Flashnote

HSBC Global Research

Foreign Exchange
Asia

VND…time for some good news

- **Vietnam is due for some good news in the short term**
- **Inflation and the trade balance will improve, and interest rate hikes will shift capital flows**
- **The NDF curve appears increasingly to have overshot**

Trip report

We present some thoughts on the VND following a recent trip to Vietnam:

Comparisons with other countries, such as Thailand, that have had serious currency crisis or have approached default, remain off the mark. Vietnam is experiencing little more than a wildly overheated economy. Genuine default risk remains negligible. The following are some of the numbers. Vietnam's total (private and public) external debt with a maturity of less than one year is US$260m. Gross national debt of longer maturities totals 32% of GDP, but around 80% of that is donor debt with an average interest rate of less than 2%. There is no solvency issue here. Any onshore foreign currency debt is basically matched with foreign currency deposits in the banking system. In addition, official comments suggest reserves are around US$20bn.

86% of the consensus-shocking May monthly CPI rise (after two months of declining increases) was due to higher rice prices. Apparently the CPI survey was taken in the midst of a run on rice supplies in HCMC and Hanoi. Anecdotes suggest that rice prices are down sharply over June, indicating the CPI number due at the end of June should be much better behaved. The first annual northern rice harvest is currently underway, and reports indicate the crop is larger than forecast.

The trade deficit should show some improvement. The circa US$1bn quota for gold imports for 2008 is now full - this is unlikely to be increased until the overall situation stabilises, while in fact, anecdotes suggest that gold importers are now looking to re-export some excess inventory; other anecdotes abound of speculative steel imports of earlier in the year beginning to be re-exported; car imports accounted for 4.4pp of the growth in imports this year and these have all but stopped now; and there is some talk of over-invoicing of imports (but it is patchy). We also understand that foreign currency assets held offshore by domestic banks have been materially depleted by the shortage of dollars in the FX market. That should begin to exert some quantity influence on the volume of imports.

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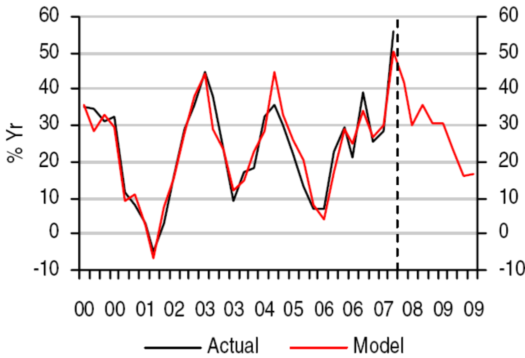
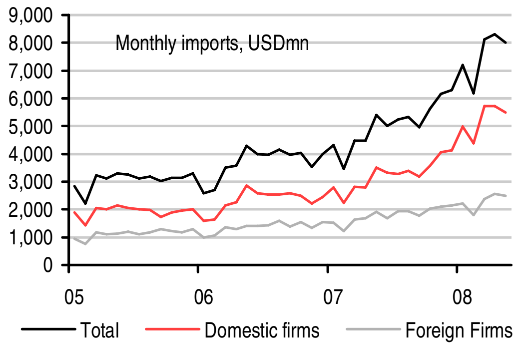
Chart 1: Import surge explained by domestic firms



Source: HSBC, CEIC

Chart 2: Import surge explained by domestic firms



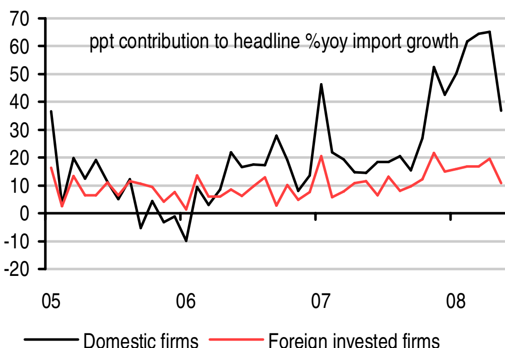
Source: HSBC, CEIC

Beyond this, it was always difficult, if not impossible, to explain the surge in imports in the first half of 2008 on the basis of macro aggregates alone. In fact, imports have substantially overshot any level which can be explained by the standard explanators used by our economist – domestic demand, the exchange rate, interest rates or exports (the re-export channel). Chart 1 comes from "Deficit Dangers", published on 3 April by our Vietnam economist. In data released since then, yoy import growth in Q1 went to 75% and in Q2 it is currently 66%. It seems clear that there is something else going on. Only the rise in oil prices can, and then only partially, explain the leap in imports. This is supportive of the onshore anecdotes that hoarding of commodities for speculative purposes has played a significant role in the sharp deterioration in the trade balance. The detailed data available on imports also support this view (see Table 1 and Charts 1 and 3).

Monthly imports have increased by US$1.7bn since December 2007. Only US$350m of this is accounted for by foreign invested firms. The residual of US$1.35bn is accounted for by domestic firms. If the pickup in FDI this year, or in fact the FDI boom generally, was a key part of the reason for the surge in imports, then we would expect the contribution from foreign firms to be larger than this.

In fact, recently released BoP data, which for the first time includes quarterly data for 1Q08, show that outside the well recognized deterioration of the trade account, the Balance of Payments dynamic has been stronger than generally recognized. For example, remittance inflows surged in 1Q08 to the tune of USD2.6bn, some 45% faster than the average quarterly flow last year. Actualized FDI flows have

Chart 3: Which suggests hoarding as an explanator



Source: HSBC, CEIC

Table 1: Import growth by category

%-pt contribution to May-08 YTD %yoy growth	
Uncategorized	25.7
Steel Products	10.9
Petroleum	9.3
Machinery and Spare Parts	9.1
Automobiles	4.4
Fertilizer	2.6
Electronic Product	2.0
Plastics	1.6

Source: HSBC, CEIC

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continued to be strong. With USD1.6bn in 1Q, and given recent unofficial reports of year-to-date dispersed FDI upwards of USD5bn, this implies that FDI inflow in fact strengthened in 2Q, despite the macroeconomic and market volatility seen since March. It is the strong performances of the less visible aspects of the BoP that likely led the market to initially underestimate Vietnam's FX reserves, which remain above USD20bn, compared to street estimates as low as USD15bn.

While it is questionable how much effect higher interest rates in Vietnam have on the broader economy, we can identify some important implications for capital flows. It is likely that a not insignificant share of portfolio inflows last year came from the Vietnamese diaspora. The weakness in the equity and property markets would likely have seen some repatriation of those funds. The drying up of FX market liquidity, high level of USD-VND and sharp increase in deposit rates (to a globally significant 18% or so, the highest levels in at least a decade), suggests that increasing amounts of these funds will stay in VND now. On FDI, only 30% of an FDI project needs to be provided as enterprise capital. The rest can be borrowed. With loan rates now somewhere close to 21%, and with the high level of USD-VND, this is likely to mean that increasing amounts of FDI capital are brought in from offshore, rather than being borrowed domestically.

In addition to this, the lack of FX market liquidity has seen importers become progressively more aggressive in sourcing dollars, while exporters have become progressively more speculative in selling any dollars they hold. With interbank spot now around 16% above the ceiling of the official band, and interbank 25% higher since the March low, it would not take a significant shift in the news flow to have a significant impact on the exchange rate. Today's price action is perhaps indicative of this.

Certainly a range of medium term questions remain, and we may not be through the current period of difficulty. Conditions, however, certainly look better now than a month ago. In the medium term, one of our key questions relates to FDI. While other forms of capital inflow have slowed or reversed, it seems clear that FDI is still flooding in at a rate which seems difficult for the economy to absorb. Disbursements were equal to 8% of GDP last year, and this year they are running even faster than that. There are currently no plans to apply any controls on FDI. We struggle to comprehend how an economy already operating at full capacity can possibly absorb those flows. Supporting this view, it seems that wages increased ahead of inflation this cycle, and that acute shortages of skilled labour were being reported as far back as 2006.

Fixed Income

In spite of USD/VND volatility, VGB yields have started stabilising around 21-23% following the 2%-point hike in SBV's base rate on 11 June. At these levels, VGBs offer higher yields than USD/VND NDF implied rates in 2yr tenors and longer, which may limit switching activity by offshore investors out of VGBs into short USD/VND NDF positions.

Moreover, there are several reasons why we are starting to become cautiously optimistic on the outlook for VGBs.

Outlook for inflation and trade balance: Vietnam's economy is currently at an inflection point with headline inflation close to peaking (+25.2% y/y) and the widening of the trade deficit (USD14.4bn during 5M 2008) likely to moderate going forward.

Bank liquidity may start to ease: At present, bank liquidity remains very tight as deposit growth remains lacklustre and banks require time to call in their loans, in particular amongst the weaker banks. Deposit flows, therefore, remain sensitive to VND weakness, headline inflation and any occurrence of liquidity strains among some of the weaker banks, although SBV continues to support the weaker banks (e.g. through refinancing of loan contracts). Nevertheless, the O/N rate has softened from a high of 21%, last week to 14% at present during which SBV has reduced its liquidity injections into the banking system from VND53tr to VND37tr at present. Moreover, bank liquidity should gradually improve going forward as bank credit growth has come to a standstill (many SOCBs have hit their 30% annual lending target) and as corporates deleverage in response to high financing costs. Already, VGBs are seeing moderate demand from onshore bank accrual books, which should intensify as bank credit growth slows below the rate of deposit growth.

Moderate supply pressures: According to a presentation by Vietnam's Finance Minister on 19 June, the government ran a modest budget surplus of VND4.5tr during Q1 08 (although it is uncertain whether this includes off-budget expenditures). More importantly, the government has reduced recurring spending by 10% year-to-date, which would reduce spending by VND25.4tr, and plans a further 10% reduction going forward. In addition, the government plans to reduce investment spending financed through bond issuance by VND16tr. This would reduce overall public sector bond issuance from VND90tr to VND74tr, of which VND64tr conducted by the central government. Of the VND74tr in revised gross issuance (VND90tr minus VND16tr), the government and SBV have each raised approximately 15% of their funding needs. Moreover, the government still had VND30-40tr excess liquidity in March, most of which was parked on deposit in the banking system, though reports are that these deposits have gradually been moved to the SBV in recent months. According to MOF, the government has sufficient liquidity, though it should be noted that VGB coupon + redemption payments will pick up from October 2008 onwards.

As a consequence, we believe that VGB yields have peaked. The question then is whether VGBs are attractive now to new offshore investors?

This depends on prospective developments in the FX market. After a sharp rise to 19,500, the USD/VND has declined to 18,300-18,500, apparently as a result of gold re-exports. Moreover, our impression is that the authorities view 18,000 as a fair value for USD/VND, which suggests more manageable FX risks on VGB holdings within an 18,000-19.500 range. More importantly, however, is the authorities approach towards the FX market as official measures to control interbank activity have sharply curtailed the supply of USD in the interbank market. Although we see little risk that the Vietnamese authorities will impose capital controls, the lack of USD supply onshore implies a reduction in VND convertibility, which comes on top of modest liquidity in the secondary bond market.

Although we view the authorities' clampdown on the interbank market as a knee-jerk response to VND weakness (the Finance Minister stated in the conference call that the authorities are working on a plan to unfreeze the supply of USD), we recommend offshore investors sell USD/VND NDFs instead of buying VGBs for the time being until there is further clarity on this front.

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