Flashnote

HSBC Global Research

Macro and FX
Vietnam

Vietnam at a Glance

Oil shock aside, impact of rate cut on inflation will be muted

- **Policy rates have been cut 1% due to easing price pressure**
- **Domestic oil prices were increased 10% to reflect international price rises, while the duty for most energy imports was removed**
- **However, a favourable base effect coupled with dampened demand should be enough to ease inflationary pressure**

Don't worry, prices will still slow

Inflation may become a problem again in Asia later this year. But, in Vietnam, things are likely to be different. After last year's rapid rise, price pressures are now cooling amid slowing demand and falling credit growth. The State Bank of Vietnam has thus been able to cut rates by 1%. The cut had been priced in by the market but the question of whether it will stoke inflationary pressure and destabilize the dong remains. While easing policy rates in the midst of a rise in international oil prices may seem premature, the cut is unlikely to reverse the downward trend in Vietnam's inflation.

Based on our analysis of Vietnam's monetary policy, the cut comes as no surprise. The SBV implements monetary policy in two main ways: 1) it appears to track core inflation to determine policy rates; and 2) it uses administrative measures as the primary tool to target inflation. Core inflation has eased since its peak at 15.2% y-o-y in August 2011 to 12.7% in February. The slowdown of both headline and core inflation plus the stability of the dong provided scope for the SBV to cut rates.

Despite today's cut, inflation should continue to decelerate to single-digits by year-end for three reasons: sluggish domestic demand, slow credit growth and a favourable base effect. Persistently high inflation in 2011 taught consumers to be cautious, which will affect their spending this year. Meanwhile, optically, inflation's rapid rise last year means that the base effect is enough to allow y-o-y inflation to fall. We also do not expect the rising oil price to significantly have an impact on inflation in 2012, assuming that oil prices do not rise above USD140 per barrel.

For the currency, many of the factors that have concerned us are still there – double-digit inflation, negative real interest rates and a sizable trade deficit – but we are seeing improvements. For now, the risks are still skewed slightly to further VND weakness, and we forecast USD-VND at 21,500 by year-end. However, if these indicators continue to improve, then VND may start to look more attractive again.

12 March 2012

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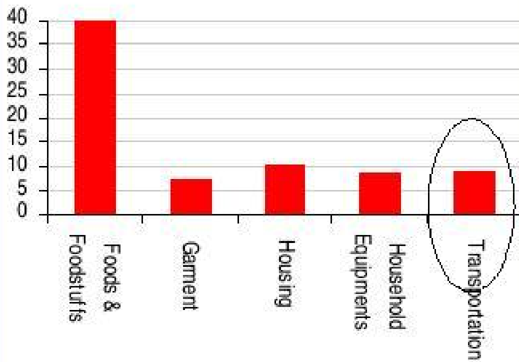
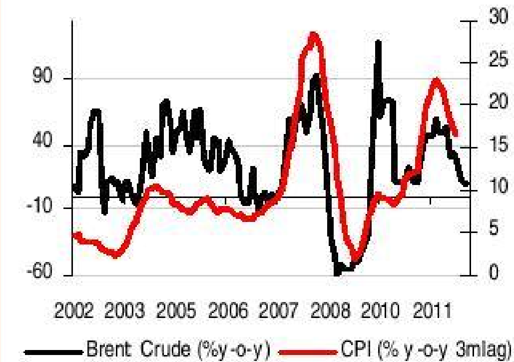
Chart 1. Oil makes up a small percentage of total weight



Source: CEIC, HSBC

Chart 2. Headline CPI only increases noticeably when the oil spike is significant and when domestic price rises



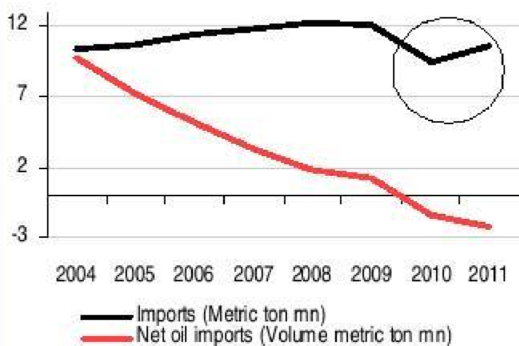
Source: CEIC, HSBC

Why oil would not reverse inflation's trend

As a nation that exports crude oil, Vietnam still had to import USD9.7bn worth of petroleum in 2011. This means that when the oil price increases, as it has recently, Vietnam benefits through the export channel but suffers on the import side. The recent rise in prices would require the state to increase the oil subsidy or pass the higher cost on to consumers. With the subsidy fund running out, the Ministry of Finance increased gasoline prices by 10% on 7 March. The rise coincides with the reduction of policy rates by 1%.

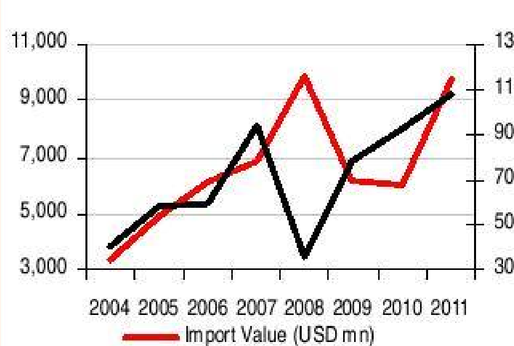
In our view, the rise in oil prices will not significantly change the direction of headline inflation, which has been trending down. Transportation costs, which we use as a proxy for oil, account for 8.9% of the total CPI basket. A 10% increase in the oil price would therefore have only a muted direct impact on headline CPI. Additionally, the government recently reduced a number of duties of energy imports. On 2 March the Ministry of Finance scrapped import taxes on petroleum gases (previously 5%), diesel (3%), kerosene (3%) and gasoline (4%). This suggests that looking forward, unless oil prices continue to climb higher, distributors will incur less cost to importing oil. Moreover, food prices, which make up almost 40% of the total basket, have decelerated sharply and would offset the effect of a higher oil price. While secondary effects of higher oil prices will feed through in a couple months, the impact will be likely be offset by low demand.

Chart 3. Oil import demand has slowed in recent years



Source: CEIC, HSBC

Chart 4. But higher oil prices have pushed the costs up



Source: CEIC, HSBC

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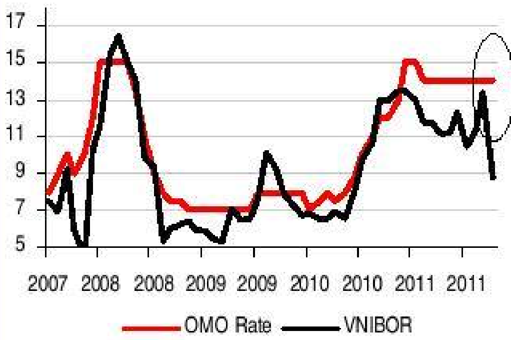
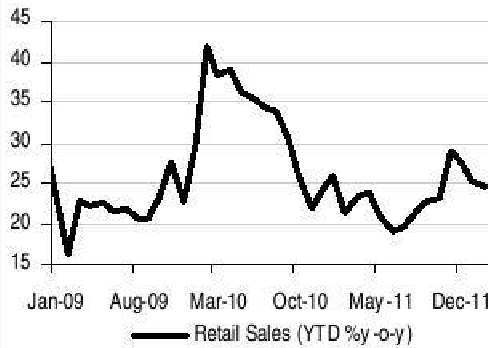
Chart 5. Loan demand has been low



Source: Reuters, HSBC

Chart 6. Domestic demand has decelerated recently



Source: CEIC, HSBC

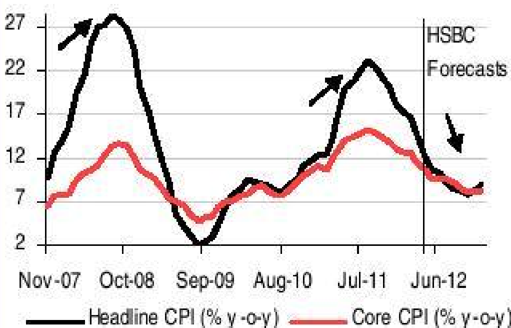
Slower domestic demand

More fundamentally, slower demand for loans as a result of earlier tightening will also reduce inflationary pressure. Chart 5 shows that the interest rate for the overnight market has been low as of late, with a spike during the Tet (New Year) festivities. We expect this trend to continue for the rest of the year. This suggests that even though the SBV has tried to pump more money to the economy through the reverse repurchase window, demand is low; thus, it will not significantly affect liquidity in the financial system. Moreover, consumption has cooled recently, especially after the Tet festivities. Chart 6 shows the deceleration in retail sales, a proxy for consumption. We expect both loan demand and private consumption to be sluggish in 2012.

Strong base effect will bring the rate down

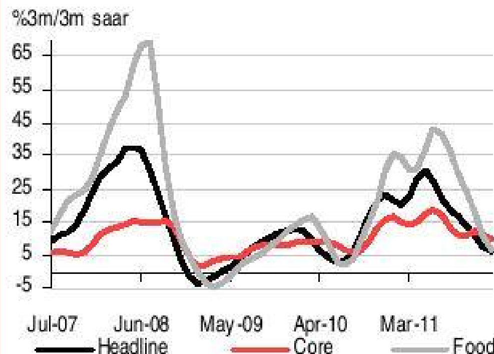
In the next six months a strong base effect, which reflects the strong 2% m-o-m (seasonally adjusted [sa]) increase in March-May 2011, will likely bring inflation down. The inflection point for inflation is not until November 2012, when we expect the y-o-y inflation rate to begin to pick up. However, should loan demand remain low, the currency stay stable and no significant supply shocks occur, then headline inflation could even decelerate beyond November. At this point, we expect the base effect alone to have a powerful downward effect on y-o-y inflation readings until then. After that, other factors, such as electricity and oil price rises, as well as demand and monetary shocks would meaningfully affect inflation.

Chart 7. Even with oil price increases factored in, inflation would still go down



Source: CEIC, HSBC estimates

Chart 8. Food makes up 40% of the basket and its prices are falling fast

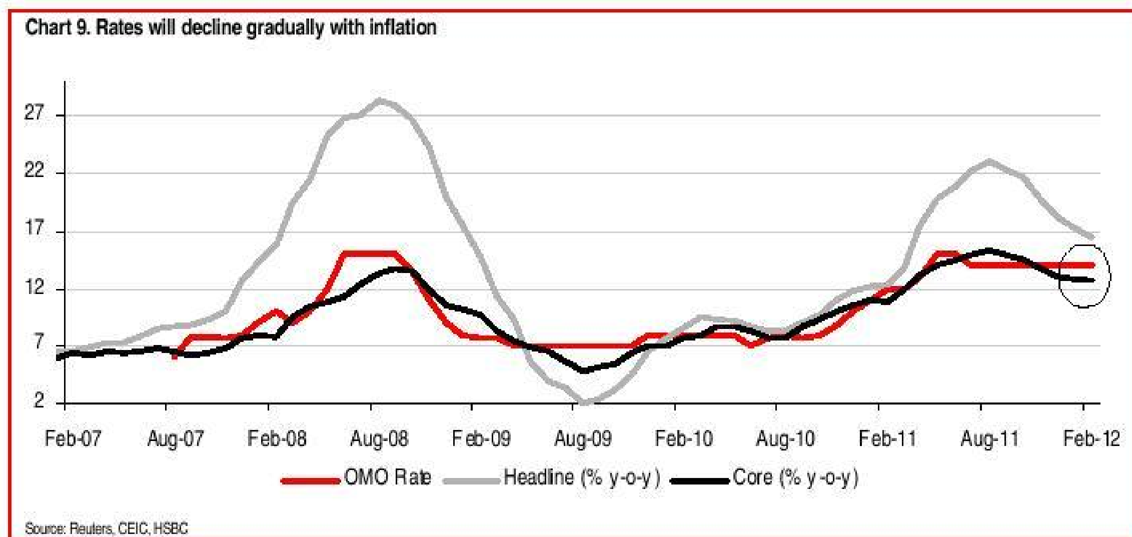


Source: CEIC, HSBC

Inflation decelerated to 16.4% y-o-y in February, compared with 17.3% in January. On an sa basis, prices slowed to 0.4% m-o-m in February compared with 0.6% in January. Food inflation rose 21% y-o-y in February compared with 23% in January. On the month, food prices decelerated 0.2% m-o-m sa in February compared with 0.5% in January. The sharper-than-expected deceleration in prices suggests that the filtering through of tightening policy (Resolution 11), the easing of demand after Tet and the base effect are all working together to keep price pressures low. And we still expect prices to decelerate to single-digits this year.

Weaker credit growth more important

Chart 9. Rates will decline gradually with inflation



Source: Reuters, CEIC, HSBC

Before we discuss the policy rate easing, we should look at credit growth in Vietnam, a more important measure of liquidity conditions. Credit grew 10.9% in 2011, compared with 27.7% in 2010. The government capped credit growth at 20% in 2011, suggesting that demand was low in 2011 given that actual growth was lower than the cap. For this year, the cap is 17%, 15%, 8% and 0% for different banks. The growth for loans for investment and trading in stocks and real estate as well as consumer loans is capped at 16%. Given the lacklustre demand in the market, the cap is unlikely to be reached.

The easing of interest rates then would only meaningfully affect the domestic economy if it ultimately increases demand. The open market operations (OMO) rate was lowered to 13% from 14% and the refinance rate to 14% from 15%. The government also decreased the deposit cap on interest rates to 13% from 14%. Both policy moves are part of the SBV's attempt to respond to complaints from consumers concerning high interest rates. With the overnight interest rate being significantly lower than the OMO rate and expected to remain so for the rest of the year, the move is unlikely to significantly change domestic demand.

As such, we reiterate our call that inflation will continue its downward trend this year. This, however, does not imply that Vietnam's battle with inflation is over indefinitely, as high inflation in 2011 exposed structural bottlenecks in the economy that would need to be addressed. In the short term, dampened demand, lower credit growth and a favourable base effect should be enough to keep price levels more stable this year. Once the shock of a 10% increase in oil prices subsides and the benefits of energy tax reductions filter through, consumers will breathe a sigh of a relief as prices decelerate this year.

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FX outlook better, but still wary

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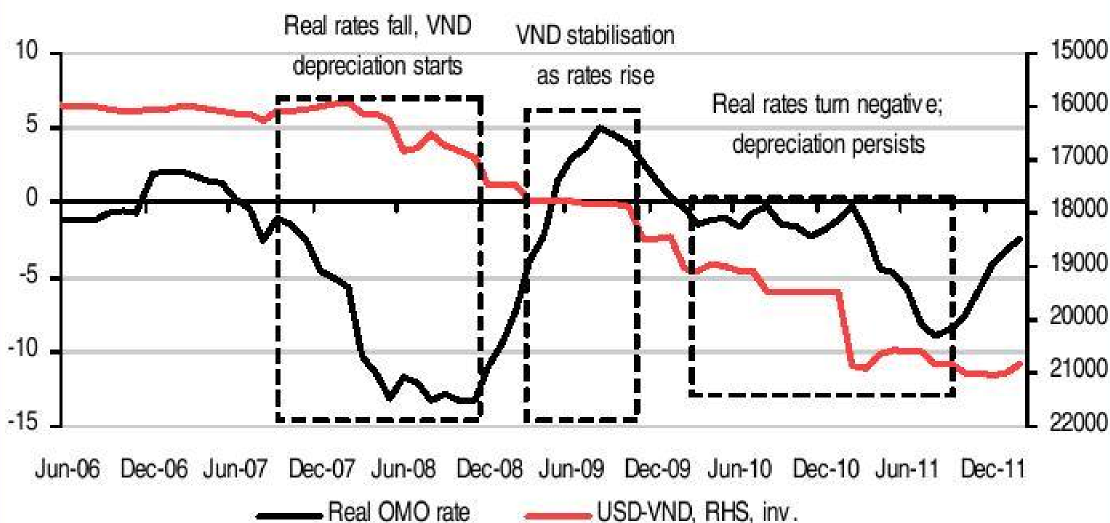
VND – waiting for the tide to turn

We have long been of the view that VND still faces downside risks and have been calling for further depreciation of USD-VND to 21,500 by the end of 2012. This would be largely in line with what the SBV recently stated was its view for the dong in 2012 – when Governor Nguyen Van Binh stated that he saw no more than 2-3% depreciation this year. Many of the factors that have worried us on the VND remain – double0digit inflation, negative real interest rates and a sizable trade deficit – but we are seeing improvements in these indicators. For the moment, the risks are still skewed slightly to further VND weakness. However, we are watching these indicators and if we continue to see improvement, then VND may start to become more attractive again.

Interest rate cuts – slowly does it

Inflation has come off notably since its peak in August last year, down from 23% to 16.4%, and our economists forecast this to continue moving lower. The risk, from our perspective, is that rate cuts come too soon and too fast, and that investors both domestically and abroad start to fear the re-emergence of the inflation-depreciation cycle. Historically, negative real interest rates, or falling real interest rates, have been associated with weakening pressure on the VND (Chart 10). In this cycle, the positive news has been that real rates have narrowed from being highly negative. This should limit the disincentives of holding VND instead of USD. Provided interest rates don't fall too fast, and inflation continues to drop, then the real rate environment should be more positive for VND.

Chart 10. VND has faced stronger depreciation pressure when real interest rates have been negative or falling



Source: Bloomberg, HSBC

The volatility in gold prices has also limited the onshore demand for the precious metal, which has been seen as a good alternative store of value, given the history of the depreciating VND. Authorities have also redoubled their efforts to clamp down on gold trading and therefore on gold imports. The rising inverse correlation seen late last year between gold and VND has declined notably in recent months (Chart 11). With less demand onshore to hold gold for investment or store of value purposes, some of the pressures that had previously been weighing on VND have been removed.

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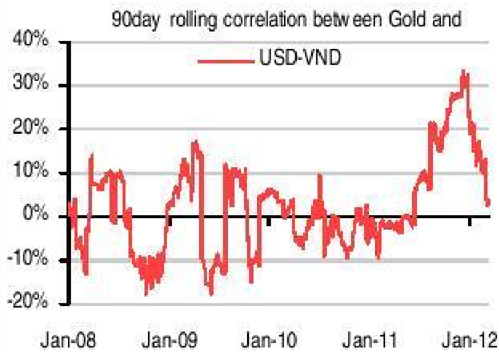
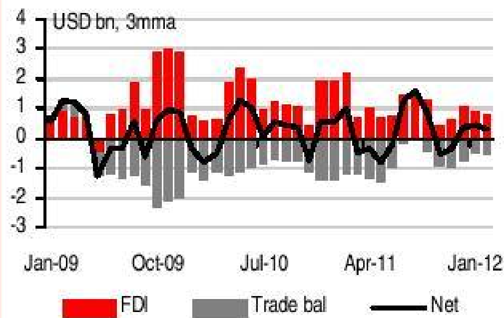
Chart 11. USD-VND and gold less correlated now



Source: Bloomberg, HSBC

Chart 12. Improvement in trade and robust FDI has boosted underlying flows



Source: CEIC, Bloomberg, HSBC

Flow picture looking more positive

One of the notable improvements for VND has come though the narrowing of the trade balance. The overall picture has been improving for some time, with a small trade surplus recorded in January, which was only the second monthly surplus in three years. The previous VND depreciation has no doubt had something of an impact, but so too has the fact that Vietnam exports a lot of primary goods with stable underlying demand, such as rice and fish produce, which means it has suffered less from the global slowdown.

Meanwhile, FDI flows have remained relatively robust. One thing to watch will be investment from Japan. Since the earthquake in 2011 affected much Japanese production, firms have been looking to diversify their production lines to other Asian centres. Thailand had been a key destination for such investment, but with the floods late last year affecting Japanese companies, many are being forced to consider more diversification, and Vietnam could benefit. Indeed, February's data shows more than USD800m in FDI from Japan to Vietnam. If similar flows continue then it will provide a useful source of foreign exchange to the country.

Finally, from a capital flow perspective, there has also been an improvement. Ytd flows into the equity market have been around USD500m (Chart 13). As the inflation-growth outlook improves, onshore asset markets should start to look more attractive. At the same time, with a lower depreciation risk expected, investors are likely looking at the onshore markets with a more favourable risk-reward. With western central banks priming the printing presses, excess funds will continue to flow to emerging markets. If broader risk sentiment returns, then investors may start to look more closely at markets like Vietnam.

USD borrowing rising giving a shorter-term VND boost

Anecdotal evidence suggests that onshore there has been good demand to borrow in USD, given the low rates compared to VND loan rates. This has led to spot selling in USD-VND and the currency has been trading in the middle of the daily trading band (Chart 14). On the plus side this should have allowed the SBV to come into the market to pick up USD to boost its ailing reserves. However, we would be a little wary of using this development as an indicator of long-term strength. As these loans roll off in 3-6 months, there could be increased pressure on USD-VND spot on the other side, as USD is needed to repay loans. This would particularly be the case if export earnings are not as strong as expected, and

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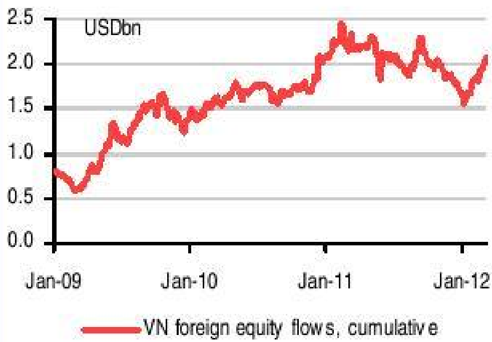
Chart 13. Capital flows have also improved this year



Source: Bloomberg, HSBC

Chart 14. USD-VND trading in middle of the band allows SBV to build reserves

Source: Bloomberg, Reuters, HSBC

exporters need to repay the loans with dollars bought in the spot market. Also, with VND rates slowly coming down, there will be less incentive to borrow in USD in the future too, which should make this a shorter-term factor, rather than a long-term indicator for VND. Moreover, the SBV recently announced that importers would not be able to take out foreign currency loans, unless they already have foreign currency for repayment, effective 2 May 2012. They would therefore need to source their USDs in the spot market, which could add to VND weakening pressure.

Still too many ifs and buts for now

So while the picture for VND has no doubt improved, particularly in recent months, we remain wary. There are still too many risks to the weak side for now. However, if the improvements in the trade balance and real interest rates can become more sustainable, then VND would likely start to look more attractive. We stick to our call of further depreciation, but then see USD-VND stable at 21,500 in the medium term.

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