

Expect continued FX appreciation and possibly more rate rises

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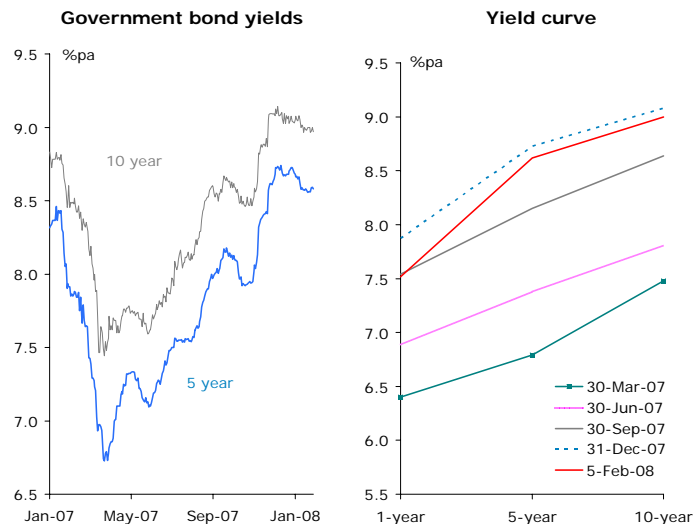
A recent news item in the Vietnam Investment Review suggesting that the February inflation release will show a 14.8% annual rise in the CPI suggests a negative tone as markets return this week. Inflation is becoming the key issue in Vietnam, with the State Bank of Vietnam (SBV) having raised official interest rates, hiked its reserve requirement ratio and widened the band in which the Vietnamese dong trades within the past two months

While the SBV has taken some appropriate measures on inflation, we believe more will be required to put the inflation genie back in the bottle. All Asian central banks are now evaluating their stance between still present domestic inflation risks on the one hand and falling external demand on the other; for the SBV, this judgment is at a crucial phase. Here, we provide our latest assessment on the inflation outlook and what it means for FX and rates markets in Vietnam.

Going forward, we expect:

- Accelerated appreciation of the currency from USD/VND15,968 at present to around USD/VND15,500 by mid year and USD/VND 15,350 by the end of 2008. This represents a nominal appreciation of 4.2% against the US dollar for 2008 versus an appreciation of 0.2% over 2007 and a depreciation of 0.87% over 2006.
- Sideways or upward movement of bond yields, with yields on 5-year government bonds unlikely to fall below 8.5% again this year. Fundamentally, a discount rate of 6% and average annual inflation of no less than 7% suggests 5-year bonds yields should be above 10%. Demand will continue to depress yields, but a rally is unlikely.
- Ongoing action to tackle inflation. Measures to reduce liquidity in the system would be most effective, for example by hiking the reserve requirement ratio or tightening credit standards. Such measures may also help to insulate the banking system from a reversal of the stellar rise in asset prices, should this eventuate.

**Figure 1: Vietnamese bond yields and yield curve**



Source: Bloomberg

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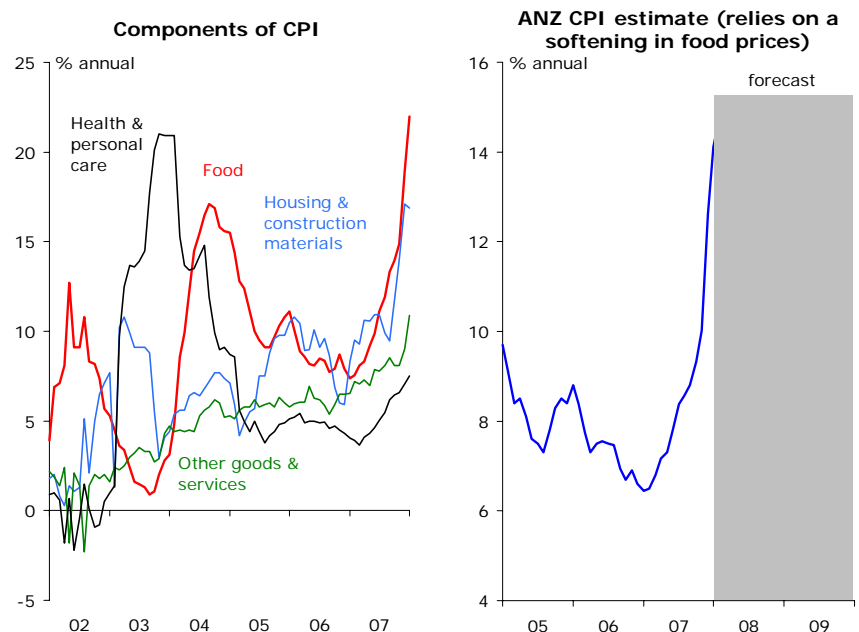
## Inflation still a very present threat...

The basis of Vietnam's current inflation problem is twofold. First, economic growth has been strong and demand is accelerating rapidly. Real GDP growth has exceeded the government's target for the past few years, and the government has again raised its target for GDP growth this year. While productivity gains are contributing mightily to real GDP growth, capacity constraints are now emerging in sectors of the labour market, in hard infrastructure and in energy.

Although available data are insufficient to analyse the extent of capacity constraints, we do know that the average monthly income for workers in the state sector accelerated last year, from annual growth of 10.8% in 2006 to 12.8% in 2007. Higher wage inflation is a sure sign of a tight labour market – the key cause of structural inflation – and it is fairly safe to assume that workers in the private sector would have experienced an even greater degree of wage inflation. Accelerating retail sales growth – up 20% per annum on average over the past three years – also shows how rising incomes are spurring rapid increases in domestic demand.

In addition to structural inflation, the economy is flush with liquidity – which, all else being equal, will encourage inflation. System data are only available with a long lag, but as of June 2007 it appears that base money (measured by M2) was rising at an annual rate of 42.7%. Base money appears to have risen at an annual rate above 30% for 2006 and 2007.

**Figure 2: Inflation - not all food**



Source: CEIC, Bloomberg and Economics@ANZ

Capacity constraints and high liquidity conditions have combined to fuel rapid price growth. Inflation has risen from a rate of 6.5% through the year to January 2007 to 14.1% in January 2008. The global phenomenon of rising food prices has hit hard: Vietnamese food prices rose 22% over the year to January 2008 from a rate of 7.4% at the start of 2007. Food comprises over 40% of the CPI basket.

Although these strong food inflation numbers are partly a result of demand generated by this month's Lunar Tet festival, Vietnam's inflation issue is not simply due to rising food prices. The boom in the real estate sector has caused housing and construction materials prices to soar 16.9% over the year to January 2008, while higher energy prices have pushed transport and communications costs up 7.2% through the year to January 2008. Medical products and health care prices have also increased, rising 7.5% through the year to January 2008.

### But expected to moderate going forward

While we are concerned about the broad-based acceleration in inflation, we do expect the headline CPI figure to moderate from March, peaking at 14.8% in February 2008 to fall to 13.5% by June and 8.9% by year-end. This forecast is based on several assumptions.

#### Food prices to ease

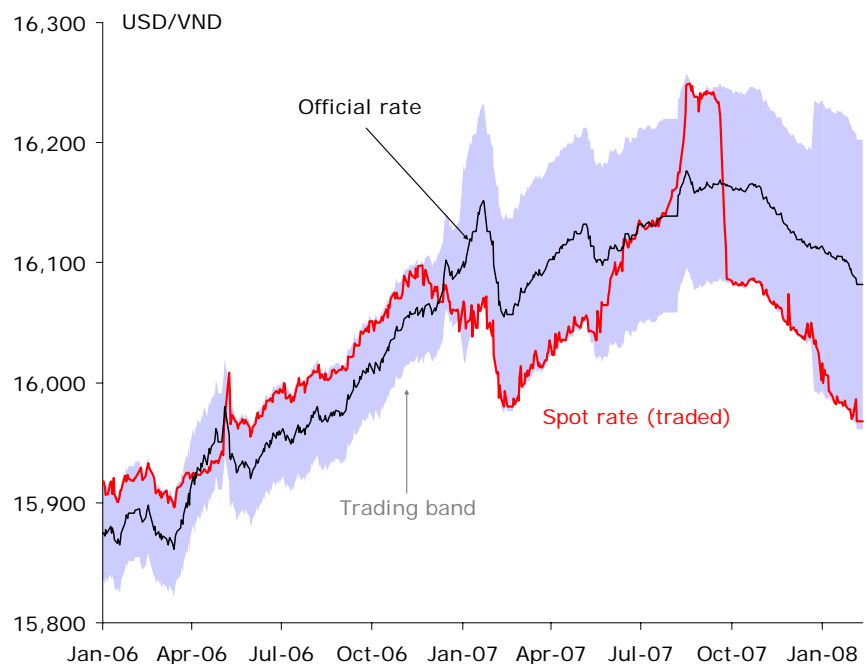
First, the acceleration in food prices is expected to ease. Global food prices are likely to remain elevated, particularly for rice given limits to supply increases in the near term. However, the pace of annual price rises should decline sharply, if only because of the base effect. The slowdown in external demand, driven by the weak US economy, should also help reduce pressure on globally traded agricultural prices, such as rice, corn and wheat.

#### Dong appreciation to continue

Second, the more rapid pace of currency appreciation should cause the price of imported goods to soften, including energy. Vietnam's imports are equivalent to more than 80% of GDP – of which a high percentage is energy and intermediate goods – making the price of imported goods quite important for the economy.

There appears to be a growing acceptance by the SBV of increased exchange rate flexibility: in a surprise announcement on 24 December, the SBV allowed daily dollar-dong movements to fluctuate in a wider range of plus or minus 0.75% from a rate set each morning by the Bank, versus 0.50% previously. The dong has appreciated to around VND/USD 15,970, the strongest the currency has traded at since mid 2006.

**Figure 3: USD/VND – recent movements**



Source: Bloomberg, Reuters and Economics@ANZ

Historically, the SBV has pursued a weak dong policy in order to encourage exports, and some commentators have voiced concern that a slightly faster pace of currency appreciation will harm export competitiveness. In our view, the loss of competitiveness through the appreciation of the real effective exchange rate – due to inflation – is causing far more harm to exporters than a very slight appreciation of the nominal exchange rate against the US dollar.

The currencies of all of Vietnam's major trade partners have appreciated against the US dollar over the past six months. Indeed, there is arguably far more room for the currency to appreciate. According to our currency forecasts, despite the expected appreciation of the dong against the US dollar for 2008, the dong is expected to depreciate by more than 5% on a nominal basis against the euro, the yen, the renminbi and the Singapore dollar over the course of 2008.

**Tightening measures take effect**

Third, the SBV has raised reserve requirements and interest rates in recent weeks, which should over time reduce liquidity in the system. Reducing liquidity is the key short-term step required to tame inflation in both consumer prices and asset prices.

The SBV increased the reserve requirement for credit institutions, effective as of 1 February 2008. For dong and foreign currency deposits up to one year (including demand deposits), the compulsory reserve rate will be raised to 11% from 10%, with the reserve rate on deposits of more than 12 months raised to 5% from 4%. The major impact of this initiative is likely to be a hoped curb in lending growth, which reached 37% last year.

Subsequently on 30 January, the SBV announced that it would increase three significant policy rates, also effective from 1 February 2008. The base lending rate was raised from 8.25% to 8.75%, the discount rate from 4.5% to 6%, and the refinance rate to from 6.5% to 7.5%.

Higher policy rates, reserve requirements and bond yields should reduce liquidity in the system and thereby reduce some of the impetus for higher inflation. In addition, the change in lending restrictions for securities investment from 3% of total loans outstanding to 20% of charter capital will limit potential growth in volumes for such investment credit, and not act to inflate equity prices further. There is probably more that can be done in the near term to reduce liquidity, particularly on the interest rate front. Vietnam's discount rate of 6.0% is itself below the rate of inflation, meaning that real interest rates are negative. It is also lower than the equivalent benchmark interest rate for other economies in the region, such as Indonesia, or even for Australia and New Zealand. Higher interest rates would be appropriate for an economy growing at more than 8% per annum with an inflation rate of above 10%, but we do not expect the SBV to move aggressively to raise rates given its track record in this area.

Although the SBV is on the road to shifting its inflation anchor away from the USD/VND exchange rate and toward benchmark interest rates, that transition is far from complete. One issue in particular for Vietnam is the degree of "dollarisation" in the financial system, with foreign currency-denominated deposits still representing around 24% of total deposits (according to the latest June 2007 data). Although this is down from a peak of 45% in September 2001, the extent of dollarisation still has the ability to interfere with the transmission of monetary policy to the economy. Allowing for a faster rate of dong appreciation against the US dollar as well as higher nominal interest rates is appropriate for Vietnam's present rate of growth and inflation, and would also encourage the de-dollarisation process to ultimately make monetary policy more effective.

**Risks to the outlook**

The key risk to the outlook for Vietnam is that the government goes for growth over price stability, meaning that the steps taken to tame inflation are insufficient and that price instability damages the economy over time. For 2008, the government has stated that it wants to aim for economic growth of 9%, faster than the 8.5% annual growth achieved in 2007. A significant proportion of the current inflation situation can be attributed to loose fiscal policy implemented in support of the government's growth target (the IMF's latest Article IV estimates a fiscal deficit of 6.9% in 2007 and 6.6% in 2008). In particular, the government has emphasised its desire to remove infrastructure bottlenecks in order to support growth and foreign direct investment in the long term, and as such has pursued capital investment projects. In the near term, a continuation of this policy will only act to maintain pressure on prices (notably in the construction sector) and would be negative not just for the people of Vietnam, but for the bond, equity and property markets in the country. A possible tightening of fiscal policy has been under discussion, but would need to be implemented soon in order to have a significant impact on inflation this year.

What is required is for the economy to slow a bit while productivity-enhancing reforms continue – including advances to the prudential regulation of the banking system to reduce any vulnerability to falling asset prices. There is no

question that the global economic and financial market outlook is increasingly negative; it is important that at this stage of its development, Vietnam continues to take a measured approach to its economic management by prioritising price stability above a high rate of economic growth or asset price inflation.

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