Macro
Vietnam Economics

Vietnam at a glance

The beginning of a better year: output rises

- **January HSBC PMI rose to the highest level since April 2011, with output, employment and new orders showing strength**
- **We expect output to continue to increase in the coming months, with foreign-invested firms leading the expansion**
- **What's left is for policymakers to accelerate banking sector reform and improve infrastructure and supply chain organization to boost domestic firms' competitiveness**

Amidst the turmoil in international financial markets, Vietnam has remained relatively robust. Having a relatively small capital market is perhaps one reason and deriving limited benefits from quantitative easing in the developed world is likely another. While some emerging market economies are grappling with a hangover from their over-reliance on cheap money for growth, Vietnam was forced to come down from its own sugar high in 2011. The government took measures to tighten monetary and fiscal policy to cool an overheating economy, improve management of the financial system starting with the classification of banks and purchasing bad debts, and reassess growth bottlenecks. Domestic demand decelerated significantly, bringing down import costs and lifting the trade balance into surplus. Inflation has stayed in single digits since May 2012. The exchange rate, once a laggard, has steadied.

While hope is running high about Vietnam's potential, especially in the international investment community, we believe the economy is still fragile, with major bottlenecks largely unaddressed. The 5.4% growth rate in 2013 was primarily driven by the sticky service sector and steady inflows of foreign investment into the manufacturing sector. The impressive registered and disbursed FDI growth rates in 2013, 81.7% and 9.9% respectively, do indeed reflect the country's labour and geographical competitiveness. However, domestic firms, especially small-and-medium enterprises, are suffering from tough credit condition, lacklustre domestic demand and declining competitiveness. This means that policymakers will have to address issues hindering domestic firms' performance to sustain growth in the medium and long term.

In the short term, the economy should continue to be supported by gradual improvement of institutional capacity building and a focus on sticky inflow of investment into manufacturing. With the January HSBC manufacturing PMI rising to the highest level since April 2011 and output likely expanding in the coming months, Vietnam welcomes the Year of the Horse full of hope for a better future. But hope can often turn into hopelessness without a plan. With the worst likely over, policymakers can now work out a concrete strategy to increase Vietnam's economic efficiency and realize its potential.

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

	Jan-14	Dec-13	Nov-13	Long-Term Average
PMI Index	52.1	51.8	50.3	49.6
Output	53.5	52.6	52.0	49.8
New Orders	52.4	52.5	48.8	49.7
New Export Orders	52.2	49.1	48.1	49.9
Backlogs of Work	47.5	47.7	47.5	47.7
Stocks of Finished Goods	45.1	47.2	49.6	49.1
Employment	53.0	53.6	51.8	50.5
Output Prices	50.4	49.0	50.5	50.4
Input Prices	54.7	54.8	54.5	56.4
Suppliers' Delivery Times	49.6	51.4	50.6	51.0
Stocks of Purchases	49.0	48.7	49.3	47.7
Quantity of Purchases	55.2	53.8	52.1	49.4

Source: Markit, HSBC; Scale moves from contraction (grey) from the previous month to expansion from the previous month (red)

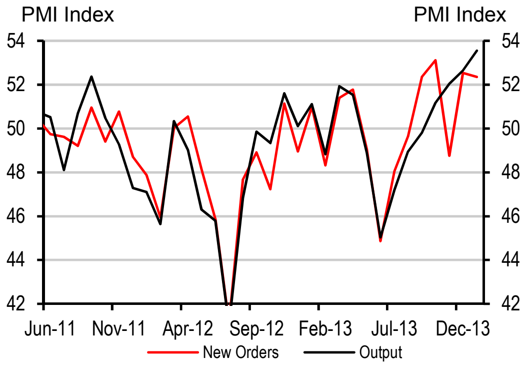
A noticeable bounce

Manufacturing activity in Vietnam is heating up, as indicated by the PMI heat-map on Table 1. The sharp increase of output to 53.5 from 52.6 reflects rising demand for Vietnamese goods. External demand is improving, with growth in the Eurozone and the US expected to be stronger in 2014 than 2013. Vietnam's high exposure to these markets should buoy its export of goods in the Year of the Horse. The new export orders sub-index mirrors this trend, with the sub-index increasing to 52.2 from 49.1 in December. Employment continues its six-month expansion trend, with the January figure indicating a solid increase of headcount. The most positive jump came from the quantity of purchases, which rose to 55.2 from 53.8 in December, reflecting stronger demand of goods for production.

In the coming months, we expect output to accelerate. Chart 3 shows that production is not keeping up with demand. Inventories, after having been reduced to record low due to de-stocking measures, are falling sharply. New orders, however, are rising on foreign demand and stabilized domestic conditions. This caused the lead indicator – new orders minus inventories, to jump to the highest level since April 2011. This means that production will be ramped up in the months ahead to meet demand. We expect the manufacturing sector to support Vietnam's slight acceleration of GDP growth to 5.6% in 2014e from 5.4% in 2013.

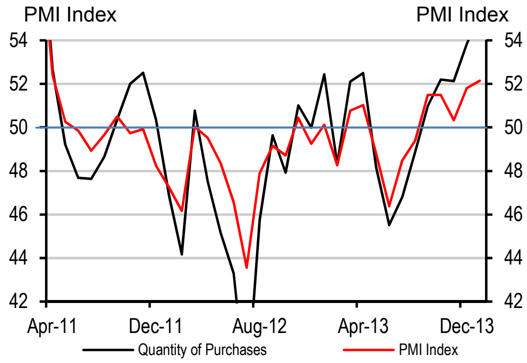
But the acceleration of manufacturing is sector-specific and reflects increased foreign investment rather than a healthier domestic economy. Chart 4 shows manufacturing increasing its importance to Vietnam's economy – both thanks to strong growth rates as well as the deceleration of other sectors such as mining

Chart 1. Output is accelerating thanks to higher new orders



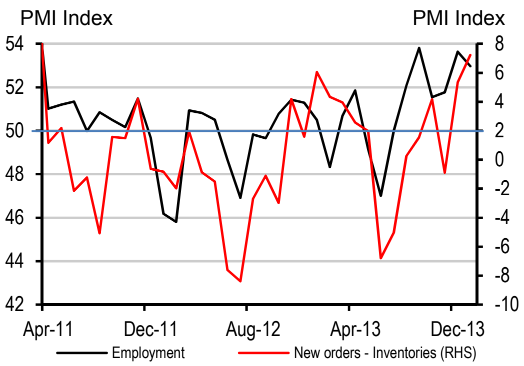
Source: Markit, HSBC

Chart 2. The PMI reaches the highest level since April 2011



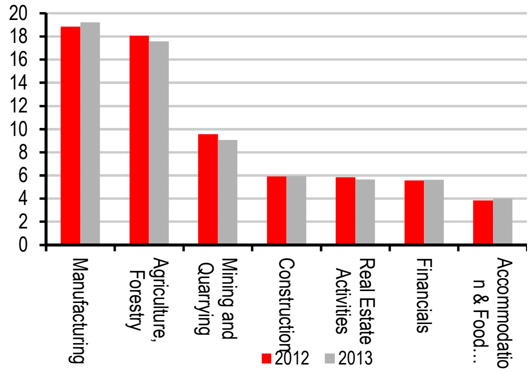
Source: Markit, HSBC

Chart 3. The new orders minus inventories lead indicator shows a sharp jump, suggesting that output will rise



Source: Markit, HSBC

Chart 4. The manufacturing sector is increasing its share in the economy but it is still small (% of total GDP)

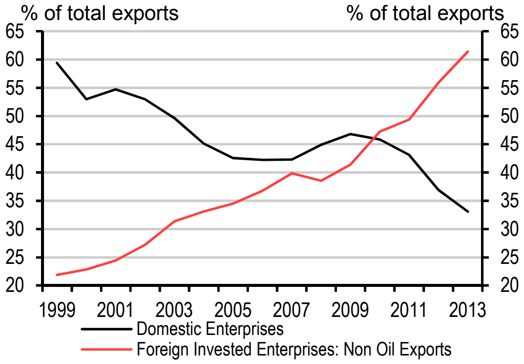


Source: HSBC

and quarrying, construction and real estate and agriculture and forestry. The real estate and construction sectors have been most affected by tightening measures and slowing domestic demand. The sluggish credit growth rate in 2013 reflects low risk appetite in Vietnam as well as a large burden of bad debts that still haunt the financial system.

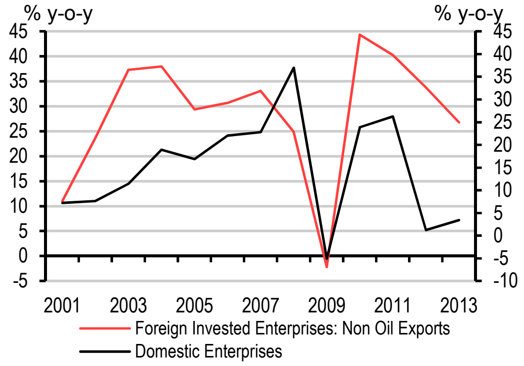
Chart 5 and 6 paint a more sobering picture of domestic firms' performance. The rise of manufacturing certainly is positive, especially with strong inflows of sticky foreign capital and the introduction of international production standards to Vietnam. This should help the economy pass through a difficult period of slowing investment and consumption. However, during this period, a strategy to raise the competitiveness of domestic firms would also be vital. Whether it's increasing domestic firms' linkages to the supply chain, improving the value-add to production beyond labour and raw material inputs, coordinating logistics to improve efficiency and competitiveness or supplying more skilled labour, we believe a policy agenda is required to ensure domestic firms do not fall behind. Failing this, there would be a risk that economic instability could result in the future when labour costs start to rise more sharply. Chart 5 shows that domestic firms' ownership of total exports has declined since 2009. This partly reflects a sharp global slowdown of demand for exports but also a tough domestic condition in Vietnam, which hinders productivity and competitiveness. Chart 6 shows that although foreign invested firms bounced back from the Global Financial Crisis, domestic-export oriented firms are still underperforming. This

Chart 5. Domestic firms are losing their share of exports



Source: CEIC, HSBC

Chart 6. Domestic firms are also not growing as fast



Source: CEIC, HSBC

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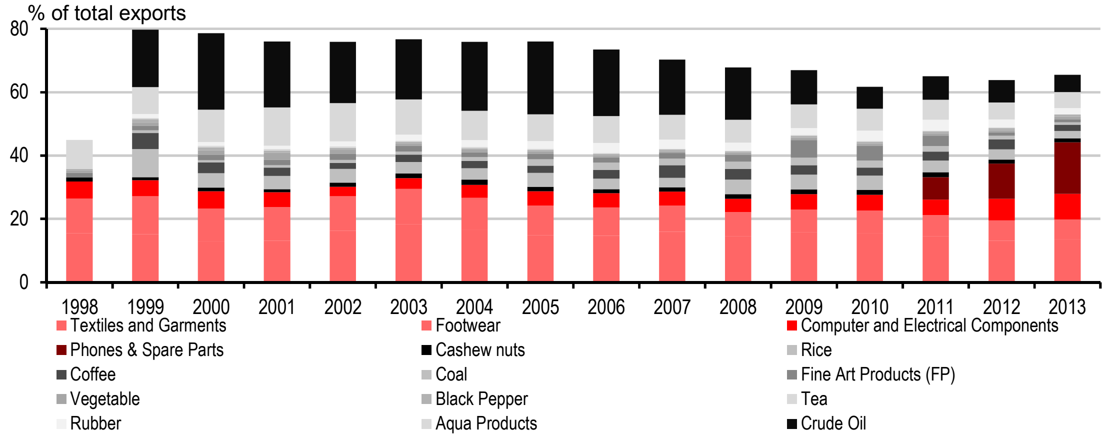
Chart 7. Manufactured goods have increased their share of total exports (in red colours) while raw materials are losing value (grey)

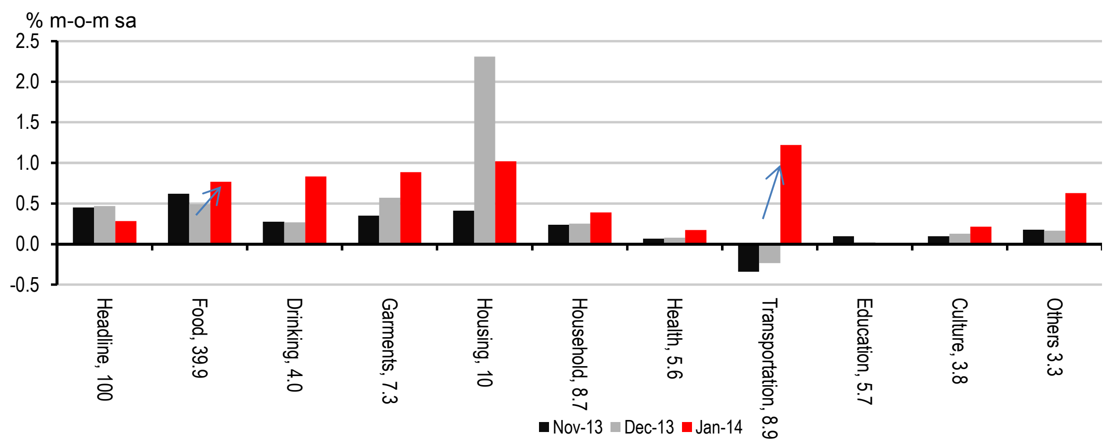


Source: CEIC, HSBC

partly reflects sluggish commodity prices but it also shows a still very fragile Vietnam, which is still trying to recover from years of inefficient allocation of capital.

Chart 7 shows a detailed look at the major forces behind Vietnam's stellar export performance. It is the only country in Asia where exports continued to grow in double digits since the Global Financial Crisis. At first glance, chart 7 shows increased manufacturing exports over the years (red columns), especially since 2011. But a closer look shows that it is primarily driven by phone and spare parts (maroon columns), which did not really exist before 2011. This primarily reflects increased FDI inflows of firms such as Samsung. While this is not considered negative given that these firms demand headcount and invest in infrastructure, it is also an important reminder that Vietnam has not significantly moved away from being a primarily agrarian economy and that the future of its development is far from certain. FDI certainly is more positive for Vietnam's economic stability, as proved by Vietnam's relative resiliency in contrast to recent volatility in financial markets affecting countries too dependent on portfolio inflows for growth. However, FDI alone is not enough. A concerted effort to maximize its benefits is required. Prime Minister Nguyen Tan Dung gave a speech on 1 January 2014. In his speech, he highlighted the importance of levelling the playing field and improving the

Chart 8. Price pressures are relatively tame, with core prices decelerating while food and transportation prices rising



Source: CEIC, HSBC; the numerical value to the right indicates the weighting of the sub-index

Table 2. Recent data trends

	August	September	October	November	December	January
Headline CPI, % y-o-y	7.5	6.3	5.9	5.8	6.0	5.5
Core CPI, % y-o-y	11.4	9.1	8.0	7.1	7.4	6.5
Retail sales, % y-o-y	14.6	15.7	11.0	13.5	12.2	11.9
Exports, % y-o-y	12.4	17.9	22.2	15.9	12.4	-10.2
Imports, % y-o-y	8.6	21.1	23.1	10.4	23.6	-2.8
HSBC Manufacturing PI	*	*	*	50.3	51.8	52.1
Credit growth, % y-t-d	5.3	5.8	6.6	8.4	12.5	*
NPL Ratio	4.6	4.6	*	*	3.8	*
Policy Rate	5.5	5.5	5.5	5.5	5.5	5.5

Source: HSBC; Scale moves from weaker (blue) from the previous month to expansion from the previous month (red); * denotes data unavailable for disclosure

skills of the labour force for competitiveness. This message shows that policymakers are well informed about the bottlenecks of their economy. It's a question of the timing and pace of reforms in the years ahead.

The January inflation figure shows that demand remains low. Headline inflation slowed to 5.5% y-o-y in January from 6.0% in December. On a sequential basis, headline prices increased 0.3% m-o-m sa from 0.8% in December. Food prices slowed to 4.5% y-o-y from 5.1% in December. On a sequential basis, food inflation rose 0.8% m-o-m sa from 0.5% in December. Core inflation, which reflects demand stripping out volatile prices such as food and transportation, decelerated to 6.5% y-o-y in January from 7.4% in December. We expect core inflation to hover around 6-7% this year. Inflation should remain tame in 2014, albeit with a rise from 2013 due to higher food prices. Higher electricity prices may also stoke inflationary pressures. We expect the OMO rate to stay on hold in Q1 2014.

Table 3. Main HSBC Vietnam forecasts

	Q3 2012	Q4 2012	Q1 2013	Q2 2013	Q3 2013	Q4 2013	Q1 2014f	Q2 2014f	Q3 2014f	2012	2013	2014f
GDP (% y-o-y)	5.4	5.5	4.9	4.9	5.5	6.0	5.4	5.5	5.7	5.2	5.4	5.6
CPI, average (% y-o-y)	5.6	7.0	6.9	6.6	7.0	5.8	5.9	6.7	6.9	6.3	6.6	7.3
OMO rate, end quarter (%)	8.0	7.0	6.5	6.0	5.5	5.5	5.5	6.0	7.0	7.0	5.5	7.0
VND/USD, end quarter	20853	20835	20930	21170	21119	21036	21100	21100	21100	20835	21036	21100

Source: HSBC forecasts

Disclosure appendix

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