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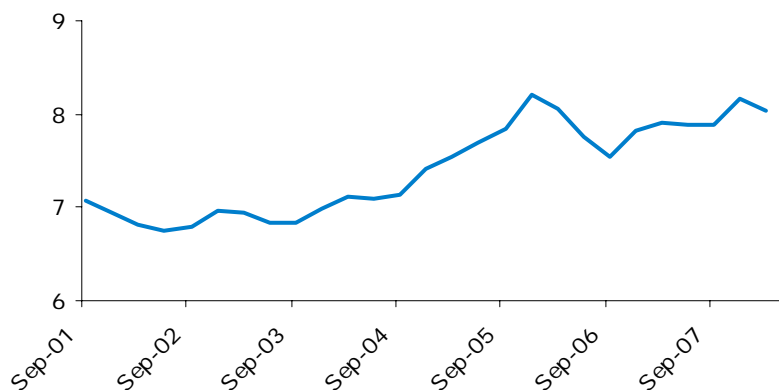
Vietnam faces an increasingly challenging policy environment. Owing to the fast pace of growth and global price developments, inflation is the highest in emerging Asia, and the trade deficit has widened sharply. As a result, confidence in the currency has declined noticeably as the sustainability of the external position has come into question.

While there is still time to stabilize expectations and markets—particularly since key macro numbers could improve somewhat in the coming months—waiting in the hope that the situation will correct itself is becoming an increasingly untenable policy. Indeed, if the anticipated improvements in inflation and the trade balance do not come through soon enough and the authorities maintain their largely passive policy stance, markets could bring about a much more abrupt and painful adjustment in the economy than one resulting from an appropriately designed and timely policy package. In either case, restoring balance and sustainability to the economy means that growth will have to slow. Policy moves over the past week or so give cause for hope.

Background

Vietnam's strong potential and economic fundamentals have resulted in a decade-long boom. Growth has risen steadily, averaging 8 percent in the past three years (see figure), net foreign direct investment has averaged some 4 percent of GDP, and equity markets surged on the back of rising confidence, rising to historic highs in 2007 (before falling back sharply, by two-thirds, since late in the year).

Figure 1: Vietnam: Real GDP Growth



Source: Bloomberg

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Central to Vietnam's economic policy apparatus is its exchange rate regime featuring a (slowly) crawling peg to the U.S. dollar. This regime provides a nominal anchor for the economy as well as certainty for foreign direct investors with regards to a key condition for profit repatriation. It also reflects limited local institutional capacity.

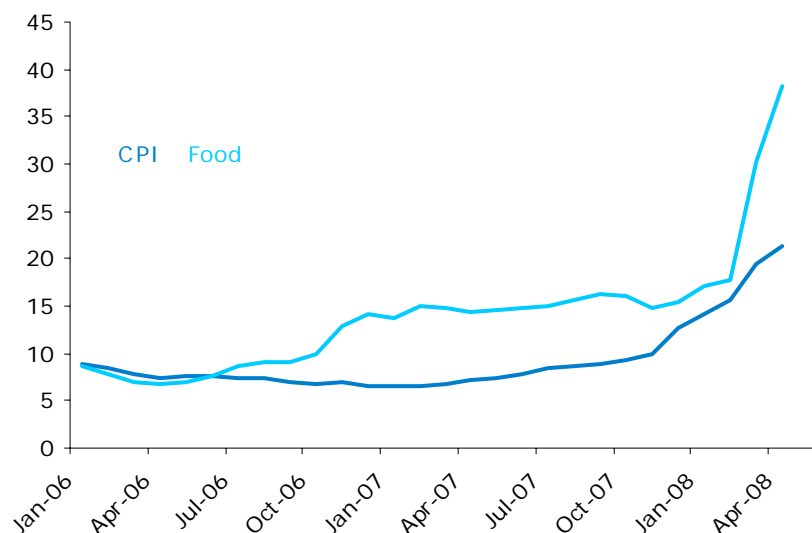
Given the authorities' preference for high growth, the balance of payments inflows associated with the boom went largely unsterilized. The resulting increase in the money supply fed into accelerating credit and investment, pumping up GDP growth and providing fuel for inflation. On the external side, the investment requirements of fast growth, the effects of rising incomes, and the real effective appreciation of the dong owing to relatively high inflation led to rising imports. This high growth strategy left the door open for macroeconomic instability, particularly in the event of negative shocks to the economy. Recent developments in world food and fuel prices provided these shocks.

Fallout from a Fast Growth Model

The interaction between Vietnam's growth model and recent global price developments has resulted in a spike in inflation and a sharp deterioration in the trade balance. These, in turn, have generated balance of payments pressures and have begun to erode confidence on the currency.

First, inflation has picked up sharply since late 2007, rising from 8-9 percent in Q3 to 25 percent in May 2008 (see figure). This initially reflected the global shock of higher food and fuel prices. However, price pressures have more recently spread to core items, where inflation is in the low double digits, itself a cause for concern. While rising inflation has certainly not been limited to Vietnam, it has risen further and faster than in other countries in the region given Vietnam's relatively high rate of credit expansion, fast GDP growth relative to potential, and loose monetary policy.

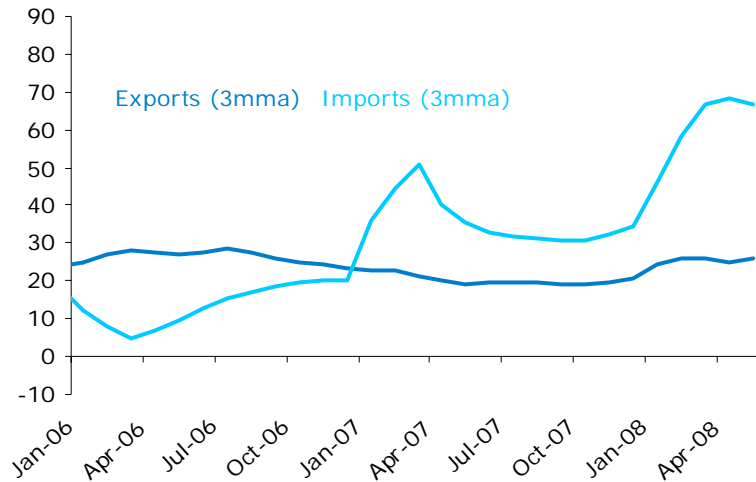
Figure 2: Vietnam Inflation (y/y)



Source: CEIC

Second, the trade balance has deteriorated sharply as import growth has surged. On a rolling 12-month basis, the trade balance has risen from just over \$3 billion in mid-2007 to \$23 billion in May 2008 (over 30 percent of 2007 GDP). On the positive side, there are indications that import growth may have peaked (see figure) with most major categories showing a decline in May. The expected moderation in food price inflation is a cause for some optimism as well. Also of note, export growth is holding up, with the latest (three month average y/y) growth rate at about 25 percent. This suggests little loss of export competitiveness despite a more appreciated real effective exchange rate.

Figure 3: Vietnam Trade Developments



Source: Bloomberg

Notwithstanding some scope for improvement going forward, the combination of high inflation and a burgeoning trade deficit has shaken investor confidence. Equity markets sold off sharply earlier in the year and negative real deposit rates combined with growing fears about the sustainability of the exchange rate regime have resulted in a flight away from dong assets to U.S. dollars and gold, and a shift toward dong-denominated liabilities. In addition, social pressures have risen and, in response, the authorities have begun to shift their focus from promoting high growth to fighting inflation.

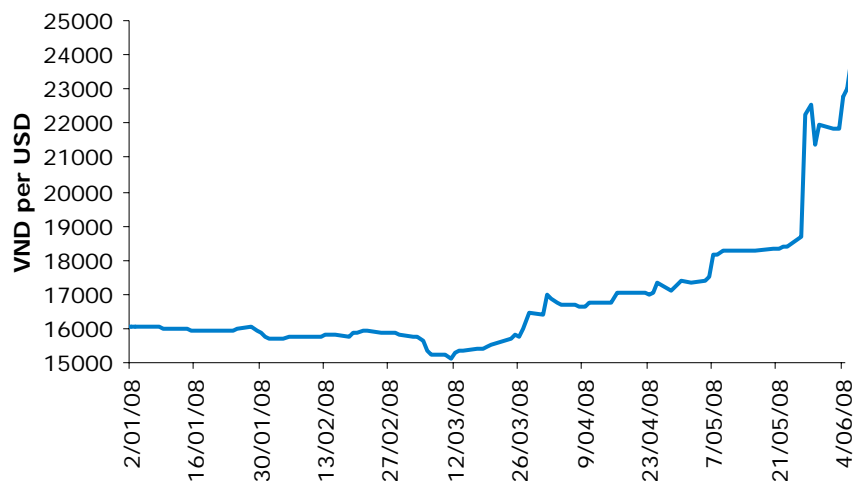
Despite the Policy Response to Date, Pressure on the Dong Continues

The authorities' policy response to date aimed at putting the economy on a more sustainable path has been in the right direction, but insufficient in strength.

In an effort to further curb credit expansion and raise the attractiveness of dong deposits, the base interest rate was raised on 19 May from 8.75 percent to 12 percent. Lending rates promptly went to 18 percent (banks are allowed to deviate from this base rate by a factor of one-half) while deposit rates rose to 14-15 percent. The base rate was further increased to 14 percent on 10 June. While these moves are likely to provide some support for the dong, real interest rates remain negative, at least when deflated by headline inflation, and thus have not meaningfully altered the monetary conditions picture. Importantly, some banks are reportedly levying additional charges on borrowers, resulting in effective interest rates above the allowed maximum (now 21 percent, or one-half higher than the base rate), suggesting that there is still excess demand for credit at the officially allowed rate. Rates will need to rise further.

More worryingly has been the lack of strong policy action on the currency front. While the official exchange rate was recently devalued by 2 percent, parallel market trading of the dong has been in the range of VND17,500-18,000 per U.S. dollar—still some 10 percent weaker than the official rate. With trading at the official rate largely limited to U.S. dollar sales to officially sanctioned importers, that rate has lost its relevance as a price signal. In the (admittedly thin) NDF market, the 12-month contract as of mid-June is trading at VND 23,000 per U.S. dollar (see figure), up sharply from around VND 16,000 three months ago, implying a devaluation of the dong of over 40 percent against the U.S. dollar.

Figure 4: Vietnamese Dong: 12 Month Forward



Source: Bloomberg

“Benign neglect” of the parallel market is fraught with risks, particularly when the exchange rate there has moved considerably away from official spot. Given the wedge of about 10 percent, a hope that the parallel market rate will appreciate back to the official rate in a largely costless manner strikes us as misplaced. While verbal intervention by the SBV may (and has) worked for smaller deviations, it is not clear that it will work for the current large wedge. If neglect of the parallel market exchange rate is viewed as a form of “stealth” devaluation to restore competitiveness (despite the ongoing strong performance of exports), this risks setting in motion dynamics of both inflation and capital outflows that may be difficult to manage. Reports of SBV intervention last week suggest that deviations from the official exchange rate are beginning to be taken seriously by the authorities.

If active intervention is required, how many reserves have been spent and how much is available to defend the currency? Official reserve numbers have not been provided since last July so the stock of SBV ammunition is unknown. We estimate that reserves are around \$23 billion.

The key question is: what amount of reserves is needed? First, we would not frame our answer in terms of months of imports—that measure is a bit old-fashioned and not particularly relevant for an economy with a relatively open capital account and on-shore dollar deposits. A better metric is to estimate how much could be called upon under various plausible scenarios. The foreign portfolio investment total stock is estimated at around \$3 billion, and most of the rest of foreign money is seen as dedicated and not subject to outflow pressures in the near term regardless of developments. The trick is therefore to maintain domestic confidence and here the evolution of the conversion of VND assets to US dollars (and gold) is important to watch. Foreign currency deposits are around one-quarter of total deposits, but exceeded 40 percent of total deposits earlier this decade. A return to that percentage of foreign currency deposits would be equivalent to around one-third of current reserve levels.

Bottom line: the SBV's present level of reserves appears adequate to defend the dong under the current exchange rate regime. A recent official announcement carrying the same message was helpful for investor confidence, although that needs to be buttressed in terms of concrete action.

Winning the Confidence Game

Since the amount of reserves appears sufficient to defend the currency, the challenge is how to rebuild confidence. In our view, the authorities need to demonstrate to both foreign and domestic investors that they understand the risks to macro sustainability at the current juncture. Our list of actions would include the following, in concert:

1. **Exchange rate regime.** If the exchange rate regime is to remain a tightly managed peg to the U.S. dollar, then the SBV will need to take more aggressive action, including direct intervention with banks in order to bring the parallel rate back toward the official spot rate. Allowing the VND/USD parallel market rate to remain significantly away from the official rate or worse, drift higher, will only fuel speculation that either an official devaluation is forthcoming or the authorities are trying to deflate their way out of the current difficulties despite official proclamations. This will likely fuel a full-scale run out of the dong. Using reserves decisively to defend the official rate would also have a positive demonstration effect.

2. **Monetary policy.** There is a need to increase the relative attractiveness of holding dong. To this end, bank deposit (and lending) rates will need to be increased further. While it is arguably not necessary to engineer positive real rates relative to headline CPI inflation (particularly given the sizeable supply-side contribution to inflation, at least so far) a move in the base rate beyond the current level of 14 percent will be required. In stabilization programs it is often necessary for interest rates to “overshoot” temporarily and this should not be ruled out. The objectives should be to slow credit growth and stem the drain from dong denominated to USD-denominated deposits.

3. **Growth.** The necessary reduction in inflation and the trade deficit will require slower growth. The 4 June announcement of a reduction in the official growth target this year from 9 percent to 7 percent is welcome, although restoring price and balance of payments sustainability may require growth to fall below that level until confidence is rebuilt. As interest rates may need to temporarily overshoot, growth may need to temporarily “undershoot.” Once the current difficulties are overcome, the high growth policy (meaning largely unfettered credit growth) would need to be revisited.

4. **Fiscal policy.** While the current situation is largely a reflection of loose monetary policy, fiscal tightening can help as well. The recently announced intent to curb SOE spending is positive and needs to be effectuated. Also, the stock of outstanding government debt should be managed, including through buy-backs, to ensure that public sector debt is not unnecessarily crowding out credit to the private sector.

The main risk is that the policy response is too little and too late. While the economy may “auto-correct” with inflation moderating, import growth slowing (although export growth will decline too owing to the global slowdown in train) and exchange market pressures abating, recent developments suggest that this is not the most likely scenario. Even with some macro improvement in store, the dynamics of exchange rate expectations (and the knock-on effects on inflation expectations) are front and centre. At this juncture, a passive policy stance where the market leads the necessary adjustment is likely to result in a less orderly and more painful process than one stemming from appropriate policy action.

1997 All Over Again?

Finally, the possibility of Vietnam sparking a repeat of 1997 has received considerable attention in the financial press. We think this is unlikely. While some aspects of the present situation in Vietnam resemble Thailand 11 years ago—fast GDP growth driven by an excessive rate of credit expansion, a worsening external balance, and deteriorating sentiment toward the currency—others do not. Namely, reserve coverage seems adequate (although the SBV should consider providing more timely information to the market) and the structure of the capital account is more sustainable. Moreover, while there are a few other Asian economies with “Vietnam-like” characteristics—India and Indonesia have rising inflation and a worsening current account balance—most countries across the region have more flexible currencies, official reserves are substantially higher, information on key economic variables is more available, and policymaking is better informed than a decade ago. Because of this, any spillovers from turbulence in Vietnam should be manageable for the rest of Asia.

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