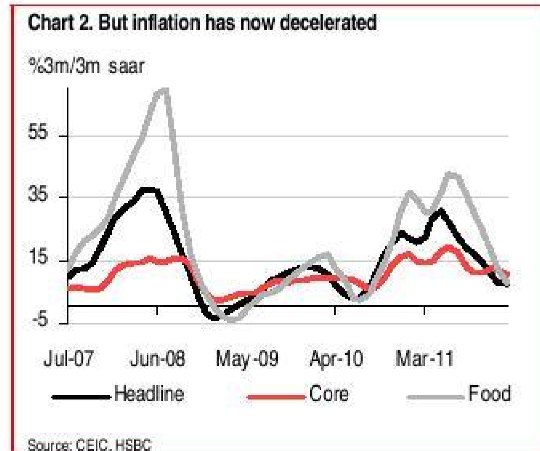
Macroeconomic conditions have improved

Inflation is on its way down

Chart 1. Prices rose significantly in early 2011

Source: CEIC, HSBC estimates

Chart 2. But inflation has now decelerated



Source: CEIC, HSBC

One major challenge that should keep both Vietnamese people and foreign investors cautious in 2012: high inflation in 2011. Even as prices are decelerating and inflation is expected to reach single digits by the end of 2012, people are likely to be cautious about how sustainable and stable this trend will be. In January 2012, price decelerated to 17.3% y-o-y from 18.1% in December 2011 (see Chart 1), marking the fifth consecutive slowdown on a y-o-y basis since inflation peaked at 23% in August 2011. On a sequential basis, inflation rose 0.6% (seasonally adjusted) in January 2012 versus 0.4% m-o-m (seasonally adjusted) expansion in December 2011. Food inflation rose 23% y-o-y in January 2012 versus 24.8% in December 2011. Core inflation, on the other hand, has remained relatively sticky (see Chart 2), decelerating slightly to 12.7% y-o-y in January 2012 from 13% in December 2011. Some upside risks remain, in our view, especially from imminent electricity rate hikes, as well as an oil import tax increase (up from 0% to 4% in December 2011). Although the downward trajectory is much needed, we believe it is unlikely to be enough to alter people's cautious behaviour. Memories of 2011 are still fresh.

In contrast to 2012's expected deceleration, inflation rose on average 2% month-on-month (seasonally adjusted) for the first five months of 2011. While Vietnam experienced a similar episode in 2008, when inflation averaged 23.1% for the year, the emergence of high inflation brought attention to Vietnam's long-standing economic challenges. This had the effect of turning any discussion about Vietnam from its impressive growth rate back to what it needs to do to address its structural inefficiencies. In response, the government tightened credit conditions to curb inflation in the short term and in the medium term it unveiled plans to increase investment efficiency by restructuring the banking sector.

As a consequence of high inflation and tighter liquidity, businesses faced credit constraints, which forced many to close or stop production. Consumers faced higher costs of living, higher borrowing rates, diminishing housing values, and more challenging employment conditions. The problem has been especially acute for people in the low income bracket, for whom food consumption makes up a larger share of total expenditure (food inflation increased 26.6% y-o-y in 2011). Manufacturing firms, especially those that came to Vietnam due to its low-wage competitiveness, faced pressure to increase wages as their

low-skilled workers struggled to afford rising costs. Firms faced 857 strikes in the first 11 months of 2011, more than double the number in 2010.

The Ministry of Labour, Invalids and Social Affairs reported that the average monthly wage rose 19.6% in 2011 to VND3.84m based on a survey of 3% of enterprises in Vietnam. This suggests that on average, real wages expanded by 1%. The breakdown shows that most of the increase came from state-owned enterprises, which have the highest average salary of VND4.41m compared to VND3.88m paid by foreign direct investment (FDI) firms and VND3.32m for those in the private sector. The wage disparity at FDI firms is significant, with the highest paid employees receiving nearly 20x more than the lowest paid workers. Among wholly state-owned companies, the multiple was 8x and at private firms it was 5.5x. The exact breakdown of salary increases for low- and high-skilled workers are not yet available, but anecdotal evidence suggests that wage growth was very unequal and that low-skilled workers suffered from negative real wage growth, as well as delayed pay in some cases.

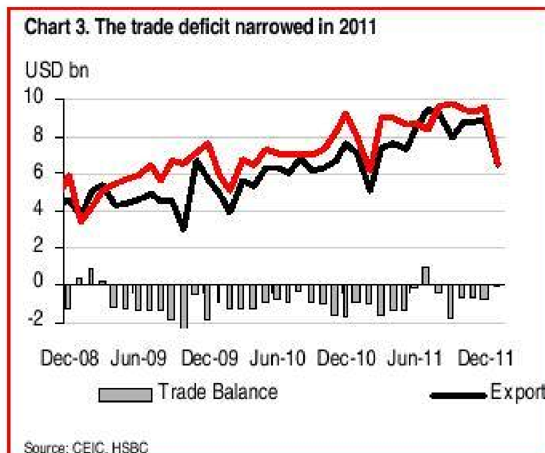
While the challenges highlighted above are likely to ease this year, due to decelerating inflation, they have left a lasting impression on the population and international investors. As a result, investors will likely be more cautious than they were last year and operate on a "wait-and-see" basis to reflect their scepticism and belief that effective structural reforms will take time. We expect private consumption to decelerate to 4.2% in 2012 from 4.3% in 2011.

Weaker external demand

Vietnam's exports and imports are expected to decelerate this year. This is due to weaker external demand, prompted by a slowdown in the US and China and a recession in Europe, as well as slower domestic demand for imports. Contained commodity prices should also bring down the value of Vietnam's major exports. We expect the value of exports to decelerate to 24.0% y-o-y in 2012 from 34.2% in 2011. Similarly, import values will likely slow to 22.0% in 2012 from 25.9% in 2011, in our view.

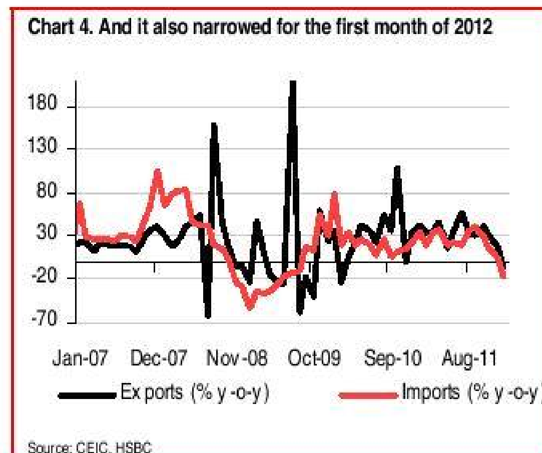
A preliminary estimate (based on customs data for the first 15 days of January) for January 2012 shows that Vietnam's trade decelerated; the trade deficit is expected to be USD100m in 2012 (versus USD876.7m in 2011). Exports for January 2012 are expected to contract 11.1% y-o-y and imports by 18.7% y-o-y. The drop in imports was steep in January 2012. This could be due to government's effort to dampen demand for imported goods to help curb inflation during the Lunar New Year festivities, as well

Chart 3. The trade deficit narrowed in 2011



Source: CEIC, HSBC

Chart 4. And it also narrowed for the first month of 2012



Source: CEIC, HSBC

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as lower demand for imported goods due to weaker growth expectations. The SBV made it difficult for banks to borrow funds to purchase imports and urged the public to spend less on imported goods. While these steps help relieve pressure on the VND, they also have the effect of dampening local growth. While most of the slowdown could be due to the seasonality effect of Tet being in January, rather than in February, as it was in 2011, a deceleration of both imports and exports is expected in 2012.

To aid agriculture exports, which performed well in 2011, the SBV reduced the reserve requirement ratio (RRR) to a fifth of the ordinary RRR (3% for VND and 8% for USD for less than one-year) for five banks (Central People's Credit Fund, Vietnam Bank for Agriculture and Rural Development, Mekong Joint-Stock Commercial Bank, Mekong Housing Joint Stock Commercial Bank (MHB), Lien Viet Post Joint Stock Commercial Bank), which have a high proportion of agricultural and rural loans on 2 February 2012. This is seen as part of the government's effort to support the agricultural sector and rural areas, as well strategic economic segments.

A more stable VND

In contrast to 2011, which began with a sharp weakening of the currency, high inflation, and several tightening measures, we believe 2012 will be relatively more stable. Several factors should contribute to this trend: slower inflation, better management of macroeconomic policy by the new Governor of the SBV (Nguyen Van Binh), and improved trade and fiscal positions. The trade deficit is expected to stabilise at USD10.1bn in 2012 (versus USD9.8bn in 2011) and the consolidated government balance is expected to decelerate to 3.8% in 2012 from 3.9% in 2011.

For example, the VND has stabilised in recent months. Historically, the VND had come under a lot of pressure during the Lunar New Year due to stronger demand for USD. This reflected a rush towards the end of the year to pay for dollar-denominated loans, as well as higher demand for imports during Tet. This did not happen in 2011 (see Chart 5) for several reasons:

- First, imports grew more slowly than exports, which helped narrow the trade deficit. Additionally, remittances were robust (estimated to be cUSD10.0bn, up from USD8.4bn in 2010), as well as FDI (estimated to be cUSD11bn versus USD11.0bn in 2010). These factors helped bolster the balance of payments.
- Second, the SBV has gradually raised the daily reference rate, allowing the VND to gradually depreciate, as well as intervening when the spread widened. In October 2011, the spread between the reference rate and the unofficial rate widened due to higher demand for USD to purchase gold. The SBV intervened by allowing more gold to be imported. Additionally, some banks and top jewellery companies received approval to participate in offshore account gold trading activities. As a result, the FX market stabilised.
- Third, a lot of companies accelerated the pace of their USD loan payments, as they anticipated that there would be a rush towards the end of the year. The high demand for USD in October 2011 caused them to prepare themselves. As such, USD demand during December 2011 and January 2012 was lower than in previous years.
- Fourth, demand for VND increased during the Lunar New Year due to seasonality factors, as well as a consequence of the merging of three small banks. Many small banks could not access VND in the

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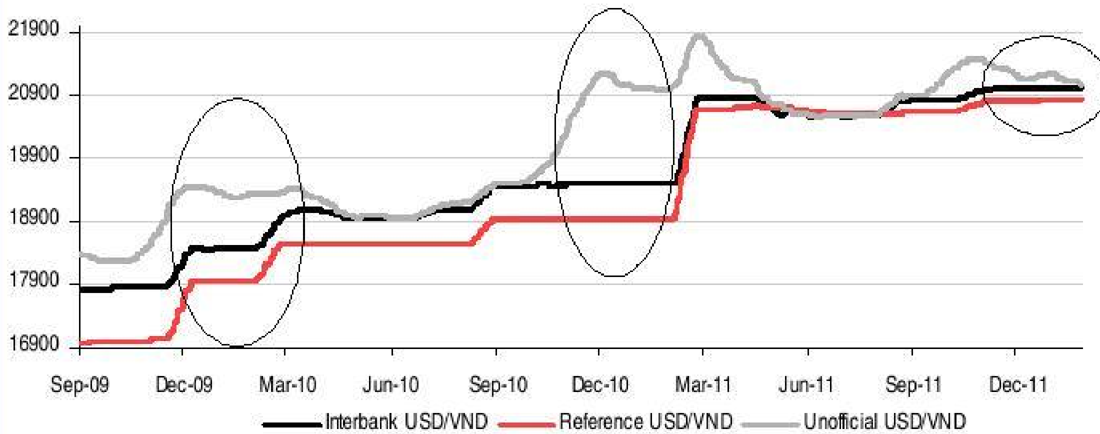
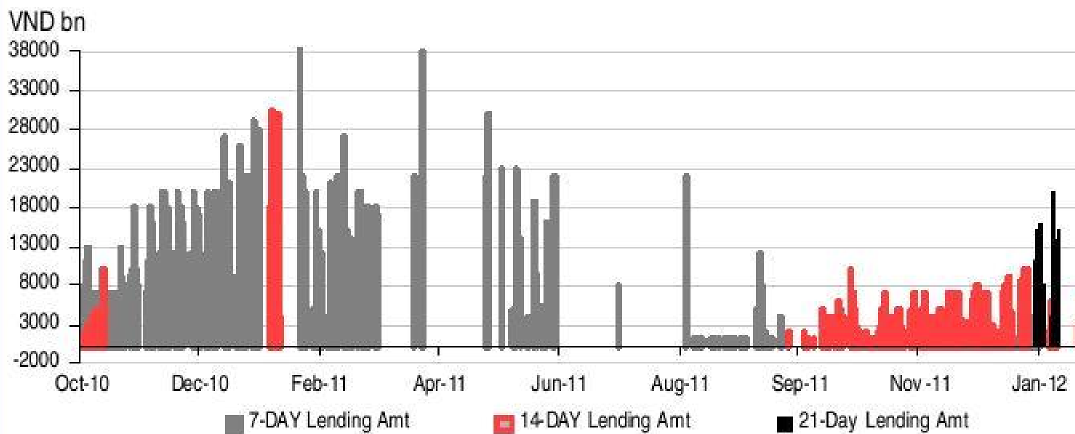
overnight market at this time and they had to use collateral to borrow funds. The SBV intervened by pumping up its 14-day lending programme, as well as commencing 21-day lending in January (see Chart 6). This satisfied some VND demand, but still was not enough to meet total demand. As Chart 5 shows, the unofficial USD/VND exchange rate appreciated slightly and has remained relatively stable since November 2011. In fact, the unofficial rate has narrowed and is closer to the interbank overnight rate, as well as the reference rate.

Chart 5. The VND showed stability, even during the Lunar New Year



Source: Reuters, HSBC

Chart 6. The SBV increased lending for the 21-day window and 14-day window



Source: Reuters, HSBC

Encouragingly for Vietnam's monetary policy in 2012, the new SBV Governor, Nguyen Van Binh, is communicating his intentions clearly and following through on his promises. He had stated that the VND would not depreciate more than 1% from September 2011 to the end of 2011, and it did not. He had mentioned that the VND would face downward pressure, but he would try to avoid a significant depreciation, as happened in the February 2011, when the currency fell 8.5%. Therefore, the VND is likely to weaken gradually in 2012. Governor Nguyen Van Binh has stated that, without any additional external shocks, the VND is likely to lose around 3% of its value by the end of 2012.

In the short term, the SBV will likely strengthen its grip on the management of the FX market, as well as the gold market. There is a plan to encourage people to sell their gold to the government; this will require them to first deposit their gold in banks. Governor Van Binh has stated that there are around 300-500 tonnes of gold circulating in the economy. This is part of the SBV's effort to control both the demand and supply of gold in the economy. As we stated previously (see *Vietnam at a Glance: A little less conversation*, 2 December 2011), the SBV had 'administratively' acquired Saigon Jewelry Company as part of its plan to maintain a monopoly over the country's gold market. The SBV also issued several circulars to exert control over the FX market.

Patience required

Given the current global landscape, our forecast of 5.7% growth for 2012 is still respectable. This reflects Vietnam's robust exports, albeit at a slower pace than in 2011, strong investment backed by steady inflows of FDI, and domestic demand (also slower than in 2011). Additionally, Vietnam is also expected to have a more stable macroeconomic environment, thanks to decelerating inflation, contained trade and budget deficits, and better management of monetary policy. Based on recent trends, it appears that Vietnam seems to be heading towards the right direction in 2012 despite global headwinds.

However, we believe this will not be enough to repair the psychological damage that high inflation has had on the population, as well as investors; both will need a lot of convincing to return to the spending levels of pre-2009. Those affected by macroeconomic instability in 2011, as well as in 2008, will be more cautious this time around. Last year was particularly damaging, as it confirmed that Vietnam's struggle with macroeconomic imbalances was far from over. In our view, reforms are needed for people to change their expectations, as short-term fixes are no longer enough.

Since our last publication, the SBV has pushed forward with its reform of the banking sector as part of the nation's long-term strategy to increase the efficiency of investment in the economy, as inefficient allocation of resources has created bottlenecks in the economy. While small banks make up a small percentage of the banking system, they pose significant systemic risks. They are generally more exposed to the real estate sector, which is not doing well at the moment, as well as state-owned enterprises. Additionally, they tend to circumvent SBV regulations and create large distortions in the financial market. Concerned about the risks involved, the SBV has tightened liquidity and started to force them to merge.

Three small banks, all with liquidity issues, were merged in December 2011 (First Commercial Bank, Tin Ngia, and Saigon Commercial Bank). While this signals that the government is serious about reforming the economy, the merger was considered symbolic. The banks are still largely separate entities, and it is unclear how merging the three bad banks will solve their liquidity problems, as aggregating small bad debts would only create one large bad bank. Five to seven more banks are expected to be merged this year. While the SBV is determined to resolve this issue – which sends a positive signal – at the moment it appears unclear how to get the job done. More than likely the SBV will use a trial-and-error approach, which could take some time.

However, we are optimistic that Vietnam will make the necessary reforms to unleash its potential, even though this is likely to require more patience than we would like. In 2011, most observers were perplexed by the methods used to curb inflationary pressures as they fell outside conventional economic wisdom. Despite this, the SBV was effective in curbing credit growth – it grew by 10.9% in 2011 versus 27.7% in 2010. It set the limit for credit growth at 20% in 2011, which suggests that many people were reluctant to take out loans as the

interest rates were high. Inflation has been falling for the past five months, and we believe the trend is set to continue until the end of 2012. For this year, the SBV has set the maximum credit growth rate at 15-17%.

Looking ahead, we expect this year to be relatively challenging despite improved macroeconomic conditions, such as easing inflation. Growth is expected to decelerate to 5.7% in 2012 to reflect both turbulent external conditions, as well as more cautious consumption. With easing inflation, we believe the SBV is likely to lower rates towards the end of 1Q 2012. In fact, it has already commenced the easing cycle with a reduced RRR for certain economic sectors. Whether the easing of interest rates in the future will spur consumption will largely depend on whether the government can convince the population that it is committed to reform; most people are likely to take a wait-and-see approach. For Vietnam to return to its long-term average growth rate of 7%-plus, a concerted effort to reform the economy is required to both increase investment efficiency, as well as reset the expectations of both Vietnamese and foreign investors.

HSBC Main Vietnam Forecast

	Q1 2011	Q2 2011	Q3 2011	Q4 2011	Q1 2012f	Q2 2012f	Q3 2012f	Q4 2012f	2011f	2012f
GDP (% y-o-y)	5.4	5.7	6.1	6.1	6.1	5.6	5.7	5.4	5.9	5.7
CPI, end quarter (% y-o-y)	13.9	20.8	22.4	18.1	15.2	10.5	8.4	9.2	18.1	9.2
Trade balance (% GDP)	-15.9	-9.9	-3.7	-5.8	-11.3	-8.5	-8.4	-7.0	-9.8*	-10.1*
International reserves (USDbn)	12.7	12.7	12.7	12.7	12.7	12.7	12.7	12.7	11.5	12.0
OMO rate, end quarter (%)	12.0	15.0	14.0	14.0	13.0	11.0	10.0	9.0	14.0	9.0
VND/USD, end quarter	20880	20600	20830	21500	21500	N/A	N/A	N/A	N/A	N/A

Note: * Denotes actual value in USDbn
Source: CEIC, HSBC estimates

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