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Summary
- The inflationary consequences of high capital inflows are prompting further policy changes in Vietnam.
- We expect authorities will gradually permit greater currency flexibility and allow the VND to slightly appreciate next year.
- Our new target for USD/VND is 16,040 by end-2007 and 16,008 by end-2008. This is lower than the current NDF rates for USD/VND.
- The government has also imposed a capital gains tax on property and equity market earnings in a bid to cool asset prices.
- The direction of Vietnamese bonds is highly uncertain. In the short-term, high inflation and continued SBV sterilisation should drive a negative outlook for bonds. After the Tet holidays in February appears the most likely turning point for bond prices.

VND no longer a one-way bet

In late October we foreshadowed a rising chance that the Vietnamese government would make further foreign exchange reforms in the coming year, including a move to a (slightly) appreciating VND. This followed the government’s reported decision to cut its annual depreciation target for the VND against the USD from 1.0% to 0.5%.

VND no longer a one-way bet as inflation climbs

Source: Bloomberg and Economics@ANZ

In recent weeks the VND has continued to appreciate against the USD, underpinned by strong capital inflows and, apparently, less aggressive participation in the spot market by the State Bank of Vietnam (SBV). Moreover, the SBV has substantially increased its debt issuance in an attempt to soak up excess liquidity in the local market. The SBV’s actions

1 See Currency alert: Government changes end-year target, 22 October 2007
appear to reflect an attempt by authorities to address local inflation, which spiralled to 9.3%YOY in October.

In our view, these recent events provide a signal that the government is gradually accepting the role of foreign exchange flexibility in managing inflation. The main drivers of non-food inflation, namely high capital inflows, strong domestic demand and rising global energy prices show little signs of abating.

In this environment, we anticipate that authorities will allow the VND to slowly, and slightly, appreciate in an attempt to not fuel inflation further. Our new forecasts call for USD/VND to fall to 16,040 by end-year and to 16,008 by end-2008. This forecast implies a small 0.2% appreciation in the VND next year. However, we would note that while the VND has depreciated against the US dollar, most other Asian currencies have not. Thus a slightly stronger path for the VND will only stabilise Vietnam’s real effective exchange rate in the coming year.

Our new forecasts imply a stronger VND than the current NDF market, which continues to price for VND depreciation. The current 1-month NDF rate for USD/VND is 16,114 and the 6-month NDF rate is 16,164.

<table>
<thead>
<tr>
<th>USD/VND</th>
<th>Dec-07</th>
<th>Mar-08</th>
<th>Jun-08</th>
<th>Sep-08</th>
<th>Dec-08</th>
<th>Mar-09</th>
</tr>
</thead>
<tbody>
<tr>
<td>USD/VND</td>
<td>16,040</td>
<td>16,020</td>
<td>16,000</td>
<td>15,980</td>
<td>16,008</td>
<td>15,988</td>
</tr>
<tr>
<td>Previous f/c</td>
<td>(16,123)</td>
<td>(16,143)</td>
<td>(16,163)</td>
<td>(16,183)</td>
<td>(16,203)</td>
<td>(16,224)</td>
</tr>
</tbody>
</table>

Source: Economics@ANZ

**Popularity can be a curse**

As we have repeatedly pointed out over the course of this year, the Vietnamese government’s strategy to jointly pursue strong economic growth and VND depreciation (to promote export growth) has become increasingly difficult to sustain. Significantly complicating these competing objectives has been Vietnam’s stunning rise in popularity amongst international investors. Add to this strong remittance flows and the outcome has been a surge in capital inflows into Vietnam.

Since 2004 net transfers to Vietnam (mainly remittances from overseas) have more than doubled to around US$5,200bn; net foreign direct investment (FDI) has increased 50% to around US$1,300 and net portfolio investment has increased a mammoth 550% to at least US$5,600bn.

The sharp rise in portfolio investment flows into Vietnam has seen a sharp rise in offshore participation in the local stockmarket. Offshore investors now account for around 50% of total trade value in the HCMC exchange, up from 20% at the start of 2006. This is a higher rate of foreign participation than in Indonesia (35%) but is a lower rate than is in Thailand (70%).

It’s not just offshore investors driving the market however. Locals have also been eager to join the party and domestic credit growth, especially lending for investment purposes, has been strong. Unsurprisingly, asset prices are soaring. The HCMC securities index has overcome a mid-year correction to still be up 30% since the beginning of 2007. Property prices are also now spiralling, with prices in Hanoi and Ho Chi Minh city reportedly up around 50% since January. These asset price rises are further fanning domestic inflationary pressures.

**Tax that!**

Concerned about the seemingly large speculative component to the frenzied equity and property market, the government has made the significant move to impose a capital gains tax on real estate and equity transactions. Under the new law, passed overnight and coming into affect
from January 2009, a capital gains tax of 25% will be imposed on all property transactions. On equities, a 20% tax will fall on share trading profits while foreign buyers will have a choice between this 20% tax or a 0.1% levy on the value of each transaction.

These taxes are likely to have a very negative short-term effect on the property and equity markets. Demand, amongst locals and foreigners, should cool considerably, which in turn should cap the recent stellar asset price growth.

**Capital inflows to slow**

We expect capital inflows to Vietnam will remain high in the coming year, but that their rate of growth will slow sharply. While strong domestic growth and further financial market development will keep Vietnam an attractive destination for foreign investors, the external and internal climate is now less favourable. Externally, global growth is slowing, further (and likely substantial) losses from the sub-prime mortgage crash are yet to be crystallised, short-term funding is tight and equity markets have turned bearish. Internally, the new capital gains tax should put the brakes on offshore inflows. Our current forecast is for growth in foreign direct investment to slow from 14% to around 13% this year, with growth in the (now much larger) portfolio investment flows to slow from 330% this year to ‘just’ 30% this year.

**Vietnam balance of payments**

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2005</th>
<th>2006e</th>
<th>2007f</th>
<th>2008f</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade balance</td>
<td>-2,287</td>
<td>-2,439</td>
<td>-2,776</td>
<td>-6,000</td>
<td>-5,000</td>
</tr>
<tr>
<td>Net transfers</td>
<td>2,485</td>
<td>3,380</td>
<td>4,049</td>
<td>5,200</td>
<td>6,000</td>
</tr>
<tr>
<td>Capital &amp; Financial account</td>
<td>2,447</td>
<td>2,628</td>
<td>4,486</td>
<td>10,650</td>
<td>nf</td>
</tr>
<tr>
<td>FDI (net)</td>
<td>1,342</td>
<td>1,430</td>
<td>1,757</td>
<td>2,000</td>
<td>2,250</td>
</tr>
<tr>
<td>Portfolio inflows (net)</td>
<td>na</td>
<td>865</td>
<td>1,313</td>
<td>5,600</td>
<td>7,300</td>
</tr>
</tbody>
</table>

Source: IMF and Economics@ANZ

**Bearish short-term scenario for bonds**

There is significant uncertainty over what this all means for Vietnamese bonds. This is largely because of the uncertainty around the evolution of the SBV’s approach to tackling inflation. Over time, the SBV will need to be given a mandate to maintain price stability, and likely adopt an inflation target, but this process has not yet occurred. Yet, price stability is a concern. In recent weeks, the SBV has surprised markets by stepping up bond issuance in an attempt to draw excess liquidity out of the system. This has seen bond prices fall and yields rise to 14-month highs. The 1-year government bond yield is now 7.53%; the 5-year yield is 8.41% and the 10-year yield is 8.89%.

A likely gradual rate of VND appreciation and slower growth in inflows from offshore is still not likely to provide a short-term fix to the surplus liquidity that is a key driver of Vietnam’s high inflation rate. As such, in the coming few months we expect the SBV will maintain or even step up its current rate of debt issuance. This would see bond prices fall further while yields rise.

In our view a positive outlook for bonds would require either a turnaround in inflation, or another surge of offshore appetite for Vietnam assets, or both. At the same time, bonds may become a relatively more attractive asset class since they do not appear to be subject to the new capital gains tax. However, in the absence of further policy changes, the most likely timing for this is after Tet (Vietnamese New Year) in February next year. Until then, high global inflation (especially energy prices), rising domestic food prices and continued SBV sterilisation will be the biggest negatives for bonds.
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