

# Vietnam Monitor (Issue 25)

Do not chase the equity rally

11 September 2009

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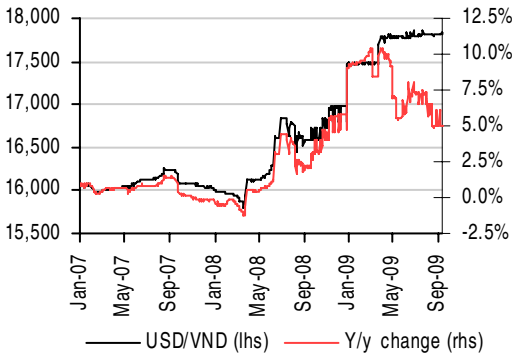
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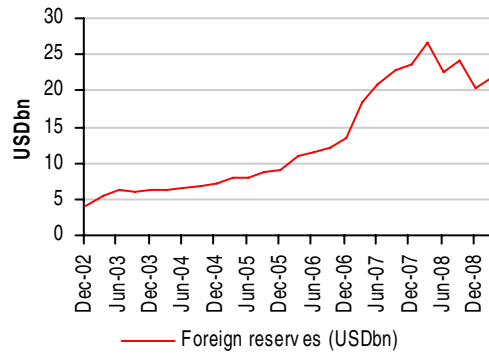
- ▶ **Economics:** With the economic cycle turning and inflation expected to rise quite quickly, we expect the central bank to hike the base rate by 200bps in 1H10 to 9%.
- ▶ **Equity Strategy:** Vietnam's stock market has risen strongly, making it the third-best performer in Asia y-t-d. But this has been driven almost entirely by local investors. With a 12-month forward PE of 19x and little transparency on earnings, we are wary of chasing the market at this stage.
- ▶ **Fixed Income Strategy:** A worsening liquidity crunch is forcing VGB yields higher. Recent capital adequacy rules and high loan demand exacerbate these liquidity pressures. The increase in VGB yields may accelerate towards year-end.
- ▶ **FX Strategy:** Little has changed in USD-VND in the past few months. However, depreciation pressure is steadily building; in particular, re-dollarisation is a growing risk. This suggests the recent stability will not last.

USD/VND



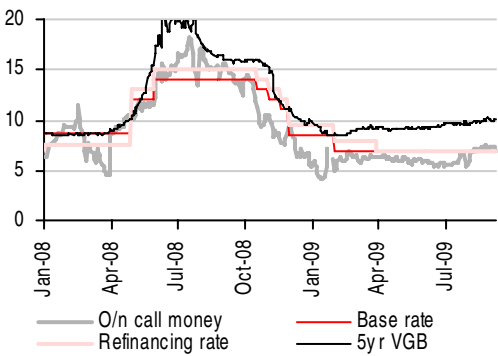
Source: Bloomberg

FX reserves



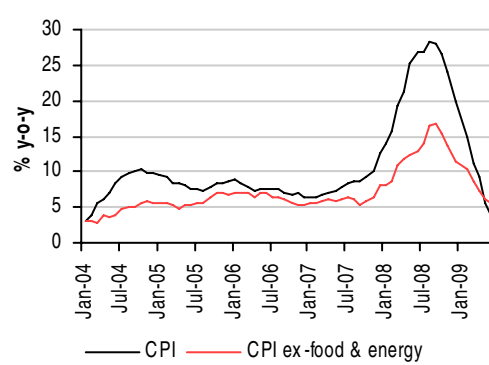
Source: CEIC

O/n call money, benchmark policy rates and 5yr bond yields



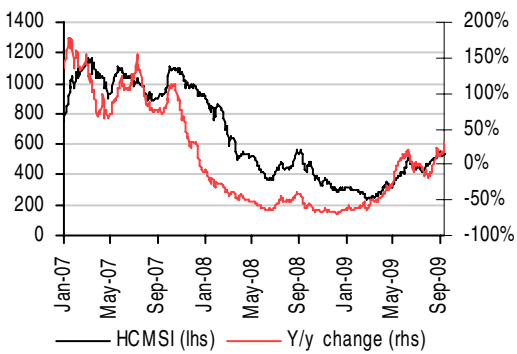
Source: Reuters, HSBC

Headline CPI and ex-food & energy



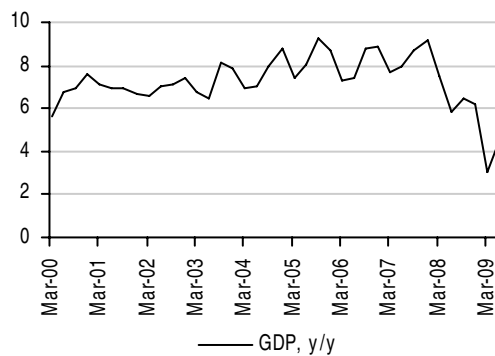
Source: CEIC, HSBC

HCMS Index



Source: Bloomberg

GDP growth



Source: CEIC

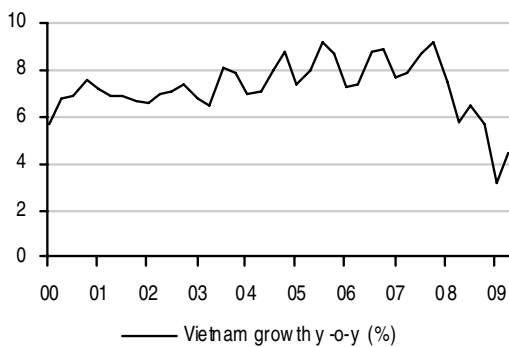
# Economics

- ▶ With the economic cycle turning...
- ▶ ...and inflation expected to rise quite quickly...
- ▶ ...we expect the central bank to hike the base rate by 200bps in 1H10 to 9%

## Growth: looking good

The Vietnam economy bounced back strongly in the second quarter, expanding by 9.4% q-o-q annualised, more than offsetting the 6.5% contraction in the first quarter. In y-o-y terms growth ticked up to 4.4% from 3.1% the previous quarter. The V-shaped recovery that we had been anticipating is now under way.

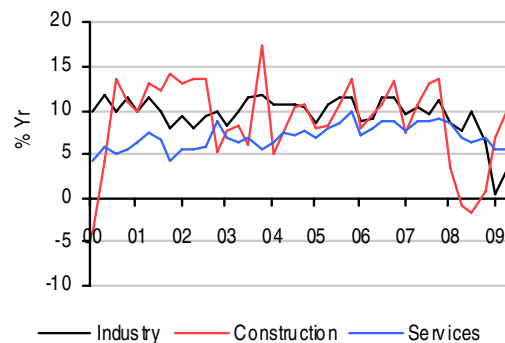
### 1. V-shaped recovery now under way...



Source: CEIC, HSBC

The main driver of this turnaround has been the industrial sector coming back to life, supported by improvements in external demand and consumption at home, with retail sales running at 20% y-o-y. The construction sector is now back to clocking 10% y-o-y growth given lower lending rates, a collapse in construction costs and progress on government infrastructure projects.

### 2. ...supported by the turn in industry while the construction sector is now booming



Source: CEIC, HSBC

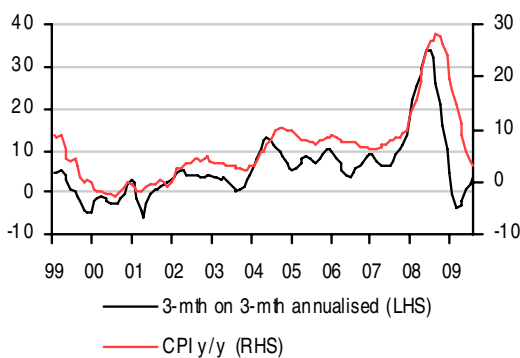
Looking ahead, we remain confident that the growth numbers will continue to improve through the year, clocking at least 6% y-o-y by the fourth quarter. Our year average forecast stands at 4.7% for 2009 and 6.8% for 2010.

There are a number of reasons for this optimism. First, the benefits of the massive monetary policy easing and the USD8bn fiscal package are still feeding through. Second, the developed world is showing increasing signs of stabilisation. Third, most Asian economies made a strong comeback in the second quarter, with more up to date indicators looking good as well.

## Inflation: ready to take off

Vietnam has been on an inflation rollercoaster over the last 18 months. It rose rapidly through 2008, hitting a peak of 28.3% y-o-y in August before falling to a six-year low of 3.3% in July this year. The swings are largely explained by commodity price movements, particularly food, oil and construction materials.

### 3. Sequential inflation has already risen



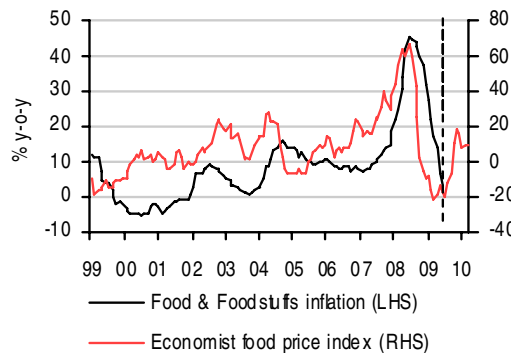
Source: CEIC, HSBC

Now the inflation engines are revving up again. On a sequential basis, inflation has already risen for five consecutive months. With the 3-month on 3-month annualised change of the seasonally adjusted series, which serves as a good lead indicator for the y-o-y change, having risen to 3.3% in July from a low of -4% in February.

We think risks to inflation are squarely on the upside going forward on account of the following:

- ▶ First, domestic food prices, which make up 43% of the CPI basket, are strongly related to international food commodity prices (correlation of 0.80 with a lag of six months). Even if we assume that the latter remains unchanged at current levels, it is going to move significantly higher over the coming 6-9 months (chart 4).

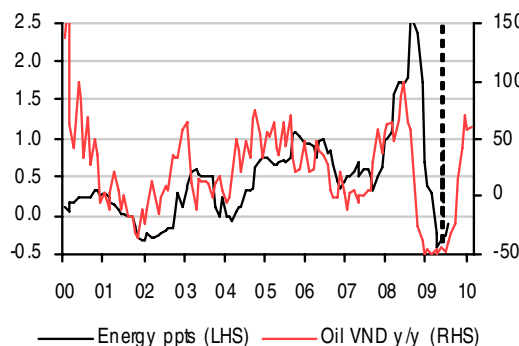
### 4. Food-related inflation to head higher again



Source: CEIC, HSBC

- ▶ Second, as in other countries, the energy contribution of the CPI (10% of the basket) is closely linked to oil price movements. Again, assuming that oil prices remain flat at current levels, the energy contribution is going to move up fairly rapidly (chart 5).

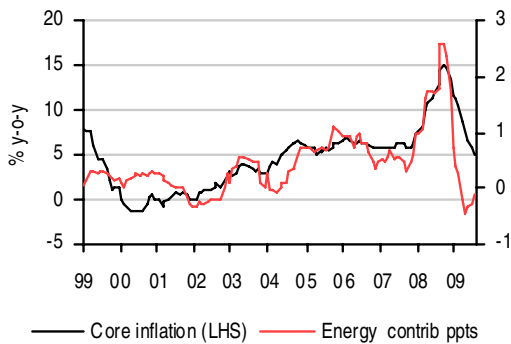
### 5. Energy contribution to inflation to rise sharply



Source: CEIC, HSBC

- ▶ Third, it's fair to highlight that core inflation in the country is very closely linked to energy prices, reflecting quicker pass-through into the economy. This is something which we have also noticed in Thailand. With the energy contribution already having turned the corner and with more to come, we believe that core inflation will also tick up.

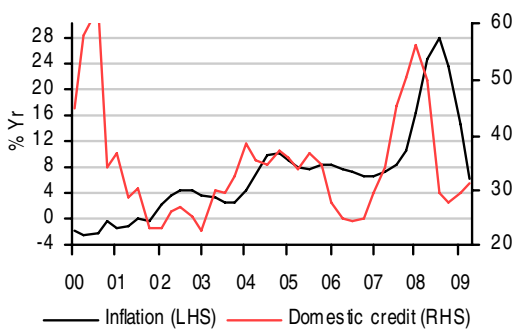
#### 6. Quick pass-through of energy into core inflation



Source: CEIC, HSBC

- ▶ Fourth, credit growth, which leads inflation by one to two quarters, has picked up quite a pace, especially with the government's 4ppt interest rate subsidy scheme. Lending of around USD22bn has been made y-t-d under this scheme.

#### 7. Credit growth to fan inflation



Source: CEIC, HSBC

**So where does that leave us?** Inflation printed at 3.3% in July and we think it will ease further to 2% in August as the fuel price hike of last year drops out of the annual comparison. However, after that inflation is going to zoom ahead, hitting 9% by year end and 13% by the end of 1Q next year, assuming that the currency and international commodity prices stabilise at current levels.

## Policy: tightening to come

The prospects of rising inflation are refreshing recent memories of the run-up that we saw last year, with investors wondering whether the central bank will be ahead of the curve this time around.

For its part the State Bank of Vietnam (SBV) has not only flagged its concerns about price pressure, with Governor Giau saying in mid-July that in "the second half of the year there is a threat of recurrence of inflation". It has also quietly started to tighten policy.

- ▶ First, it cut the interest on compulsory reserves to 1.2% effective 1 August from 3.6%.
- ▶ Second, the SBV has cut the proportion of short-term funds that can be used to make medium and long-term loans by 10ppts to 30% to ensure adequate liquidity, effective 1 January 2010.
- ▶ Finally, the central bank plans to cap broad money supply to 25-27% this year. To end-July it was up 20.2% from end 2008.

We think such quantitative restrictions will continue, with the central bank urging credit institutions to tighten lending to real estate, stock investors and consumers.

On the base rate, we believe that the central bank will keep it unchanged at 7% until the end of the year to ensure that growth continues. However, with the balance of risks tilting towards inflation from growth, we expect the SBV to hike the base rate by 200bps in the first half of 2010.

**Robert Prior-Wandesforde**

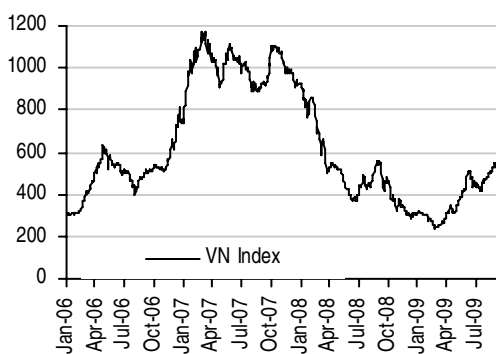
# Equity Strategy

- ▶ Vietnam's stock market has risen strongly, making it the third-best performer in Asia y-t-d
- ▶ But this has been driven almost entirely by local investors
- ▶ With a 12-month forward PE of 19x and little transparency on earnings, we are wary of chasing the market at this stage

## Locals take the lead

The Vietnamese stock market has performed well since March, moving up in line with global and regional markets and, given its high beta, outperforming most. In USD terms, VN Index has risen by 70% y-t-d, making it the third best market in Asia behind Sri Lanka (84%) and Indonesia (75%).

1. Vietnam stock index

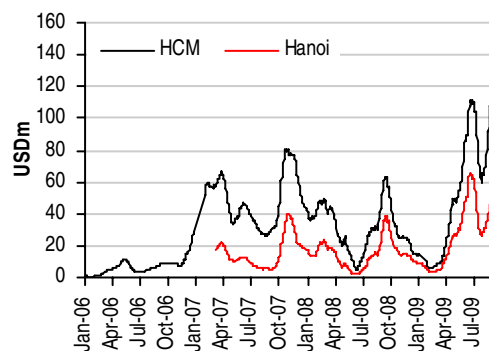


Source: Bloomberg

One result of the rally – often seen before in Vietnam – is that a rising market has been accompanied by a pick-up in liquidity and the ability of foreigners to find stocks large enough to trade. Daily turnover in August for the Ho Chi Minh and Hanoi exchanges combined totalled USD166m

(Chart 2), with the HCM exchange in particular trading more than USD100m most days recently.

2. Daily trading value on HCM and Hanoi exchanges (20DMA)



Source: Bloomberg

There are now nine stocks with a market cap of USD1bn or greater (including the recently listed Vietcombank, Vietinbank and Baoviet Holdings) and a further seven above USD500m – giving a total of 16 companies that most foreign institutions should find big enough to buy. Of these, all but two are still below their foreign ownership limits. (A list of all companies with market cap of USD200m or more is shown in Table 8).

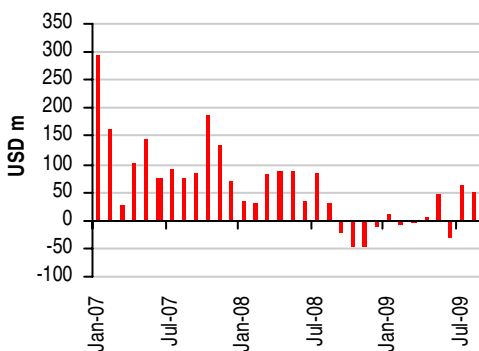
**3. Key stock market data**

	HCM	Hanoi	Total
Market cap (USDm)	27,306	6,177	33,482
No. of stocks	177	198	375
Stocks with mkt cap >USD1bn	8	1	9
Stocks with mkt cap >USD500m	15	1	16
Stocks with mkt cap >USD200m	26	6	32
Stocks that hit foreign limit	3	3	6
Daily turnover (USDm, 1mth ave)	133	59	193
Foreign ownership	18.2%	12.7%	17.2%
PE (2008) x	24.8	17.2	
ROE	22.9%	17.2%	22.8%
DY	2.9%	5.0%	

Source: HSBC, Bloomberg, HOSE

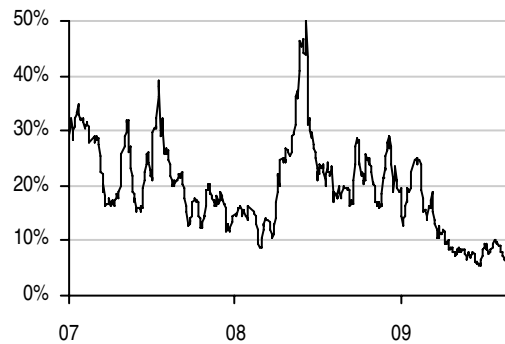
It is clear, however, that the recent stock market run has not been driven by foreign investors. The proportion of turnover represented by foreigners has fallen to around 7-8% this year, down from 20-30% during most of 2007-8 (see Chart 5). At the same time, they have turned net buyers – a total of USD133m of Vietnam stocks net since April after a six-month period of selling (see Chart 4) – although volumes have been low compared to 2007.

**4. Foreign net buying of Vietnamese equities**



Source: Bloomberg (To Sep 9)

**5. Foreign share of turnover, HCM Exchange**

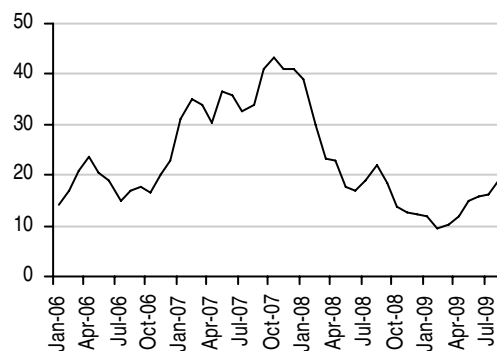


Source: HSBC, Bloomberg

**Forward PE of 19x**

The rise in the market has also pushed up valuations substantially. The HCM Exchange now trades on 25x historic earnings. We continue to assume that EPS will grow by 20% both this year and next. If this is correct, 12-month forward PE comes out at 19x and 2010 PE at 16x. That is quite expensive compared with 12-month forward PEs of 15x for China H-shares, 14x for Indonesia and 12x for Thailand.

**6. Estimated 12-month forward PE for VN Index**



Source: HSBC

Could earnings growth be significantly better than 20% and therefore justify the current level of the market? As always in Vietnam, earnings lack a great deal of transparency, with no consensus forecasts and considerable EPS volatility as companies make extraordinary write-offs.

### **2Q earnings still patchy**

The evidence from 2Q earnings (which were announced by the end of August) is not especially helpful. As shown in Table 7, during 1H net profit for the largest companies with comparable data rose by 2% y-o-y, with a pick-up to 30% y-o-y in 2Q compared to -9% in 1Q. But this mainly represented a below-the-line improvement (fewer extraordinary losses than in the prior-year period). Operating conditions remain weak, with sales in 2Q down 4% y-o-y and operating profit up just 3%. There were also huge variations between companies, with some companies (banks, real estate) producing strong double-digit OP growth in 2Q, and others (PV Fertiliser, Vinamilk) seeing big drops.

Under Vietnamese accounting rules, most companies do not need to take extraordinary items into account until the full-year results and so the EPS growth for the year will depend to a large extent on how many fewer one-offs there are this year than last. That is impossible to forecast.

### **We remain wary**

In the end, we remain somewhat wary on this market. Foreign investors have mostly missed the run-up over the past six months and we would not advise them to chase the market at the moment. Until there is more transparency on earnings, and improvements in investment procedures (such as the IPO and listing processes), there are more attractive emerging markets in Asia to buy at lower multiples.

**Garry Evans**

8. Key valuation data for the largest listed Vietnamese stocks (market cap >USD200m)

Code	Name	Industry Subgroup	Exchange	Mkt cap (USDm)	Ave daily t/over (USDm)	Foreign ownership	Foreign limit	Room for foreign buying (USDm)	PE	Chg 3M
VCB	JSC BANK FOR FOREIGN TRADE	Commer Banks Non-US	HCM	3,631	n/a	2%	9%	255.2	n/a	n/a
CTG	VIETNAM JSC COMMERCIAL BANK	Commer Banks Non-US	HCM	2,360	n/a	0%	11%	250.9	n/a	n/a
ACB	ASIA COMMERCIAL BANK	Commer Banks Non-US	Hanoi	1,654	8.67	30%	30%	0	11.9	-17%
VNM	VIET NAM DAIRY PRODUCTS JSC	Food-Dairy Products	HCM	1,537	1.45	45%	46%	9.1	21.9	47%
PVF	PETROVIETNAM FINANCE JSC	Finance-Invest Bnkr/Brkr	HCM	1,214	2.45	13%	30%	203.1	428.8	2%
BVH	BAOVIET HOLDINGS	Multi-line Insurance	HCM	1,212	n/a	14%	49%	428.2	n/a	n/a
STB	SAIGON THUONG TIN COMMERCIAL	Commer Banks Non-US	HCM	1,099	13.04	30%	30%	0.0	20.5	10%
HAG	HAGL JSC	Real Estate Oper/Develop	HCM	1,026	4.23	20%	49%	296.8	26.2	34%
DPM	PETROVIETNAM FERT & CHEMICAL	Chemicals-Diversified	HCM	1,016	2.05	21%	49%	283.0	13.1	-6%
HPG	HOA PHAT GROUP JSC	Miscellaneous Manufactur	HCM	804	4.17	33%	49%	124.6	16.4	18%
PVD	PETROVIETNAM DRILLING AND WE	Oil-Field Services	HCM	689	1.07	28%	49%	142.5	13.3	1%
FPT	FPT CORP	Telecommunication Equip	HCM	669	2.08	37%	49%	81.1	13.8	8%
SSI	SAIGON SECURITIES INC	Finance-Invest Bnkr/Brkr	HCM	641	9.71	45%	49%	25.4	40.2	-4%
VIC	VINCOM JSC	Real Estate Oper/Develop	HCM	636	0.37	6%	49%	271.2	87.6	21%
VIC	VINCOM JSC	Real Estate Oper/Develop	HCM	636	0.37	6%	49%	271.2	87.6	21%
PPC	PHA LAI THERMAL POWER JSC	Electric-Generation	HCM	522	1.50	20%	49%	150.6	-43.7	-18%
KBC	KINH BAC CITY DEVELOPMENT SH	Bldg-Residential/Commer	Hanoi	450	2.39	12%	49%	168	29.3	-7%
ITA	TAN TAO INVESTMENT INDUSTRY	Real Estate Oper/Develop	HCM	436	1.37	29%	49%	85.5	25.2	-8%
VPL	VINPEARLLAND TOURISM JSC	Resorts/Theme Parks	HCM	418	0.05	18%	49%	130.0	208.7	-21%
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VCG	VIET NAM CONSTRUCTION & IMPO	Building&Construct-Misc	Hanoi	412	3.90	4%	49%	184	21.8	-4%
PVS	PETROLEUM TECHNICAL SERVICES	Transport-Services	Hanoi	401	1.75	11%	49%	153	11.5	-9%
SJS	SONGDA URBAN & INDUSTRIAL ZO	Building&Construct-Misc	HCM	386	2.24	33%	49%	63.0	58.0	74%
SHB	SAIGON - HANOI COMMERCIAL	Commer Banks Non-US	Hanoi	337	2.53	4%	30%	89	30.8	-22%
DIG	DEVELOPMENT INVEST CONSTRUCT	Building&Construct-Misc	HCM	320	n/a	16%	49%	105.4	13.5	n/a
VSH	VINH SON - SONG HINH HYDROPO	Electric-Generation	HCM	316	0.61	30%	49%	60.8	15.2	2%
VSH	VINH SON - SONG HINH HYDROPO	Electric-Generation	HCM	316	0.61	30%	49%	60.8	15.2	2%
KDC	KINHDO CORP	Food-Baking	HCM	255	0.57	33%	49%	40.6	-53.2	50%
PVX	PETROVIETNAM CONSTRUCTION CO	Building&Construct-Misc	Hanoi	252	n/a	0%	49%	124	n/a	n/a
GMD	GEMADEPT CORP	Transport-Services	HCM	236	1.59	32%	49%	40.4	-23.7	49%
REE	REFRIGERATION ELECTRICAL ENG	Appliances	HCM	218	2.95	40%	49%	18.6	-25.1	-10%
PHR	PHUOC HOA RUBBER JSC	Agricultural Operations	HCM	204	n/a	12%	49%	75.4	n/a	n/a

Source: HSBC, Bloomberg, HOSE (Data as of Sep 8)

7. Earnings so far in 2009 (companies with market cap >USD200m and sufficient comparable data)

Code	Name	Mkt cap (USDm)	Sales 2Q	y-o-y 1Q	OP 2Q	y-o-y 1Q	NP 2Q	y-o-y 1Q
ACB	ASIA COMMERCIAL BANK	1,654	5%	15%	64%	-10%	50%	-18%
VNM	VIET NAM DAIRY PRODUCTS JSC	1,537	-31%	14%	-15%	32%	-21%	57%
STB	SAIGON THUONG TIN COMMERCIAL	1,099	-1%	-2%	91%	-5%	72%	-17%
DPM	PETROVIETNAM FERT & CHEMICAL	1,016	2%	101%	-38%	-12%	-41%	-14%
HPG	HOA PHAT GROUP JSC	804	-23%	-31%	-18%	-23%	-3%	-33%
PVD	PETROVIETNAM DRILLING AND WE	689	-11%	30%	-7%	27%	0%	23%
FPT	FPT CORP	669	0%	-11%	-17%	45%	15%	18%
SSI	SAIGON SECURITIES INC	641	-21%	-73%	-315%	-61%	-245%	-74%
VIC	VINCOM JSC	636	-3%	-3%	-172%	-223%	38%	-70%
PPC	PHA LAI THERMAL POWER JSC	522	10%	2%	4%	-17%	40%	-1%
KBC	KINH BAC CITY DEVELOPMENT SH	450	-54%	-60%	-65%	-66%	47%	-144%
ITA	TAN TAO INVESTMENT INDUSTRY	436	143%	-36%	-2%	-53%	1%	-63%
VPL	VINPEARLLAND TOURISM JSC	418	3%	3%	0%	-1%	20%	14%
PVS	PETROLEUM TECHNICAL SERVICES	401	27%	49%	14%	-7%	40%	25%
SJS	SONGDA URBAN & INDUSTRIAL ZO	386	147%	-96%	265%	-109%	3839%	-83%
VSH	VINH SON - SONG HINH HYDROPO	316	-13%	-4%	-20%	-40%	2%	19%
KDC	KINHDO CORP	255	6%	1%	-183%	-27%	426%	-66%
GMD	GEMADEPT CORP	236	-5%	-7%	-9%	-10%	5555%	-11%
REE	REFRIGERATION ELECTRICAL ENG	218	9%	-48%	-53%	-11%	-399%	-171%
<b>TOTAL y-o-y</b>			<b>-4%</b>	<b>-1%</b>	<b>3%</b>	<b>-14%</b>	<b>30%</b>	<b>-9%</b>

Source: HSBC, Bloomberg

# Fixed Income Strategy

- ▶ Worsening liquidity crunch is forcing VGB yields higher
- ▶ Recent capital adequacy rules and high loan demand exacerbate these liquidity pressures
- ▶ The increase in VGB yields may accelerate towards year end

Many of the inefficiencies of the banking system that we discussed in the previous Vietnam Monitor (8 July, *Issue 24: Further rise in VGB yields expected*) – such as liquidity tightness, financial repression and credit rationing – have been exacerbated since we last published. The heightening of these factors has led to a 40-60bp increase in VGB yield quotes to 10.00% (mid) for 2yr and 5yr VGBs.

New capital adequacy requirements that the SBV introduced in August – while well intentioned and a step in the right direction towards improved prudence in the banking system – may perpetuate tightening in VND liquidity and accelerate the increase in VGB yields towards the end of the year and as much as 200bp higher in the next six months.

Last month, the SBV also raised its credit growth target from 25% to 30% (reversing an earlier decision to lower it from 30% just on 26 June). Raising this target could appear to be at odds with the SBV's recent capital requirements, but we caution that this move merely reflects the fact that credit creation had already reached +22% y-t-d since the end of August. During February-August, VND400trn in loans under the government-directed subsidised lending programme were disbursed. However, anomalies in the financial system will hamstring banks' ability to profitably

extend loans, despite continued demand for credit by local corporates.

This government's lending programme as well as slack deposit growth has tightened domestic liquidity in Vietnam, exemplified by an increase in call money rates to above 7.00%, which is the highest since Jan-2009. The scarcity of funds by the most aggressive lenders has led these banks to raise deposit rates by roughly 100ppts over the last two months to a high of 10.2%, near the SBV's 10.5% official cap on bank lending rates to corporates. Higher deposit-funding costs and the ceiling on corporate loan rates have compressed bank net interest margins and eroded profitability, especially those of state-owned and joint-stock banks, which have provided the bulk of loans under the subsidised lending programme.

Furthermore, capital adequacy requirements introduced by the SBV in August will exacerbate banks' demand for capital:

- ▶ SBV has directed banks to decrease the percentage of short-term (<12mth) deposits used for medium and long-term loans (>12mths) from 40% to 30%. This ratio must be achieved by October or else new loans may be suspended until the end of the year. This has fuelled competition between banks

for short-term deposits, which has moved deposit rates higher towards 10.2%.

- ▶ Non-joint stock commercial banks (JSCBs) must raise charter capital to at least VND2trn by end of this year while JSCBs have until end-2010 to raise charter capital to VND3trn. Currently only 22 out of 38 domestic JSCBs are in compliance, according to local press<sup>1</sup>, which should spur equity offerings as well as bank bond issuance.

While it appears the SBV would like to rein in rampant loan creation, it would also like to avoid a credit freeze in 4Q09. This has led to questions over whether the SBV will extend the subsidised loan programme from the VND425trn originally planned in February or raise its 10.5% corporate lending rate cap by banks. We assign a high probability of the SBV providing banks and corporates such an adjustment period in order to prevent a standstill in the credit market, facilitate the rollover of maturing loans and prevent economic dislocations during the heightened period of seasonal liquidity tightness between Christmas and Tet.

Regardless of how the SBV will accommodate loan demand in the coming months, the relatively scarce capital in the banking system is likely to continue to produce further liquidity tightness, which will drain investable funds for VGB purchases.

## Market outlook

Going forward, we expect VGB yields to continue to rise due to tightening VND liquidity. O/n call money has risen to above 7% despite the SBV's liquidity injections (VND42trn in OMOs since 1 September).

If liquidity is not reason enough for banks to withhold purchases of VGBs, other factors should also independently lead to higher VGB yields, namely:

- ▶ Incipient inflation pressures: SBV governor has said inflation in 2010 could be 10% if bank loans and money supply expanded 25-27%. HSBC Economics sees headline CPI rising from 2% in August to 9% by end-2009 and 13% by end-2010 (see *Economics* section of this report for more details).
- ▶ Expectations of SBV rate hike: According to our economist, policy rate hikes in the order of 200bp during 1H10 are warranted due to inflation pressures. The impact of these rate hikes on VGB yields are likely to be muted given that yields have already largely unhinged from the benchmark rate of 7.00%.
- ▶ Financing needs: Local press has reported that only 20% (VND7.5trn) of planned 2009 VGB issuance has been undertaken<sup>2</sup>. However, the announcement of a VND6trn 40yr interest-free loan from the World Bank last month is a positive development, but this is likely to represent the end of further multilateral aid this year for a total of VND10-11trn (versus roughly VND6trn last year).

To conclude, we believe the banking system will continue to experience tight domestic liquidity through year-end, which will continue to impair the capacity for banks to absorb VGB issues at current SBV yield cut-off levels (8.9% for the 2yr and 9.3% for the 5yr VGB set on 24 August). Taking these considerations into account, we raise our VGB yield forecast to 11.00% for the 2yr VGB over the next six months.

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<sup>1</sup> "Banks rush to raise capital", *Vietnam News Service*, 24 August 2009

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<sup>2</sup> "Vietnam Sold 19% of Planned Bonds for 2009, Thoi Bao Reports", *Bloomberg*, 21 August 2009

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VGB yield forecasts

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		Yields				
		Current	+ 1mth	+ 3mths	+ 6mths	+ 12mths
New	2yr	10.00	10.00	10.20	11.00	12.00
	5yr	10.00	10.00	10.20	10.50	11.00
Prior	2yr	-	10.00	10.10	10.30	10.30
	5yr	-	10.20	10.50	10.50	10.50

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Source: HSBC

Virgil Esguerra

# FX Strategy

- ▶ Little has changed in USD-VND in the past few months
- ▶ However, depreciation pressure is steadily building; in particular re-dollarisation is a growing risk
- ▶ This suggests that the recent stability will not last

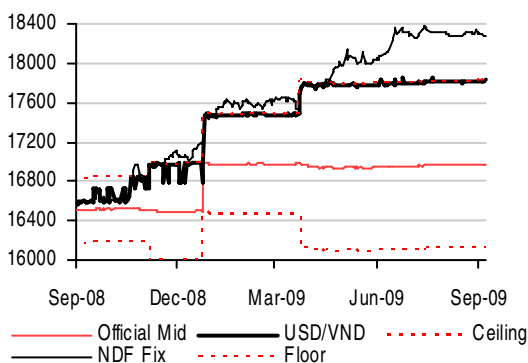
The USD-VND market has been more stable in the past two months than it has been perhaps in the last two years. The daily official fixing and official spot rate, which continues to hug the band ceiling, has drifted up an almost imperceptible VND27, while the NDF fixing, our favoured indicator of the market-clearing rate, has kept within a range within VND60 on either side of 18,300 (Chart 1). The gap between the official and market-clearing rate, a measure of excess USD demand in the FX market, has now stabilised at around VND450 (Chart 2).

However, this masks growing depreciation pressure that is building which may interrupt this fragile stability that the FX market has enjoyed recently. On the fundamental macro side, the

economics section flags the expectation that inflation will rebound sharply to 9% by the end of the year. Equally concerning has been the notable rise in imports, which now exceed USD6bn a month, and the resulting re-widening of the trade deficit, which printed -USD1.5bn in August, the highest deficit since May last year (Chart 3).

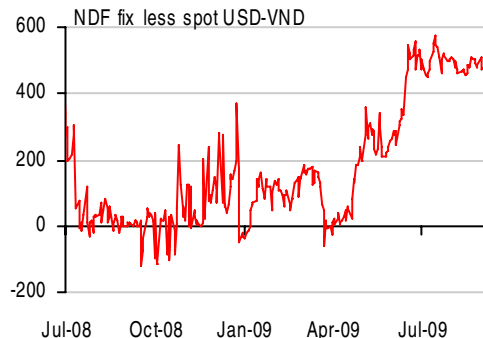
These impart a negative currency impact in several ways. First is the obvious flow impact from higher net demand for USD for imports. Importantly, the foreign investment environment does not seem supportive enough at this point to fund this rising trade deficit. FDI commitments, having showing some rebound in the middle of the year has softened again (Chart 4), and new monthly FDI commitments (which have historically run ahead of actual utilised

1. USD-VND, trading band, and NDF Fix



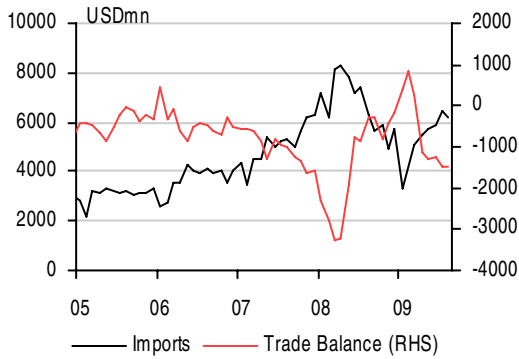
Source: Bloomberg, Reuters

2. The imbalance in the FX market remains high, but steady



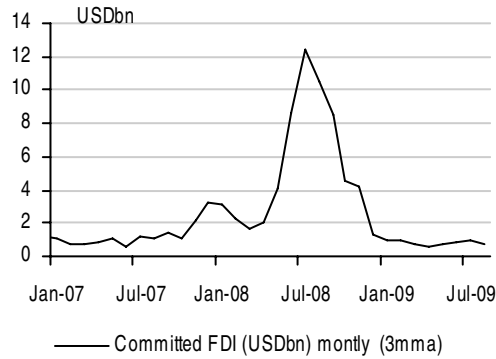
Source: Bloomberg

**3. Imports rising, trade deficit widening**



Source: CEIC

**4. FDI commitments remain weak**

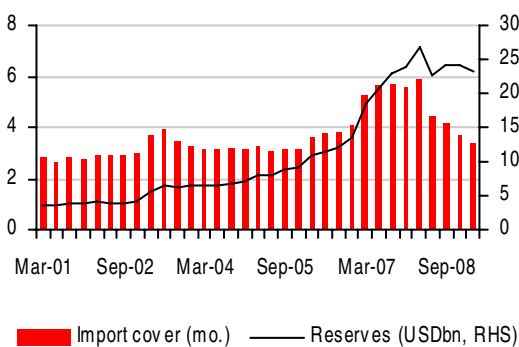


Source: CEIC

FDI are now running substantially below monthly trade deficits.

Secondly, the rising import bill, combined with reported continued USD selling by the SBV<sup>3</sup>, will further lower Vietnam's FX reserves import coverage ratio, which has already trended down below 4 months as of the latest reported end-2Q FX reserve data. The standard benchmark minimum is 3 months import coverage.

**5. FX reserves**



Source: CEIC

Beyond this, the combination of higher inflation and a rising trade deficit will further fuel higher expectations of currency depreciation, with the

memories of the 1Q08 overheating episode still a fresh memory. This, in turn, further encourages the dollar hoarding that is ongoing, which increases further risk of a broader re-dollarisation trend in the economy, a phenomenon that the press has already begun highlighting<sup>4</sup>.

While the absence of short-term capital flows that have helped keep the FX market more stable this year, an sharp increase in household USD demand would disrupt this stability. A one-off depreciation combined with the tightening moves our economist expects early next year, as well as a more active intervention policy which can more credibly support the official exchange rate, would do much to reset expectations and reverse some of the recent USD hoarding seen. We continue to expect the official USD-VND rate to reach 18,200 by the end of the year.

**Daniel Hui**

<sup>3</sup> "Vietnam sees balance of payments gap at \$1 billion", *Vietnamnet*, 8 August 2009, <http://english.vietnamnet.vn/biz/2009/08/862459/>

<sup>4</sup> Aude Genet, "In Vietnam, many see dollar not dong as king" *AFP*, 1 September 2009, <http://www.google.com/hostednews/afp/article/ALeqM5jIYxLHWraskNVSQHstf4H9Q2QFoQ>

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