HSBC Global Research

Vietnam at a glance

Coming soon: the return of twin deficits

ECONOMICS
ASEAN

- External headwinds remain strong: the manufacturing PMI slowed to 49.4 in November from 50.1
- The widening trade deficit, however, is more a product of robust domestic demand, which is itself a result of re-leveraging
- With these trends likely to continue, we forecast a current account deficit of 1.6% of GDP in 2016; this should be manageable, but requires timely tightening by the SBV

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Weak external demand hurting manufacturing activity…

After a brief rebound in October, the manufacturing PMI slipped back below the waterline in November, falling to 49.4. Weak external demand is to blame: new export orders are stuck at four-month lows. Exports will likely stay sluggish through Q1 16, but we remain optimistic that they will bounce back in 2016 as new FDI comes online. Over the longer horizon, Vietnam's manufacturers should continue capturing global export market share, as on-going trade liberalisation efforts bear fruit.

…but the widening trade deficit is more a product of robust domestic demand…

Vietnam's merchandise trade deficit has also widened this year. However, the main driver is increased imports, not falling exports. Recently, domestic demand has picked up strongly, reflecting the re-leveraging of the economy. Credit growth is on track to reach 17% this year.

…which requires the SBV to deliver timely rate hikes in 2016

Benign inflationary pressures mean that the State Bank of Vietnam (SBV) has the space to keep rates on hold for now. However, with strong growth likely to continue in the quarters ahead, we see inflation rebounding to 4.9% y-o-y by end-2016. Our outlook for stronger domestic demand means that we also see the current account slipping into deficit in 2016, equivalent to 1.6% of GDP. These are still manageable levels, but the SBV may choose to tighten monetary policy next year to maintain a sustainable growth path. We forecast the first 50bp rate hike in Q3 16, taking the OMO rate to 5.5%.

Table 1. Main HSBC Vietnam forecasts

	Q2 15	Q3 15	Q4 15f	Q1 16f	Q2 16f	Q3 16f	Q4 16f	2014	2015f	2016f
GDP (% y-o-y)	6.5	6.8	6.9	6.3	6.5	6.8	7.3	6.0	6.6	6.7
CPI, end (% y-o-y)	1.0	0.0	0.5	2.5	3.1	4.7	4.9	1.8	0.5	4.9
OMO rate, end quarter (%)	5.0	5.0	5.0	5.0	5.0	5.5	5.5	5.0	5.0	5.5
VND/USD end quarter	21,839	22,478	22,500	22,500	28,000	23,000	23,000	21,388	22,500	23,000

Source: HSBC forecasts

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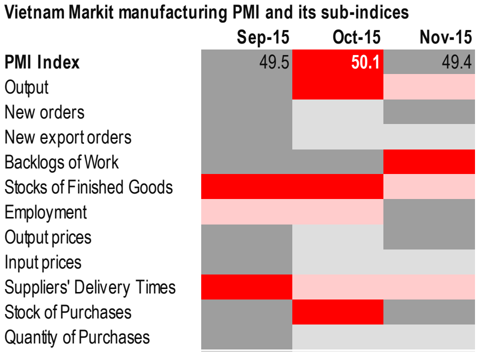
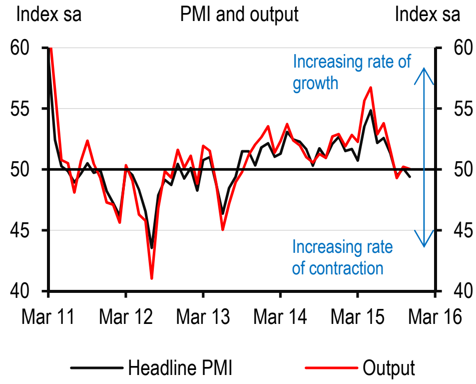
Chart 1. Manufacturing PMI heatmap



Source: Markit, HSBC. NB: Scale goes from grey to red. The dark colours in our heatmap indicate that the pace of expansion/contraction is accelerating, while light colours represent a slowing in the pace of expansion/contraction.

Chart 2. Activity slowed in November



Source: Markit, HSBC

Back below the waterline

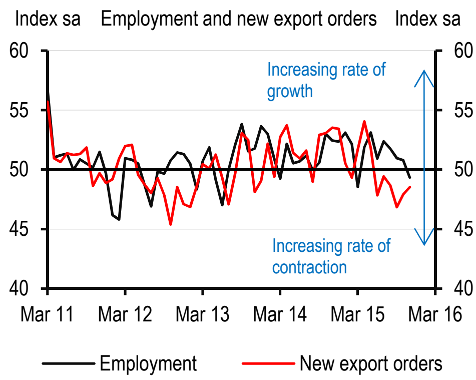
The manufacturing PMI fell to 49.4 in November…

After rebounding in October, the Nikkei Vietnam manufacturing PMI once again slipped below the 50-threshold in November, indicating a moderate contraction in activity (Chart 2). Momentum is unlikely to accelerate in the near term: a quick glance at the heatmap above shows key PMI sub-components cooled last month. New export orders, while improving, remain stuck at four-month lows (Chart 3). Meanwhile, profit margins are starting to come under pressure as a result of weak demand: output prices contracted at a faster pace in November, while the fall in input prices eased somewhat. Renewed declines in the employment sub-component suggest that manufacturers are growing more cautious about adding headcount.

…dragged down by lacklustre global demand

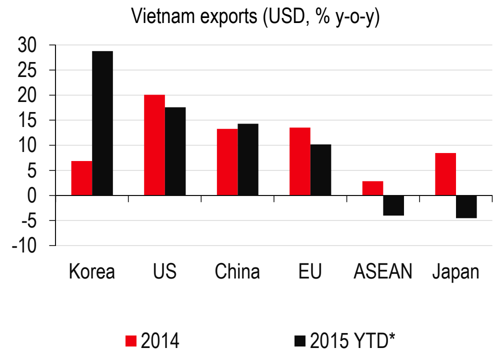
These developments support our view that export growth, which fell to 8.3% YTD y-o-y in November from 8.5% in October and 13.4% in 2014, will likely slow further through Q1 16. Data from the General Statistics Office (GSO) show that the main drag on exports is coming from lower demand in the Eurozone (Vietnam's number 2 export market), ASEAN, and Japan (Chart 4). Shipments to the US, which remains the number 1 destination for Vietnamese goods, have slowed relative to 2014 but are still holding up at a robust 17.6%. Meanwhile, exports to Korea have jumped 28.8% in the first eleven months of 2015, reflecting FDI that has recently come online (in 2014, South Korea was the largest foreign investor in Vietnam). This is a reminder not to get overly pessimistic on Vietnam's export outlook: as of November, YTD implemented FDI is tracking a record high USD13bn and could exceed USD15bn in 2015. Going forward, the new

Chart 3. Firms are cautious on expanding headcount



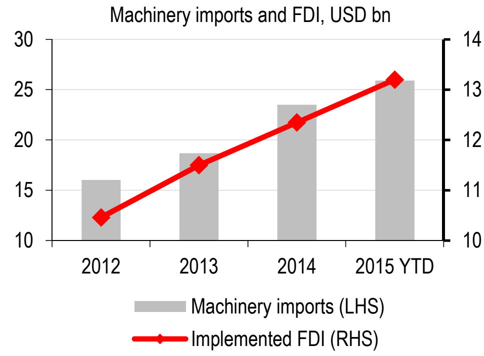
Source: Markit, HSBC

Chart 4. Exports dragged down by slowing EU, ASEAN, and Japanese demand



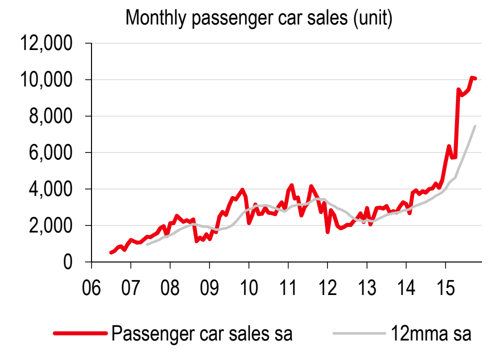
Source: GSO, HSBC. *As of November 2015.

Chart 5. Rise in machinery imports parallels surge in FDI



Source: CEIC, HSBC. NB: YTD as of November 2015.

Chart 6. Car sales are going through the roof



Source: VAMA, HSBC

investments should boost Vietnam's shipments, even if global demand remains soggy. As a result, we forecast exports to rebound 13.1% y-o-y in 2016. Down the road, recent trade liberalisation efforts should allow Vietnam to continue capturing global market share, adding to the tailwinds for the manufacturing sector.

Is the widening trade deficit "good" or "bad"?

Global trade headwinds have contributed to a widening of the trade deficit…

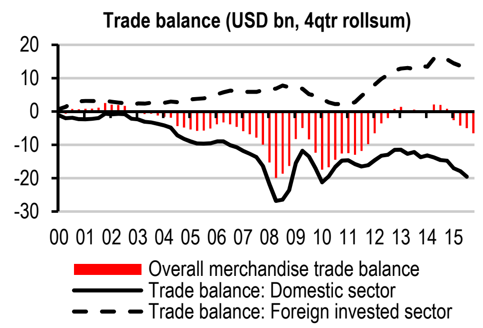
Nonetheless, the recent weakness in exports, especially on a value basis, has resulted in some investor concerns over the outlook for Vietnam's external balance position. Indeed, the merchandise trade deficit has worsened in 2015, standing at USD4.6bn as of November. A seasonal widening of the deficit in December is likely to push the full-year number to over USD6bn, up from USD0.6bn in 2014.

By definition, the widening trade deficit reflects the fact that imports have been outpacing exports. So imports merit a closer look. The good news is that a significant portion of the 13.7% YTD y-o-y increase in imports is associated with demand for capital equipment. Machinery imports, for example, have remained robust in 2015 and are on track to expand at close to last year's 25% y-o-y pace. Since this represents investment aimed to build out production capacity, we are not concerned about the rise per se. Chart 5 shows that machinery imports have indeed moved in tandem with implemented FDI.

…but strong domestic demand is also a factor

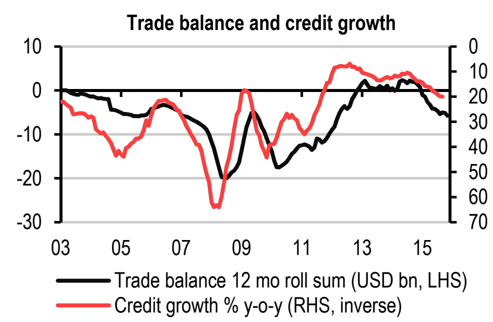
If this were the whole story, we wouldn't have much to worry about. However, a closer look at the trade account suggests that consumer-oriented imports have also increased. Imports of finished automobiles are up 96.7% y-o-y, adding about 1ppt to YTD import growth. This is

Chart 7. Keep an eye on the trade deficit of domestic enterprises



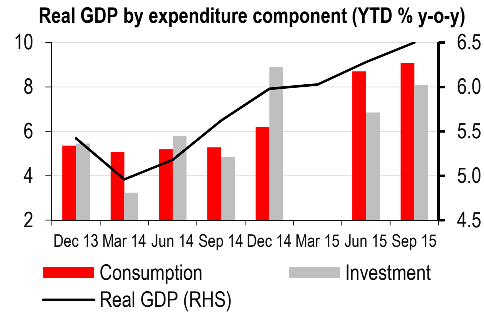
Source: CEIC, HSBC

Chart 8. The trade deficit tracks credit growth closely



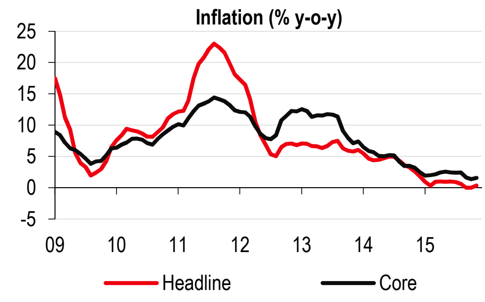
Source: CEIC, SBV, HSBC

Chart 9. Strong consumption has more than offset the drag on GDP from net exports



Source: GSO, HSBC. NB: Expenditure breakdown of Q1 15 GDP is not available.

Chart 10. Inflation has shown early signs of bottoming out



Source: GSO, HSBC

mirrored in substantial growth in domestic car sales, which have been buoyed by a more favourable credit environment, as well as government support programmes (Chart 6).

Our suspicion that the widening in the trade deficit is not just due to increased demand for FDI-related inputs deepens when we look at the yawning gap between the trade balance of the foreign-invested sector vs. domestic enterprises. In the past, the trade deficit of domestic firms, especially SOEs, has widened on the back of credit-fuelled consumption and investment (Chart 7).

Credit growth, continues to pick up, supporting consumption and helping reflate the property market

Re-leveraging is also driving an increase in the deficit (Chart 8). Though not yet at alarming levels, credit growth has been running much more strongly in 2015, boosting domestic demand and pushing up growth to 6.5% YTD y-o-y, as of Q3 15, up from 5.6% during the same period last year (see *Vietnam at a glance: Domestic demand to the rescue?*, 1 October 2015). Consumption has been particularly strong, rising 9.1% YTD y-o-y in Q3 15 (Chart 9).

The improved availability of credit, coupled with excitement over changes to Vietnam's foreign ownership regulations, have also helped spark a revival in the property markets, especially in the big cities of Hanoi, Ho Chi Minh City (HCMC), Da Nang, and Hai Phong. So far, the pick-up in credit to the real estate sector has been benign, running at 14.6% YTD y-o-y in September, and far from resembles the speculative excesses that led to the collapse of Vietnam's property market in 2008 and again in 2012. In fact, our sense is that the government and central bank are proactively working to reflate the property market since a recovery in real estate prices boosts banks' collateral values, helping Vietnam's banking sector grow out of its bad debt problem.

Twin deficits set to return in 2016

We forecast inflation to rise from a record-low 0.5% in 2015, to 4.8% by end-2016…

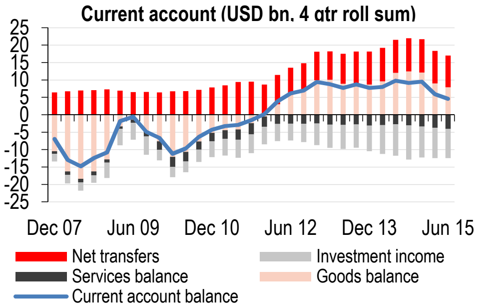
We expect rising domestic demand to stoke higher inflation pressures in 2016. Thanks to lower global commodity prices, average headline inflation looks likely to slow to a record-low 0.5% y-o-y in 2015 from 4.1% in 2014. However, the November CPI report offers tentative signs that inflation is beginning to bottom out: after briefly slipping into deflation in the early fall, headline inflation ticked up to 0.3% y-o-y in November, driven by a smaller drag from energy prices and pick up in core inflation to 1.6% y-o-y from 1.4% (Chart 10).

This isn't exactly cause for alarm bells at this stage. However, with strong growth likely to continue in the quarters ahead, we see inflation rebounding to 3.1% y-o-y by end-H1 2016, partly on the back of base effects. We then expect it to accelerate to 4.9% y-o-y by end-2016. We therefore stick with our call that the SBV will have to shift to a tightening mode next year, and expect the central bank to deliver the first 50bp hike in Q3 16, taking the OMO rate to 5.5%.

We expect the SBV to hike rates in Q3 16, but the risk is that tightening comes sooner

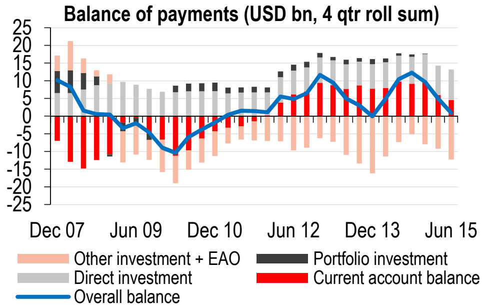
If anything, the risk is that tightening will have to come sooner. Since 2011, Vietnam has comfortably run a current account surplus, thanks to a sharp turnaround in the goods trade

Chart 11. The erosion of the trade balance has led to a thinning of the current account surplus…



Source: IMF, SBV, HSBC
NB: Note that methodological differences in the measurement of exports and imports means that the BoP-based goods balance remains in surplus, in contrast to the merchandise trade balance, which has fallen into deficit.

Chart 12. …which has added to the balance of payments pressures



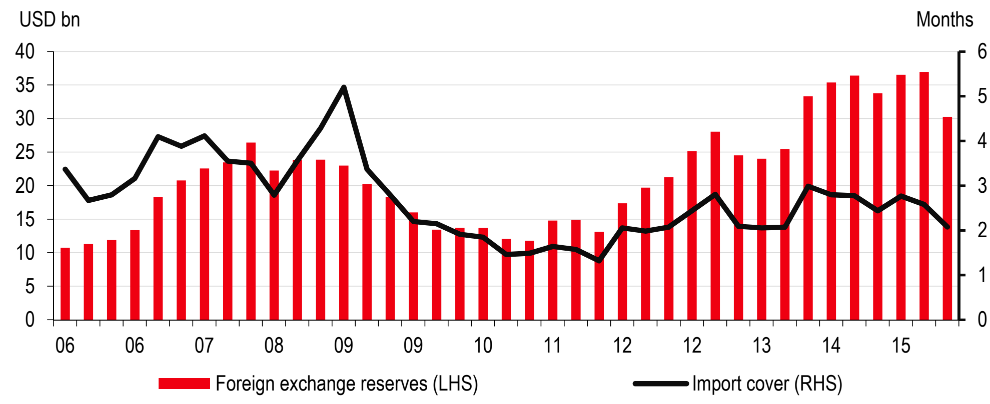
Source: IMF, SBV, HSBC
NB: EAO stands for "errors and omissions"

balance and steady remittances (captured under "net transfers" in the balance of payments). However, the erosion of the merchandise trade balance has led to a thinning of the current account surplus (Chart 11). In Q1 15, the current account balance fell into a USD1bn deficit, the first shortfall in nearly four years. To be fair, the drop was partly seasonal. However, our view is that the deficits are likely to become more commonplace in the coming quarters, based on our outlook for stronger domestic demand, and an attendant widening of the trade deficit. In 2016, we forecast the current account balance to slip into a deficit equivalent to 1.6% of GDP from an estimated 0.2% surplus in 2015 and a 5.1% surplus in 2014.

On the funding side, we expect robust FDI inflows to continue supporting Vietnam's overall balance of payments; however, this may not be enough. As Chart 12 shows, the BoP balance has been under pressure as of late, due to the combination of: 1) the thinning current account surplus and 2) short-term capital outflows. The strain on FX markets following the heightened volatility of the RMB in August added to pressures on the balance of payments: though complete Q3 15 BoP data are not yet available, data from the IMF show that Vietnam's foreign exchange reserves declined by USD6.7bn in Q3 15, falling to USD30.3bn as of end-September, or an estimated 2.1 months of import cover (from 2.6 months in June, Chart 13).

The likely return of current account deficits in 2016 means that the balance of payments may remain under pressure in 2016 and into 2017. **Vietnam's macro risks are limited for the time being; however, the SBV may choose to tighten monetary policy next year to maintain a sustainable growth path.**

Chart 13. Vietnam's reserves declined in Q3 15



Source: IMF, CEIC, HSBC. NB: Import cover is expressed in months of goods and services imports.

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