

## Vietnam at a glance

No one said it would be easy

- ▶ **In July, inflation slowed to 5% from its peak of 23% in 2011; the trade deficit narrowed and foreign exchange reserves climbed**
- ▶ **Officials have thus been successful at cementing economic balance, bringing down inflation and initiating needed reforms**
- ▶ **Sluggish demand, however, caused manufacturing to slow further in July, suggesting that another rate cut is coming**

### More reforms still needed to move forward

Vietnam is not alone in its struggle with weakening domestic demand. Even the world's most powerful economies (the US, Eurozone and China) are counting on monetary officials to ease and spur spending. However, consumption is likely to remain sluggish, while structural reforms are needed to fix entrenched issues. These may take more time to be fully rolled out: restructuring an economic system is politically challenging and technically complex.

Policymakers in Vietnam have signalled that they are willing to take necessary actions to move the economy forward. Measures were taken last year to tighten credit growth to curb demand. Inflation declined to 5% in July from 23% in August 2011. The trade deficit, too, narrowed to USD58m in January to July, compared to almost USD6bn a year earlier. The VND has been stable for most of the year. Additionally, FX reserves have risen, bolstered by both an improved trade deficit and strong FDI disbursements. The government also recently passed resolutions aimed at increasing the efficiency of SOEs and the banking sector.

More remains to be done. The slowing of credit growth (less than 1% year-to-date) reflects both weak internal demand, a symptom of structural weaknesses, as well as external factors. Since the mid-2000s, the economy has become highly leveraged and much investment went into unproductive activities. The tightening of credit reveals Vietnam's dependence on credit to sustain growth, an unsustainable strategy as it increases systemic risk and fuels inflationary pressures. At the same time, it also reflects the government's commitment to shed the system of bad debt. The credit-to-GDP ratio declined from 121% in 2010 to 108% in 2011 (but this is still high compared to 48% in 2003). This deleveraging process will continue in the coming years.

In the meantime, businesses in Vietnam are suffering from both low domestic demand and weak global growth. HSBC July PMI contracted to its lowest level since the series began in April 2011. This mirrors primarily consumers' unwillingness to spend due to either high debt or a challenging outlook for growth. Cautious spending behaviours, both from corporations and consumers, and slowing inflation suggest that the SBV will step up its easing.

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Table 1. HSBC Vietnam Manufacturing PMI and its sub-indices

	Jul-12	Jun-12	May-12	Long-Term Average
PMI Index	43.5	46.6	48.3	49.4
Output				49.6
New Orders				49.6
New Export Orders				50.6
Backlogs of Work				49.3
Stocks of Finished Goods				49.8
Employment				50.2
Output Prices				52.3
Input Prices				58.2
Suppliers' Delivery Times				51.4
Stocks of Purchases				47.2
Quantity of Purchases				49.5

Source: Markit, HSBC. Note: Less than 50 and falling; Less than 50 and rising or same; Greater than or equal to 50 and falling; Greater than or equal to 50 and rising or same.

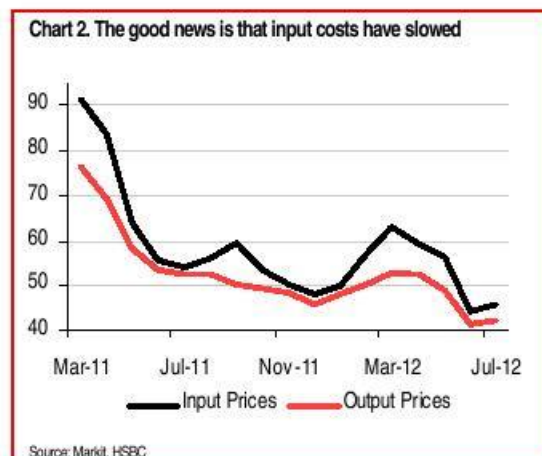
## A painful process

### Little demand

Following the tightening cycle last year, the SBV already eased most policy rates by 500bp (the OMO was reduced by 600bp) since the beginning of 2012 to spur weak domestic demand. However, this has not impacted spending yet, given that consumers and firms are either saddled with debt or cautious about the future of the economy. The July HSBC manufacturing PMI reflects this weakness: the index fell to 43.5 from 46.6 in June, the sharpest drop since the series began in April 2011. Manufacturing makes up around 26% of Vietnam's GDP. A reading below 50 reading marks a contraction from a previous month.

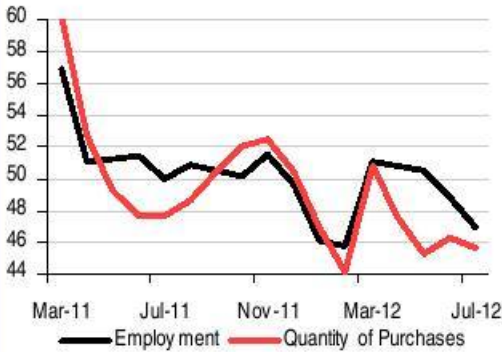
Chart 1 shows both new orders and new export orders declining to the lowest level since the series began. Thus, Vietnam not only suffers from cautious demand domestically; but also from weakened demand for goods in Europe and China. However, the biggest issue cited by managers was consumers' unwillingness to spend. On the flip side, the lack of demand, coupled with low commodity prices, causes input prices to drop. This alleviates some of the cost burden for firms. Meanwhile, output prices have also declined due to lower costs as well as increased competition, reflecting easing overall inflation pressures.

Similar to its clients, manufacturing firms are cutting back: adopting a more cautious stance on spending. Chart 3 shows a cut-back in employment as well as quantity of purchases. This means that looking ahead firms are





**Chart 3. But weak internal demand causes firms to cut back on purchases and staffing levels**



Source: Markit, HSBC

**Chart 4. Manufacturers are also reducing purchases, while inventories remain relatively high**



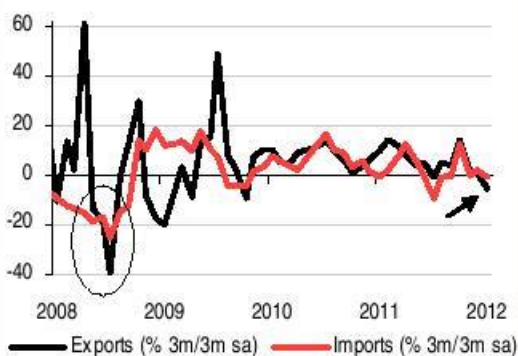
Source: Markit, HSBC

not expecting a recovery in demand anytime soon. Stocks of purchases were reduced sharply. At the same time, inventories were also cut back, painting a weak picture on managers' future outlook.

The weaker trade numbers reflect both low internal and external demand. On a year-on-year basis, exports rose by 3.8% in July versus 14.3% last month (year-to-date slowed to 19.9% from 23.4% in June). Seasonally adjusted (sa), July marks a second month of contraction on a month-on-month basis. On a trend basis, exports are showing a deepening trend of contraction due to weaker shipments of aqua products, rubber, computer and electronics, coal and tea. This primarily reflects weakening demand in China and Europe.

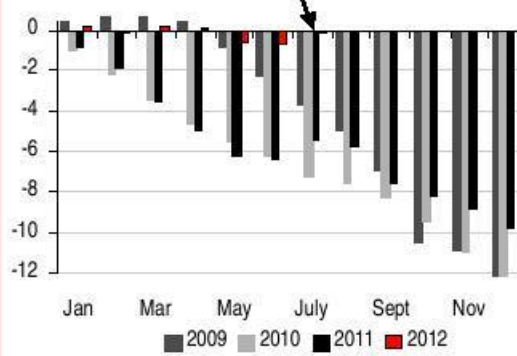
Imports also weakened to 9% y-o-y from 13.6%. Seasonally adjusted, they contracted by 3.7% m-o-m sa from a 0.5% decline in June, led by the import of sewing materials, plastics, yarn, cars, motorbikes, steel, wheat and milk. This means not only that consumption goods are declining, but items used to manufacture footwear and apparels are also contracting. With the Eurozone in a recession and the US slowing, demand for Vietnamese exports will likely decelerate further. We revise our export growth forecast down to 13.7% from 16.6% for 2012 and import growth down to 6.5% from 12.3%. For the year, the trade deficit is likely to narrow to USD3.5bn (revised downward from USD6.4bn). This means that even if easing measures spur spending towards year-end 2012, demand will only picking up gradually.

**Chart 5. Both imports and exports decelerated but nowhere near the lows of 2008**



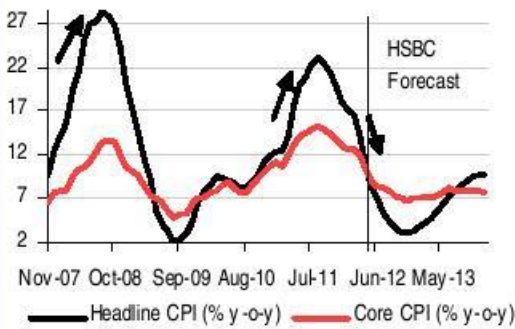
Source: CEIC, HSBC

**Chart 6. So far this year, the trade deficit is on course to come in well below the level in previous years**



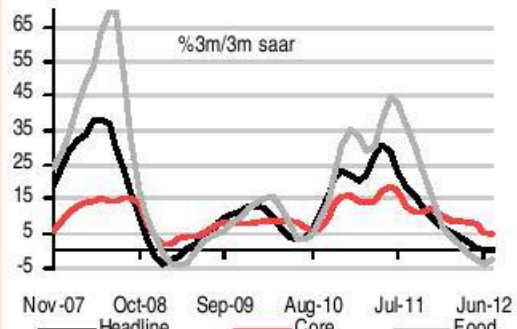
Source: CEIC, HSBC

Chart 7. Low demand pulled headline inflation down



Source: CEIC, HSBC

Chart 8. But most of the decline is due to slowing food and energy prices, as core remains sticky at around 8%



Source: CEIC, HSBC

## More easing on its way?

Yes. But that's unlikely to significantly impact demand. Headline inflation slowed to 5.3% y-o-y from 6.9% in June. On a seasonally adjusted basis, prices picked up slightly to 0.1% m-o-m sa from a contraction of 0.1% in June. Most of the slowdown in headline inflation came from food, which eased to 3.6% y-o-y from 6.3% the month before. On a month-to-month basis, food prices contracted by 0.5% m-o-m sa from 0.2% in June. Core inflation, stripping out food and energy, however, remains very sticky at 8.2% y-o-y in July (from 8.3% in June). On a sequential basis, it picked up 0.6% m-o-m sa from 0.2% in June.

Headline inflation is indeed slowing and will continue to decelerate further in the coming months, helped by a very favourable base effect as well as low demand. While this gives scope for the SBV to ease policy rates further (we expect another 100bp cut of the discount, refinance and deposit rates to be delivered soon). The OMO rate was already reduced 600bp to 8% from 14% at the end of 2011. Another 100bp rate cut for the OMO rate is increasingly likely, as growth remains weak and core inflation will decelerate to its bottom at around 7%. We expect a cut of 100bp to the discount, refinance and deposit rates to be delivered soon.

However, the cuts are unlikely to impact credit conditions significantly. The SBV already announced that it will step up efforts to pump credit to the economy for the rest of the year. Given individuals and firms are going through a deleveraging process, they are either unwilling to take out new loans or unable to because of the lack of high quality collateral and elevated indebtedness. This means that even if banks (the smaller banks are generally the ones with liquidity issues) that are flush with cash may not be able to expand their balance sheets aggressively. The SBV governor announced that the deposit rate cap will be lowered to below 8% (currently 9%) to force banks to lower lending rates (currently around 15%). The central bank is also likely to use administrative measures to persuade banks to reduce lending rates.

A stimulus similar to the one implemented in 2009 is unlikely to take place. For one, high inflation in 2011 makes easy credit less of an appealing solution, especially when much of this goes to inefficient sectors, which has come under the spotlight recently. For another, fiscally stimulating the economy through government spending is also not attractive given that policymakers recently announced a new strategy to reduce the budget deficit as well as aim to increase efficiency of public investment. Still, while it might be a painful adjustment to swallow sub-trend growth rates for a while, Vietnam is on the right track, cutting debt and adopting productivity boosting measures, which, ultimately, will launch the economy back on a path of rapid growth.

HSBC Vietnam Main Forecasts

	Q2 2011	Q3 2011	Q4 2011	Q1 2012	Q2 2012	Q3 2012f	Q4 2012f	2011	2012f
GDP (% y-o-y)	5.7	6.1	6.1	4.1	4.7	5.1	6.3	5.9	5.1
CPI, end quarter (% y-o-y)	20.8	22.4	18.1	14.1	6.9	3.5	3.4	18.1	3.4
Trade balance (% GDP)	-9.9	-3.7	-5.8	0.9	-2.7	-2.1	-5.0	<b>-9.8*</b>	<b>-3.5*</b>
OMO rate, end quarter (%)	15.0	14.0	14.0	13.0	10.0	8.0	8.0	14.0	8.0
VND/USD, end quarter	20600	20830	21034	20900	20900	21500	21500	21034	21500

Source: CEIC, HSBC; Note: \* denotes actually value in USDbn



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