Vietnam: Tackling inflation without monetary policy

VND depreciation still the first priority for the SBV

- The VND will depreciate by a nominal 1% this year, with the SBV having to take a more active role than ever to achieve this objective.
- Inflation is gathering pace reaching 8.4% YoY in July. We believe the SBV needs to be more aggressive to rein in liquidity, yet this is an ongoing challenge given the exchange rate policy.
- NDFs currently give a false signal regarding the future price of the VND. ANZ’s forecast for the VND in 12-months is USD/VND 16,339, compared with USD/VND 16,145 in the forward market.
- Short-term interest rates may tick upwards as liquidity is tightened, a necessity to keep inflation and long-term interest rates from rising. Consequently, the yield curve is unlikely to steepen in response to higher inflation, contrary to what market participants may expect.

The management of both the exchange rate and the inflation rate is an ongoing issue for the State Bank of Vietnam (SBV). Strong foreign currency inflows continue to exert upward pressure on the VND, consequently the SBV’s management of exchange rate adds significantly to liquidity that fuels inflation. This note examines recent developments in the SBV’s exchange rate management policy and the sustainability of this policy going forward. ANZ’s forecasts currently assume the SBV will be able to continue to manage the depreciation of the VND by about 1% per annum, at least over the short to medium-term. Twelve month non-deliverable forwards consistently price the VND at an appreciating rate due to the illiquid nature of the market, and do not reflect accurate pricing information.

What is happening to the VND and interest rates?
As stated in previous research pieces the SBV faces a policy conundrum, the management of both a depreciating exchange rate and inflation. Late last year, in the face of strong capital inflows, the SBV was hesitant to purchase foreign currency as it did not want to add excessively to liquidity and potentially fuel inflationary pressures. This resulted in a shortage of VND in the market, prompting both an appreciation of the currency and a steep rise in short-term interest rates, as seen in Figure 1. Contrary to prevailing exchange rate policy, the SBV then stepped in to set a stronger official rate. In addition, the trading band around the official VND rate was widened in order to facilitate currency fluctuations that would assist in clearing the market. Finally, to relieve the shortage of VND, the SBV significantly intervened in the market, becoming the ‘buyer of last resort’ for foreign currency. Despite this action, the ongoing appreciating pressure on the VND was evident, with the currency trading on the floor of the official band until May.

Figure 1 Vietnamese exchange rate and interest rates
It was at this time that the SBV proactively intervened in currency markets, in an effort to move the VND from the floor of the band, by buying USD/VND as much as 5 bps higher than the market rate. Now that the VND trades in the vicinity of the official rate, the SBV buys foreign currency much closer to the market rate, defending the depreciation of the VND rather than driving it. Significantly, this marked a change in policy from the SBV which now intervenes in the market without request from market participants (as had previously been the case). Such intervention now sees the VND consistently fluctuating around the mid-point of the band, which is also the SBV's official rate.

However, the task of managing the exchange rate continues to be onerous and the purchases of foreign currency required to keep the exchange rate at the SBV target in the first half of 2007 have been significant. It is reported that so far this year, the SBV has purchased US$7bn in foreign currency, injecting VND112tr into the economy and pushing foreign exchange reserves to an estimated US$20bn. This amounts to 67% of the total funds approved by the government for foreign currency purchases for the entire year.

The SBV has been required to buy this foreign currency as Vietnam continues to attract strong foreign currency capital inflows, the result of US$5.2bn in foreign direct investment and US$1.7bn in portfolio investment to date. We would expect this to continue and even accelerate in the second half of the year, again challenging the SBV to manage a depreciating exchange rate. FDI may reach as much as US$20bn in 2007. However, foreign portfolio investment, especially that directed into the stock market, has come off since peaking in January 2007. Vietnam is also expected to issue another foreign currency sovereign bond later this year, for US$1bn, which would result in additional inflows.

The problem for the SBV is that rising liquidity and strong economic growth appears to be raising inflation expectations. The CPI has climbed throughout the year so far, reaching 8.4%YOY in July. This now exceeds the SBV’s inflation target that requires the rate of inflation to be lower that the rate of GDP growth (the government has targeted GDP growth of 8% this year). In response, the SBV is increasingly sterilising inflows through the open market by issuing short-term debt (predominantly SBV bonds and repos) in an effort to soak up excess liquidity. It is reported that the SBV has regularly withdrawn up to VND11,000-14,000bn (US$688-875mn) per week since May. As inflation has accelerated in recent months, this has risen to as much as VND15,000-16,500bn (US$938-1,031mn) per week.

To further tighten liquidity, the SBV recently increased the domestic currency minimum reserve requirement from 5% to 10% for deposits up to 1 year and from 2% to 4% for 12-24 month deposits. These measures resulted in higher short-term interest rates throughout June (see Figure 1).
However, interbank rates have now come off from June’s peaks as strong deposit growth again saw the banks flush with liquidity. This liquidity is flowing from foreign and domestic institutions waiting to disburse investment capital funds as well as funds being redeposited in banks after being withdrawn from the stock market.

**Figure 3: Inflation and Interest rates**

![Inflation and Interest rates](image)

> Inflation is at 8.4%YOY as of July driven higher by accelerating food prices (up 11.1%YOY) and housing & construction (up 10.9%YOY)

> Official SBV policy rates were last hiked in late 2005, remaining at 8.25% for the last 18-months.

**What now for the VND?**

ANZ currently anticipates that the VND will continue along a path of gradual depreciation over the next 12-months. As late as June 25, the Deputy Premier restated the government’s official policy to see the currency weaken by around 1% per annum. For this to occur, the SBV has to continue to pursue the contradictory objective of buying foreign currency to support this depreciation, while tightening liquidity to rein in inflation. On the latter, we believe the SBV needs to be much more aggressive than it has been to tightening liquidity by increasing open market operations to reduce monetary growth from the 30%YOY-plus growth rates experience over the last 12 months. We would also expect the SBV to continue to introduce administrative measures to reduce the burden on itself to manage the VND.

In order to control inflation, the sterilisation of foreign currency inflows will continue, despite the increasing pressure it may exert on the SBV. Sterilisation will work in concert with ongoing administrative reform, yet it would be unlikely that official interest rates would rise to tackle inflation with this monetary policy tool remaining relatively ineffective.

Further, there had been speculation that the reserve requirement ratio will be increased again (to 15%) in order to assist the SBV in reducing liquidity. This could also serve to push up or stabilise inter-bank interest rates that continue to fall as liquidity in the banks expands. However, recently SBV official have played down the prospect of another increase in reserve ratios, suggesting they need to assess the impact of the first hike on inflation and liquidity over a 3 to 4 month period before contemplating further action. In any case, the ongoing tightening of liquidity may see upward pressure on short term rates going forward. Instead of using recognised monetary policy tools, we expect the authorities will continue efforts reduce inflation using supply-side measures, whilst not constraining potential capacity expansion. For this to be successful the yield curve needs to be flatter, encouraging the long-term borrowing necessary for development projects and economic growth.

The SBV's management of the VND may also be assisted if the authorities were to increase the pace of capital account liberalisation, allowing domestic entities to invest more freely in foreign markets. Such capitals outflows have been limited to date and are still heavily regulated with prime ministerial approval still required for investments in certain sectors and those exceeding certain amounts. Currently, Vietnam has a stock of out outbound foreign investment of around US$1bn. To June, outbound foreign investment for the year was only US$90mn with an expectation that this will rise to US$300mn by year's end.
Despite the significant increase, this sum is dwarfed by the billions of dollars now flowing into Vietnam. With surplus currency being deposited in banks at what are relatively low interest rates, it would be expected that there would be scope for significant capital outflow. This would ease the pressure on the SBV to manage the depreciation of the VND in a virtually one-way capital account environment. However, in the short to medium term we expect the Government/SBV will continue to be very conservative in the manner in which the capital account is liberalised.

**Vietnam: Macroeconomic and currency forecasts**

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*Source: General Statistics Office Vietnam, Economics@ANZ, Bloomberg*

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1 For further information on Vietnam and the Vietnamese exchange rate see previous Economics@ANZ publications:
- Vietnam Interest rate update (May 2007)
- Rating Vietnam: Solidly BB (March 2007)
- Trading ban widened for VND (January 2007)
- Examining the Vietnamese dong (August 2006)