

# Vietnam Inflation

Too hot to handle?

- ▶ **Inflation has doubled over the last six months...**
- ▶ **...and may rise further as high commodity prices and strong demand effects continue to feed through**
- ▶ **For inflation to show a marked decline, growth needs to slow and commodity prices need to stabilise**

## Growth slowdown is key

In addition to the rapidly deteriorating trade position, (see *Vietnam: Deficit danger?* April 2008), inflation in Vietnam has been accelerating at an alarming pace – having doubled over the last six months to hit 25% in May. The bulk of the increase is explained by surging food inflation on the back of high international food commodity prices, strong demand at home and more recently hoarding behaviour. Energy inflation has been picking up as well in line with elevated global oil prices. Additionally, inflation ex-food & energy has been trending higher for over a year, consistent with an economy that is operating above potential.

Our modelling work suggests that inflation is going to remain elevated for a while yet, with the peak sometime in the second half of 2008. After which we expect inflation to show a marked decline *assuming* stable/falling international commodity prices and slower growth. If growth were to continue unabated and international commodity price inflation maintains its current pace, then inflation shows no signs of peaking.

Our analysis shows that strong demand at home is allowing retailers to pass on high international commodity prices to consumers whilst also fanning underlying price pressures. So for inflation to temper growth needs to slow; this would also help alleviate the trade deficit situation. To achieve slower growth a coordinated monetary and fiscal package is needed. The central bank has taken some action already and we think more will come through the year, and as such we are pencilling in 300bps of further hikes in the base rate. The government has pledged to reduce its spending, however evidence of that has been disappointing to date. The bottom line is that the country needs to give up short-term growth for long-term growth.

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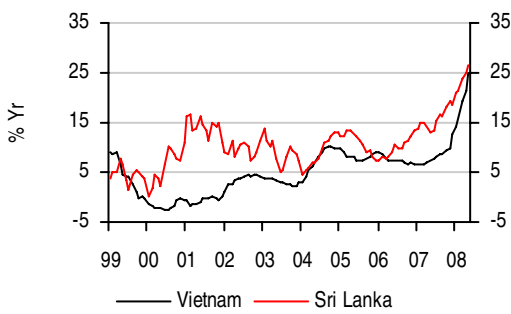
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## Inflation

### Stronger by the month

Inflation has been breaking new highs every month, with the May read being 25.2% y/y, the highest in over 15 years. In Asia, this is the second highest after Sri Lanka where inflation is running above 26% y/y – though as can be seen in chart 1 below, the gap between the two has been narrowing. The pace of the pick-up in Vietnam has also been alarming with inflation having doubled over the last 6 months.

1. Inflation: catching up with Sri Lanka

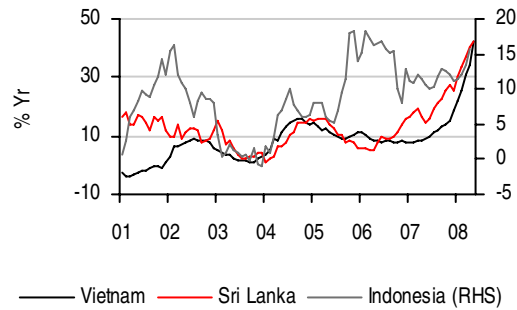


Source: CEIC

## Food to blame

As has been the case across the region, the food related-sub-index in inflation is largely to blame<sup>1</sup>. Food and foodstuffs inflation (43% of the CPI basket) touched a new record of 42.4% y/y in May. This compares with a 43% y/y increase in food prices in Sri Lanka and around a 16% y/y<sup>2</sup> rise in Indonesia.

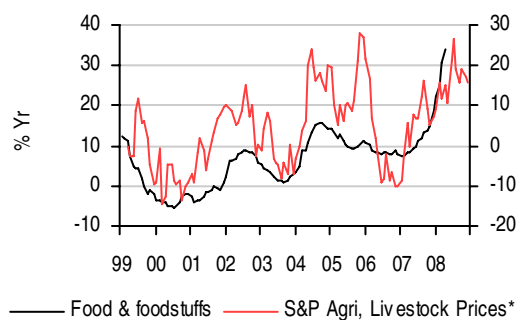
2. Food inflation: the worst hit



Source: HSBC, CEIC

Although Vietnam is still a net exporter of food<sup>3</sup>, domestic food prices have been sky-rocketing. A large part of this rise in food-related costs is probably explained by increased demand at home as income levels have risen and monetary policy has been very loose. The demand effects have been exacerbated by disease breakouts, floods etc., with the latter having some negative impact on distribution. The other reason being that domestic players are probably using international food prices as a benchmark to price things at home – so even though the country is not directly importing the goods, it is importing the high prices (!).

3. High international food prices pushing up domestic food price inflation



\* lagged 15-months (RHS)

Source: Bloomberg, CEIC.

<sup>1</sup> For a detailed analysis of food prices and the implications for Asia see *The food price scare*, 15 April 2008.

<sup>2</sup> April release.

<sup>3</sup> According to the latest available data the net food surplus was around 8% of GDP in 2005.

What ultimately happens to food & foodstuffs inflation during the course of the year then depends not only on domestic demand pressures but also on the trajectory of international food prices, the latter being a wild card.

## Modelling food & foodstuffs inflation

To get a better handle on things, we have tried to model food & foodstuffs inflation in Vietnam using the output gap<sup>4</sup> as an indicator of demand, and international food commodity indices (such as the CRB food index and S&P agricultural and livestock index) in local currency terms as explanatory variables. In addition, we investigated the importance of oil as it affects the transportation cost of food and also fertilizer costs.

We estimate the equation using quarterly average data going back to 2001<sup>5</sup>. Data limitations prevent us from going back further; this is not ideal but the period does have several turning points. We also use the model to project the trajectory of food & foodstuffs inflation till the middle of 2009. Given the uncertainty regarding international food and oil prices over the forecast horizon, we thought it would be worthwhile to look at three scenarios.

1. In the base case we assume that international food and oil prices remain at current levels, as does the USD/VND exchange rate. For calculating the output gap, we have assumed that the government's new 2008 growth target of 7%<sup>6</sup> is correct.
2. In the high scenario we assume that the year-on-year percentage change in international food and oil prices remains at current rates.

<sup>4</sup> The output gap is the percentage difference between the actual level of GDP and the trend level of GDP. The trend level of GDP is estimated using the Hodrick-Prescott filter.

<sup>5</sup> For all variables we have taken the average over the quarter to avoid month to month volatility and pick up the underlying trend over time.

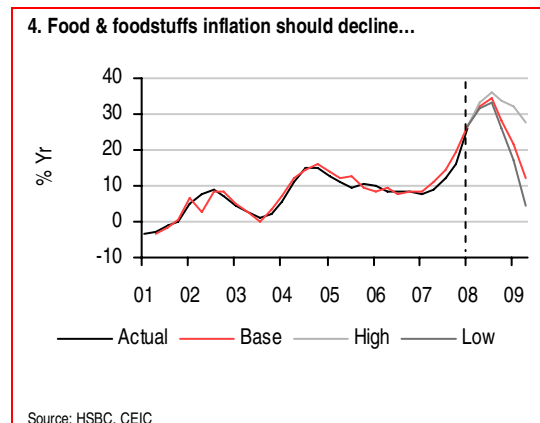
<sup>6</sup> Having started the year with 7.4% y/y growth, to achieve the 7% target, growth will have to slow through the year. Historically this would be an anomaly as, strangely, year-on-year growth usually strengthens through the year!

For the currency and output gap we use the same assumptions as the base case.

3. In the low scenario we assume that the level of international food and oil prices immediately declines by 10% and remains constant at the lower level whilst again maintaining the assumptions on currency and output gap as the base case.

## Model results

Chart 4 shows the fit of our food & foodstuffs model and the results of the various scenarios.

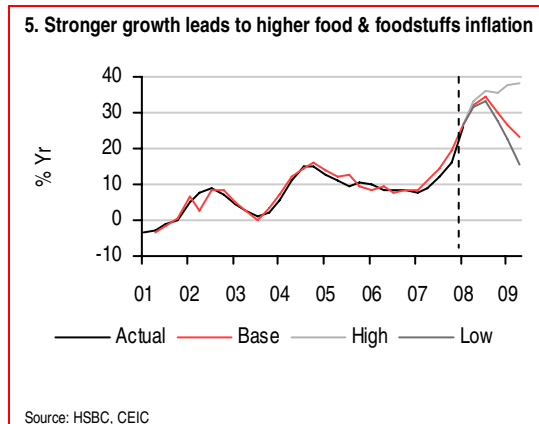


There are a few observations to make:

- ▶ The fit of the model is good with an R-squared of 92% and adjusted R-squared of 91%. As most of the explanatory variables are lagged we can make a two-quarter ahead forecast by forecasting just one variable.
- ▶ The model has been successful in picking up the turning points and to a large extent the magnitude of CPI food inflation as well. We also back-tested the model, by estimating the equation until Q1 2007 and then letting the model forecast the following year. We found that the equation accurately predicted the sharp acceleration that we have seen over the last year, giving us some degree of confidence in its predictive ability.

- ▶ In terms of the outlook, all scenarios suggest that food & foodstuffs inflation will continue to rise for a few months yet, with Q3 probably being the peak.
- ▶ On the brighter side, the model suggests that following the peak, food & foodstuffs inflation should decline to levels seen before the sharp acceleration in 2007, unless international food and oil prices continue to grow at current rates (high scenario).
- ▶ It is worth bearing in mind that the pace at which food-related costs fall in the different scenarios depends entirely on the assumptions regarding international food and oil prices – both of which are highly uncertain – as output gap and currency assumptions are the same in all three cases.
- ▶ The fact that food & foodstuffs inflation declines even in the high scenario largely reflects the slower growth assumption of 7%. To get some perspective on demand effects, we re-ran the model assuming that the growth profile of the economy in 2008 is similar to 2007 – this gives us a higher positive output gap compared with the earlier assumption. Chart 5 indicates that under the stronger growth scenario, food & foodstuffs inflation can be expected to remain at much higher levels, which would of course have direct implications for overall inflation. On average food & foodstuffs inflation is 4ppts higher than the lower growth scenario over a 20-month period. However, as the equation was estimated over a relatively short period of time, given data limitations, the importance of demand effects might be slightly exaggerated<sup>7</sup>, but that does not change the key

point that stronger growth and demand lead to higher food & foodstuffs prices.



- ▶ Last but not least, we have to emphasise that the model for food & foodstuffs inflation should only be used as a directional gauge and in the near term there is a risk that the model might under-predict. In fact this may already be happening. This basically reflects the possibility that when prices start rising very sharply this could lead to hoarding behaviour – causing people to buy much more than is required and also causing suppliers to sell less in the hope of selling at a higher price later<sup>8</sup> – thereby exacerbating the supply-demand mismatch that caused the price spike in the first place. Clearly the model will not be able to pick up the impacts of such changes and hence will under-predict.

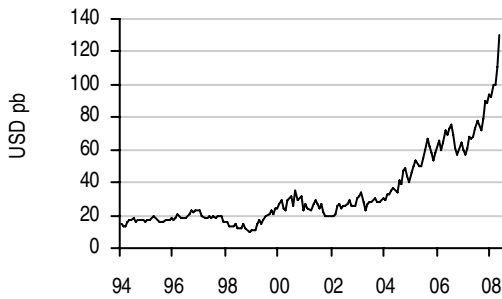
## Oil price shock

The other factor which has been applying strong upward pressure on inflation across the globe is oil. As can be seen in chart 6, oil prices (Brent) have been rising and rising.

<sup>7</sup> The low volatility of growth (standard deviation of just under 1%) also contributing to the high estimated coefficient.

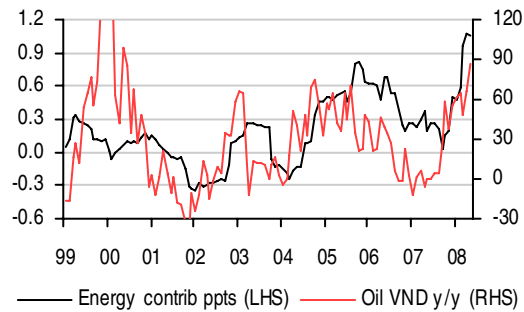
<sup>8</sup> There is anecdotal evidence of merchants hoarding rice in Vietnam.

6. Oil prices: up, up and away



Source: Bloomberg

7. Energy contribution to inflation



Source: CEIC, HSBC

Given that energy makes up a fair share of the CPI basket of most countries via transportation, utilities etc., the impact on overall inflation can be substantial. Of course, if fuels are heavily subsidised such as in Malaysia or Indonesia then that pass-through is limited. However, growing fiscal strain will at some point see policy authorities capitulate and take the hard and unpopular decision of scaling back the subsidies – as we are seeing in the case of Indonesia – which then results in an inflation spike.

### Measuring the oil impact

Let's now try to get a handle on how movements in oil prices impact inflation in Vietnam. In chart 7 we have plotted the year-on-year change in oil prices in dong (VND) terms along with the direct contribution of energy (percentage points) to inflation. The energy contribution is calculated by multiplying the rate of energy price inflation by the weight of energy in the CPI basket<sup>9</sup>.

As can be seen, the energy contribution was lower in the first half of the sample versus the second, for a given year-on-year change in the crude oil price. Additionally, the correlation between the two series is also stronger in the second half. Both of these are on account of fuel subsidies in the country, with the process of dismantling them having begun in 2004. The bulk of the subsidies for gasoline and kerosene have now been removed, with the remaining fuel subsidies (marginal) to be eliminated in 2008.

### Modelling the energy contribution

In order to come up with projections for the contribution of energy to overall inflation we built a simple model. We have estimated an equation using quarterly average data going back to 2001<sup>10</sup>, with year-on-year changes in oil and gas prices (Henry Hub futures) in local currency terms and the output gap as explanatory variables.

Given the uncertainty regarding oil and gas prices, we have again analysed three scenarios. As before, the base case assumes that oil and gas prices remain unchanged at current levels over the forecast period. In the high case we assume that the year-on-year percentage change in oil prices remains at current rates while for gas prices we assume a growth rate

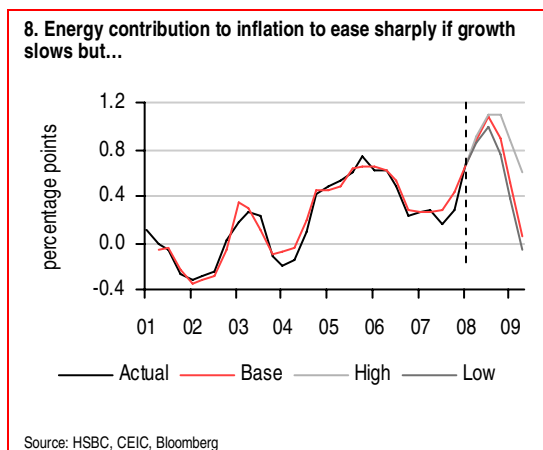
<sup>9</sup> For energy price inflation we are taking the transportation & communication sub-index. This is not ideal but we do not have a split between the two sub-components. Although the weight of the overall index is 9% we are taking a weight of 6.8% for energy, based on the example of Indonesia.

<sup>10</sup> Data limitations prevent us from going further back; this is not ideal but the period does have a number of turning points.

of 75% y/y<sup>11</sup>. In the low scenario we assume that the level of oil and gas prices falls by 10% immediately and then remains at the lower level over the forecast horizon. In all cases the output gap is calculated taking into account the government growth target of 7% for 2008.

## Model results

Chart 8 shows the fit of our energy contribution model and the results of the various scenarios.



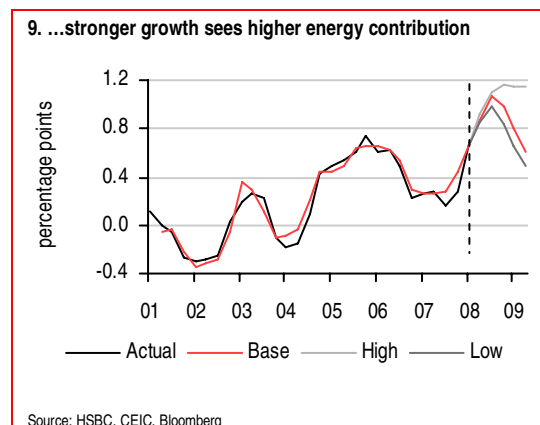
There are a few points to make:

- ▶ The fit of the model, which passes all the standard statistical tests, is good with an R-squared of 94% and adjusted R-squared of 93%.
- ▶ We back-tested the model by estimating the equation until Q1 2007 and then letting the model forecast the following year. The model did very well both in terms of predicting the direction and magnitude of the energy contribution to headline inflation.
- ▶ In terms of outlook, all three scenarios suggest that energy inflation has some way to go, with the peak possibly being in Q3 this year.
- ▶ The good news is that within 6-months or so the energy contribution to headline inflation

<sup>11</sup> Gas prices are currently running at 40% y/y versus decade average of 25% y/y. But given the historic relationship with oil prices look to be heading substantially higher.

should decline, irrespective of the scenario under consideration. This largely reflects the weaker growth forecast of 7% pencilled in by us. The pace of decline in each scenario is purely a function of the assumptions for oil and gas prices.

- ▶ To emphasise the importance of demand effects, we re-ran the model (as in the case of food & foodstuffs inflation) assuming that the growth profile of the economy in 2008 is similar to 2007 – this gives us a higher positive output gap compared with the earlier assumption. As can be seen in chart 9, even in the base and low case, the energy contribution remains above 0.4ppts (double historical average). If global oil and gas prices were to maintain their current rate of gains then energy would add nearly 1.2ppts to inflation each quarter over our forecast horizon.



- ▶ We would however like to highlight that in the context of inflation running above 20% y/y, what happens to energy contribution (1.2ppts) is not that important at present.

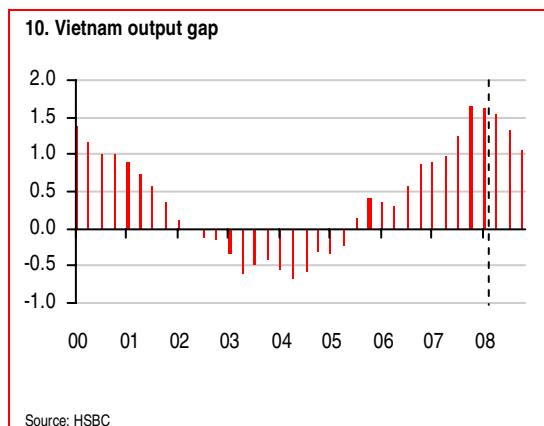
What eventually happens to oil and gas prices is a million dollar question. But given that growth across Asia remains strong, limited expansion in oil production output and geopolitical risks, oil prices could well remain at elevated levels.

Downside risks emanate from a resurgence in the

US dollar – highly likely as the Federal Reserve pauses and Europe/UK start showing weakness, and also a much sharper than expected worsening in the US economy and worse than expected spillover effects to Asia. The last of these is however not our central scenario.

## Core to rise some more

Even leaving aside food and energy-related components of inflation, core inflation (ex-food & energy) has been gaining momentum in Vietnam and a host of other countries across the region. A large part of this rise is probably explained by above-potential growth over the last few years. In chart 10 we have shown our estimate of the output gap since 2000 and its trajectory over the coming year, assuming that the government's growth forecast of 7% materialises.



## Modelling core

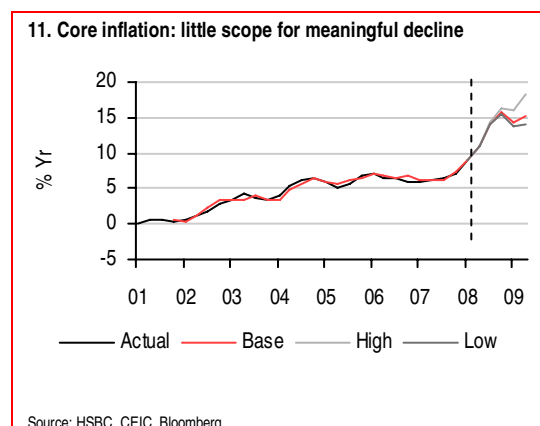
In order to get a handle on the drivers of core inflation in Vietnam, we again estimated a model. We experimented with the output gap, nominal effective exchange rate (NEER) and also the food and energy components of the CPI to investigate the evidence of second round effects. It would have been ideal to have some sort of an indicator of the labour market; however, data limitations prevent us from doing so.

The fit of the model, which passes all standard statistical tests, is shown in chart 11. The equation

has an R-squared of 97% and adjusted R-squared of 96%. We have also used the model to provide projections for ex-food & energy inflation till the middle of 2009. To do this we worked out the output gap consistent with the government's growth target of 7% for 2008 and have assumed an unchanged level of the nominal effective exchange rate over the forecast period. For food and energy inflation we have taken the three scenarios (base, high and low) discussed earlier in the report.

## Model results

Chart 11 shows the fit of our core inflation model and the results of the various scenarios.



There are a few points to make:

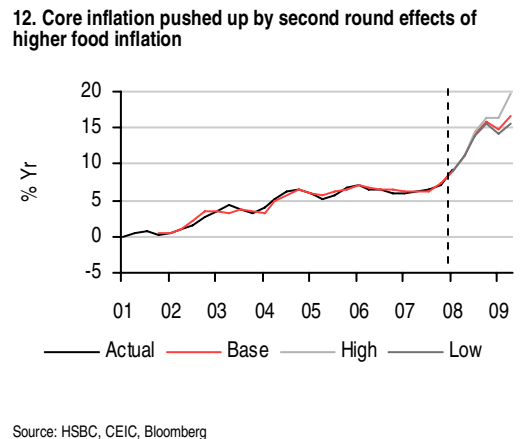
- ▶ Our statistical work shows that the output gap is the most important determinant of core inflation, with roughly a 1:1 pass-through over a 2-year horizon. This means that we are currently seeing the effects of the very strong growth registered in 2006 and 2007.
- ▶ The food component of inflation is significant with lags<sup>12</sup>, suggesting that higher costs in food-related items spill over into core elements of the CPI. Our model suggests that

<sup>12</sup> Contemporaneous food & foodstuffs inflation cannot be included as an explanatory variable on account of endogeneity issues.

a 1ppt rise in food inflation adds roughly 0.6ppts to core inflation over a 2-year period.

- ▶ What was a little surprising is that we could not find a significant energy component. We also tried to directly use year-on-year changes in oil prices in local currency terms and also the levels, but in vain. This is possibly because the data under consideration includes the period when fuel prices were subsidised in Vietnam, which is probably distorting our estimation. The other point being that the equation for food already has oil terms so maybe the impact is being picked up indirectly.
- ▶ We also found that a 1ppt appreciation of the nominal effective exchange rate (NEER) shaves off 0.4ppts from core inflation over 15-months. Given that the weight of USD/VND in the NEER is roughly 10% one would need a 10% appreciation of the Dong versus the USD to get a comparable inflation impact, assuming the Dong is unchanged against all other currencies.
- ▶ In terms of the outlook, our model suggests that irrespective of the scenario under consideration, there is more upward pressure to come on core inflation and, importantly, that there is little prospect of a meaningful decline anytime soon. This is on account of the dominating influence of demand effects (output gap) and the long lag (2-years) with which it impacts core inflation. What this means is that even if growth in Vietnam were to slow to around 7% this year it would directly impact core inflation only in 2010.
- ▶ There would of course be some indirect impact via food price inflation which sees faster pass-through of demand effects. In chart 12 we have shown the core inflation projections assuming that average growth in 2008 is 8.4% the same as 2007. Compared to

the low growth case, core inflation is on average 0.8ppts higher.



- ▶ As in the case of the other equations, we back-tested the model by estimating the equation until Q1 2007 and then letting the model forecast the following year. The model was able to accurately predict the rise in core inflation that we have seen, giving us confidence in its forecasts.

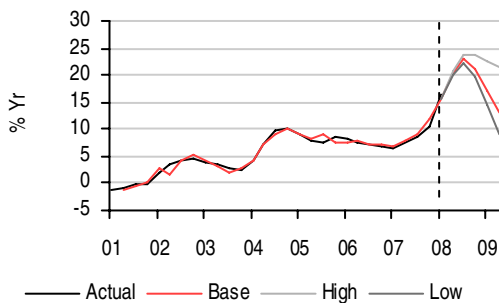
## Headline headaches

Having looked in detail at the impact of international food and oil prices, as well as domestic demand pressures and exchange rate effects, we are now in a better position to project the trajectory of headline inflation in Vietnam.

## Putting it all together

What we have done is to put back all the components of inflation, i.e. core, food & foodstuffs and energy to work out the trajectory of overall inflation. As in earlier sections, we have three scenarios – base, high and low. The high scenario obviously takes the high case in all the three components, likewise for the other scenarios.

13. Headline inflation to remain elevated for sometime yet



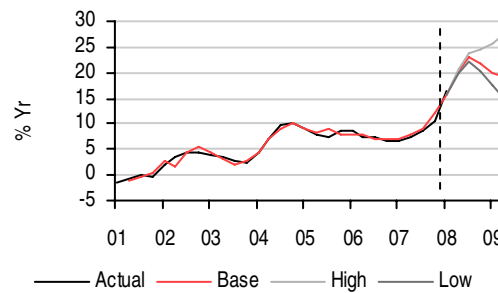
Source: HSBC, CEIC, Bloomberg

There are a few points to make:

- ▶ As can be seen in chart 13, the combined model forecast does fairly well over the sample period – even picking up the sharp rise in inflation in the March quarter.
- ▶ The results suggest that headline inflation is going to remain elevated for a while yet, with the peak sometime over the next 6-months. After which inflation is expected to decline unless international food and oil price inflation continues to rise at current rates (high scenario).
- ▶ The convincing decline in headline inflation materialises only by the end of 2008 – this is conditional on an unchanged or falling commodity price assumption (base and low case). The bulk of the slowing is explained by the fall in food & foodstuffs inflation (refer to chart 3), with energy playing a marginal role.
- ▶ Given the importance of demand effects in all the components of headline inflation, i.e. core, food & foodstuffs and energy, we thought it worthwhile to run a high growth scenario. The results are shown in chart 14. If the worst case scenario, i.e. high growth and international commodity price inflation remaining at current levels, were to eventuate then inflation shows no signs of tempering over the forecast horizon. Unchanged or falling commodity

prices do result in some decline in inflation readings, but on average CPI is 2ppts higher than the low growth scenario.

14. Policy nightmare: high growth and high international commodity price inflation



Source: HSBC, CEIC, Bloomberg

- ▶ We would again like to emphasise that the combined model should be used primarily as a directional gauge and in the near-term the risk is that the model will under-predict. As discussed in the food section, this largely derives from hoarding behaviour which sees people buying much more than they need and retailers doing the same in a bid to make a quick buck. In the case of Vietnam there is anecdotal evidence of hoarding not only of food but also a number of other essential commodities such as cement, steel etc., with speculative profit being the key motive for the latter.

## Policy challenges

So what does this mean for policy? Would a declining inflation trajectory suggest that the State Bank can sit tight? In our view, very clearly no.

### What we know

To explain the rationale we think it would be useful to highlight a few points.

- ▶ Although our models suggest that headline inflation comes down in the year ahead, premised on stable/falling commodity prices and slower growth, core inflation remains at

elevated levels given the lagged impact of above potential growth over the last few years.

- ▶ Food & foodstuffs inflation is highly sensitive to growth developments in the country. As income levels rise, consistent with stronger growth and employment opportunities, demand for food products increases as people are able to afford more meals a day. Additionally, eating patterns change with increased consumption of meat and dairy products. This is obviously to be welcomed, but it is also important that food supplies keep pace, distributional networks remain effective and hoarding behaviour is discouraged.
- ▶ Energy inflation is also correlated to growth dynamics. Strong growth in the country has seen energy demand increase sharply – to power factories, run motor cycles, light roads etc. Limited production capacity and rising demand has been putting upward pressure on prices. Additionally, the lack of refining capacity for crude oil means that the import bill has been getting a boost from high global refined product prices.
- ▶ In all our inflation models we have international food and oil prices as explanatory variables, so their trajectory is relevant for determining overall inflation. Although Vietnam is a consumer of food and oil products in the international market, its share is negligible so we can safely assume that it is a price taker<sup>13</sup>.

## What to do

So what can the Central Bank do to control inflation?

One option would be to use the currency as a policy instrument, given that all the commodity prices in our models are in local currency terms. We agree that currency appreciation helps in dampening the impact of commodity price movements. But given the size of the increase in oil and food prices, we would have to see substantial strengthening in the currency to make a sizeable difference, which seems unlikely in the current environment. It is also worth bearing in mind that the direction of the currency is largely determined by demand-supply dynamics and all a central bank can usually hope to achieve via intervention is to reduce volatility. To alter the direction of movement of the currency, opposite to what the market dictates, is a tough task even for currency targeters such as Singapore. For Vietnam with only around USD20bn worth of reserves (equal to 3.2 months of imports), the possibility of success is likely to be small.

Our discussion above seems to suggest that the key variable which the policy authorities should try to control, in a bid to clamp down on inflation, is economic growth. Slower growth would also help reduce other imbalances in the economy such as the burgeoning trade deficit. As we discussed in detail in *Vietnam: Deficit Dangers?* (3 April 2008) the trade deficit has been deteriorating at a precipitous rate<sup>14</sup> and such a rate cannot be sustained indefinitely as it creates huge funding requirements<sup>15</sup>.

## Policy instruments

Having established that growth needs to slow to control inflation and also to help limit the trade deficit, the question is what instruments can the State Bank use to slow the ship down.

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<sup>13</sup> For rice, Vietnam as the third largest exporter after Thailand and India could qualify as a price setter. However, for food that it imports it is a price taker.

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<sup>14</sup> Just to give some perspective, the deficit for the first four months of 2008 was USD11bn or 90% of the deficit seen last year. If this rate were to continue we may well see a trade deficit of USD33bn.

<sup>15</sup> See *Vietnam Monitor* 13, May 2008 for details.

► **Interest rates:** We have argued previously (*Vietnam Monitor 10*, February 2008) that the effectiveness of interest rates as a policy instrument is fairly limited in the case of Vietnam. This was largely because of the disconnect between the policy rate and market interest rates (overnight rate), and the nascent stage of development of the money/bond market. With the central bank having raised the base rate<sup>16</sup> by 325bps to 12% (effective from 19<sup>th</sup> May), the gap between policy and market rates has been reduced<sup>17</sup>. But for monetary policy to be effective there needs to be a tight relationship between the two, with the overnight call money rate trading very close to the policy rate. Then the central bank can signal its tightening/easing bias via the policy rate which subsequently feeds into the market rates and has the desired effect on the economy. For this to materialise, the SBV needs to play a more active role in the overnight market, supplying or absorbing liquidity as the case may be to ensure that the o/n call money trades close to the policy rate. No doubt we are still some way away from such a smooth ride in Vietnam, however, given the still negative real interest rate; further hikes in the base rate would be welcomed as an indicator of monetary policy stance. The hikes in the base rate would also allow banks to raise the lending rate further – as such we are pencilling in 300bps of further hikes from the central bank. Additionally, steps need to be taken to improve the functioning of the bond market, especially secondary market liquidity and risk management. We also think that greater

policy transparency in terms of regular announcements on rates and an accompanying statement would be very helpful in conditioning market expectations.

- **Reserve requirement (RR) hikes:** We had been expecting a gradual increase in reserve requirements to 13% by year ahead. Although we still think that RR is a policy instrument which the central bank should use over the longer term to slow things down, in the near term this might prove difficult given the uneven distribution of liquidity in the banking system, with liquidity being very tight for some Joint Stock Banks. The removal of the 12% cap on deposit rates (effective from 19th May) is helping to alleviate the liquidity crunch somewhat, as commercial banks have raised deposit rates to around 14-15%. From a policy perspective, the fact that liquidity is coming back to the banking system is positive as then the central bank can exercise some control over it through reserve requirements, open market operations, etc. If, however, liquidity is sloshing around outside the banking system, probably in commodity buying, then it makes policy that much more difficult in an already challenging environment. We would like to emphasise that if the new-found liquidity results in increased lending in the economy, the central bank may be forced once again to use quantitative measures. However, our bias would be toward measures to control credit growth.
- **Credit control:** According to the government's comprehensive plan to control inflation (details in *Vietnam Monitor 10*, March 2008), the State Bank is planning to limit credit growth to 30% in 2008 versus 40% last year<sup>18</sup>. Although credit has grown by nearly 15% in the first four

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<sup>16</sup> The base rate is the basic rate for commercial banks to set up trading interest rates, including both deposit and lending rates. According to the nation's Civil Code, lending rates cannot exceed 1.5 times the base rate.

<sup>17</sup> The SBV also raised the re-financing rate to 13% from 7.5% and the discount rate to 11% from 6% previously.

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<sup>18</sup> Our back of the envelope calculations show that this should shave off 1ppt from headline inflation. See *Vietnam Monitor 10*, March 2008 for details.

months of the year (from end-2007 levels) versus 10% in the same period last year, anecdotal evidence suggests that credit growth slowed in May. This we think largely reflects poor liquidity in the banking system on account of deposit withdrawals<sup>19</sup> and also high overnight rates. With lending rates now capped at 18%<sup>20</sup> (including management fees etc around 20%) we think that in the near-term quantitative restrictions on overall credit are the way forward. Additionally, steps must be taken not only to cool speculative borrowing (property/security related) but also to beef up prudential standards to boost banking system stability, for example by increasing the risk weighting of property-related lending as in India. In this regard it was pleasing to see that Governor Nguyen Van Giau recently stated that “strict control will be applied to monitor credit growth as well as credit quality and measures to curb loans to stock trading, real estate investment and consumer finance to continue to ensure the safety of commercial banks”.

- ▶ **Foreign currency borrowing:** Given that USD borrowing rates are much lower (7-8%) versus VND borrowing on average (18-20%) we have seen a surge in corporate dollar borrowing. Our onshore contacts tell us that FCY borrowing now makes up around 50% of total corporate borrowing compared with 35-40% a year ago. The bulk of these positions are not hedged. As long as the currency remains stable/appreciating this works fine but if the currency were to depreciate then corporate liabilities would increase quite sharply. This obviously reflects a risk to the domestic banking system, if a rise in corporate default rates could put bank

balance sheets under pressure. In this regard, we think Vietnam should control FCY borrowing and possibly put in place quantitative restrictions, perhaps similar to those in India<sup>21</sup>. We have seen some action from the State Bank as it is now allowing USD loans only to importers, early re-payment of offshore foreign currency borrowing and for overseas long-term investment, subject to approval. However, we think the restriction should be more comprehensive in nature.

- ▶ **Fiscal measures:** The government’s recent pledge to prioritise containing inflation over growth is a step in the right direction. Already we have seen numerous articles in the press with the Prime Minister ordering a cut back in inefficient and unnecessary investment projects. Given that the state still makes up around 50% of total investment in the economy (investment being roughly 35% of GDP), such a cut back should cause growth to slow. For overall GDP growth to slow by 1ppt, direct state investment would need to slow by 5ppts. There would of course be second round effects as well. However, what has perhaps been a bit disappointing is actual evidence that a material reduction in spending is coming through. According to newswires, so far only 30 provinces and 9 ministries have reported plans to cut back spending to the tune of USD125mn, which given the government’s target of USD6bn reduction seems small.

<sup>19</sup> Given inflation above 20% and a deposit rate cap of 12%, deposit withdrawals have accelerated in recent times.

<sup>20</sup> According to the nation’s Civil Code, lending rates cannot exceed 1.5 times the base rate (12%).

<sup>21</sup> In India, the external FCY borrowing restriction works as follows. For any borrowing less than USD20mn central bank approval is needed to use it for Rupee expenditure and for borrowing more than USD20mn there is a blanket ban that it cannot be used for Rupee expenditure.

## Conclusion

Our discussion suggests that the situation facing Vietnam and its policymakers is very difficult. The key point of the analysis, however, is that for the situation to improve growth needs to slow. Strong demand at home has allowed retailers to pass on high international food and oil commodity prices to consumers, whilst also fanning underlying price pressures. Slower growth will also help alleviate other imbalances in the economy such as the burgeoning trade deficit.

In terms of the outlook for inflation, our modelling work shows that headline inflation is going to remain high for some time yet, with the peak possibly in Q3 this year. Following which we expect headline inflation to show a marked decline *assuming* stable/falling commodity prices and importantly slower growth. Core inflation, however, is more persistent and refuses to temper even with falling commodity prices and weaker growth. This largely reflects the long lag with which demand impacts underlying inflationary pressures in an economy.

To achieve slower growth, a coordinated monetary and fiscal package is needed. The central bank has already started taking some action, with the latest move being a 325bps hike in the base rate to 12%. This follows from the 1ppt hike in reserve requirements and a 50bps hike in base rates at the start of the year, and the compulsory Treasury bill purchase (VND20.3trn) in March. Given that inflation is already running at above 25% and a further rise is expected, lending rates of 18-20% are still stimulative. As such we are pencilling in another 300bps rise in the base rate over the coming year, which will cap lending rates at 22.5% or so. However, given limited market development, monetary policy effectiveness is constrained so we think quantitative measures are probably the way forward. The central bank has announced plans to

limit overall credit growth in the economy to 30% from 40% last year. Here we think direct controls on the quantum of credit each bank is allowed to extend (as against the whole banking system) will probably be more effective.

What has perhaps been a bit disappointing is the lack of evidence that government spending is seeing a material reduction, despite pledges being made to cut back on unnecessary projects.

According to newswires, so far only 30 provinces and 9 ministries have reported plans to cut back spending to the tune of USD125mn, which given the government's target of a USD6bn reduction and the size of the economy (USD80bn or so) seems small. This is probably reminiscent of China where the central authority wants to slow things down but each province has its own incentives to support growth.

# Disclosure appendix

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