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Vietnam: Key to Re-establishing Confidence in Macroeconomic Stability Lies in the Dong

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While macroeconomic risks are for the most part inter-related, we believe the core problem is public confidence in the currency. In coming months, the dong will come under renewed pressure from stronger US-dollar demand caused by gold imports and the unwinding of sizable US-dollar borrowings by the private sector.

Currency Resiliency Ends

Recent financial-market volatility has undermined Vietnam's efforts to reinstate macroeconomic stability. The widening disparity between the State Bank of Vietnam's (SBV) official reference rate for the dong (VND), Vietcombank's onshore market exchange rate and the offshore VND fixing rate in Singapore reflects rising devaluation pressures **(Display 1)**.

This marks an end to a transitory period of resiliency in the currency following the late-February introduction of Resolution 11—a set of monetary, fiscal and structural reforms aimed at restoring stability. Measures included a one-off devaluation of the dong by 9.3%, fiscal tightening, control of credit growth and money supply, enhanced disclosure of macroeconomic variables and equitization of State Owned Enterprises (SOEs). Initial market response was positive and contributed to sovereign credit-default-swap spreads staying lower throughout the second quarter.

Nevertheless, a number of factors, in our view, are impeding efforts to convince the market that a return to macroeconomic stability is underway. The first is scepticism created by the government's track record of protecting growth at any cost. We think Hanoi needs to spend more time and effort in persuading the market that it will pursue its stabilization objectives consistently. There is a risk, for example, that sceptics would see a deteriorating global economic outlook as an opportunity for the government to delay its SOE reforms by prematurely relaxating fiscal and monetary policy to protect growth (and thus social stability), even when inflation remains elevated.

The second is the secrecy that the state still attaches to its level of foreign reserves, which is an obstacle to the market's attempts to monitor stabilization efforts. This lack of transparency has also helped turn risk aversion into market panics and waves of sell-offs in Asian currencies during the last two months.

Display 1
Devaluation Pressure Weighs on VND

Official Fixing and Onshore and Offshore Market Exchange Rates Vs. US Dollar

Through October 20, 2011
*SBV=State Bank of Vietnam
Source: CEIC Data and AllianceBernstein forecasts

Display 2
Growth in Monetary Aggregates Slows*

M2 Money Supply and Credit Growth

*2011 year-to-date data as of August 31, 2011
Other data through October 20, 2011
Source: CEIC Data and AllianceBernstein forecasts

Third, not all the initiatives in Resolution 11 have been strictly implemented at this point. While credit and money supply growth have decelerated sharply to 8.9% and 9.2% year-on-year respectively in the first eight months of the year **(Display 2)**, the government has yet to demonstrate fiscal prudence: the level of state investment, for example, has increased by 43.3% year-on-year in the first three quarters. Buoyant demand for imported capital goods and raw materials has widened the trade deficit and undermined this year's one-off devaluation.

Lastly, the continuing lack of a clear monetary-policy framework makes it difficult for the market to interpret SBV's policy orientation. Having phased out the base rate last year as guidance for banks to set their own lending rates, the central bank now conducts its monetary policy primarily through three different interest rates: the refinancing rate and the discount rate—which respectively set the interest-rate ceiling and floor in the wholesale market; and the reverse repo rate—for the conduct of open-market operations and control of system liquidity **(Display 3)**. The SBV also uses reserve requirements and other administrative measures to influence banking operations.

Monetary Policy Confusion Prevails

Under such a complex regime, SBV's policy actions have often confused the market and dented efforts to reinstate confidence in the domestic currency. In July, for example, the central bank cut the reverse repo rate and, in September, set maximum deposit rates for the banking system; both moves caused the market to worry that the SVB was easing prematurely. Shortly afterwards, however, on October 7, the SBV raised its refinancing rate. Such contradictions reflect the dilemma the SVB faces in having to try to achieve multiple policy targets simultaneously.

On the one hand, the SBV needs to tighten monetary policy to keep inflation under control (CPI climbed to 22.4% year-on-year in September from 12.2% year-on-year in January) and ease depreciation pressure on the dong (by raising the refinancing rate); on the other hand, the central bank needs to ensure sufficient liquidity in the system (by lowering the reverse repo rate), as domestic banks rush to meet higher capital requirements required by legislation by end-2011. Worse still, the sharp increase in US-dollar borrowing by the private sector this year creates—in the event of further dong devaluation—more risk to banks' asset quality (for this reason, the SBV lowered deposit rates as an indirect measure to pull down VND lending rates and reduce public incentives to borrow in USD).

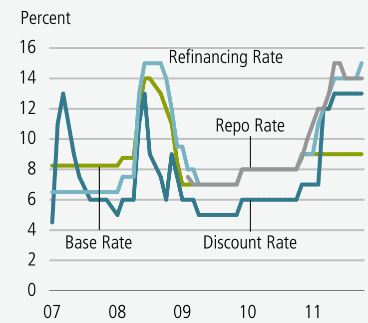
The political framework exacerbates the issues, as SBV's lack of independence (monetary policy decision-making is largely the preserve of the National Assembly) also undermines the credibility of its inflation-targeting commitments.

VND Remains Under Pressure

While current macroeconomic risks in Vietnam are for the most part inter-related, we argue that the core problem remains public confidence in the domestic currency. The level of dollarization (that is, the use of a foreign currency—in this case the US dollar—in parallel to or instead of the domestic currency) has been the main obstacle to the accumulation of foreign reserves **(Display 4)**. In the past, sustained anticipation of further depreciation in the domestic currency has resulted in a flight of domestic capital and the widespread hoarding of US dollars and gold outside the financial system to protect wealth. The increase in residents' holdings of such capital over the years has shown up in the national payments accounts as unrecorded outflows or "errors" and acted as a drag on the balance of payments (even when the net of the current and capital accounts was positive) and on the attempt to accumulate reserves **(Display 5)**. Without a convincing level of foreign reserves, the

Display 3
A Recipe for Confusion

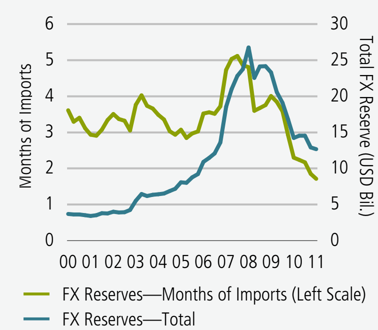
State Bank of Vietnam Monetary Policy Rates



Through October 20, 2011
Source: CEIC Data and AllianceBernstein forecasts

Display 4
External Position Is Vulnerable (1)

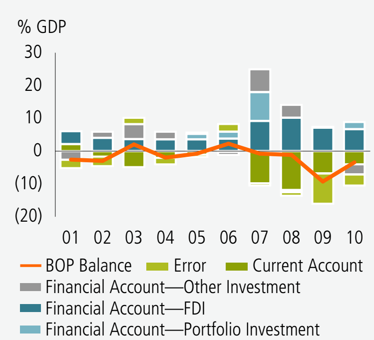
Foreign Reserves as Months of Imports*



As of October 20, 2011
*The number of months of imports that the level of reserves could pay for
Source: CEIC Data and AllianceBernstein forecasts

Display 5
External Position Is Vulnerable (2)

Volatile Foreign Investment Flows Fund Current Account Deficit



Through October 20, 2011
Source: CEIC Data and AllianceBernstein forecasts

public has limited faith in the domestic currency; this, together with episodes of economic overheating and external shocks, has created a vicious circle of macroeconomic instability.

Vietnam's external position remains highly vulnerable, with foreign reserves below two months of total imports. In particular, Vietnam's still-sizable current account deficit (which declined to 4.0% of GDP last year from the peak of 11.9% of GDP in 2008) has been funded by foreign direct investments (already in decline since 2008), portfolio inflows and international bank lending (Display 5 again). These are all volatile, being subject to market sentiment and the external outlook.

In coming months, the dong will be under renewed pressure from stronger US-dollar demand caused by gold imports (following the government's relaxation of an import quota designed to curb black market transactions) and the unwinding of this year's sizable US-dollar borrowings by the private sector.

The Road to Macro Stability

Further depreciation of the dong to a more convincing level is needed to re-establish trust in the currency and restore macroeconomic stability. Importantly, the level of external debt remains manageable at 30.5% of GDP as of 2010. The fact that most of it is held by official creditors on concessional terms **(Display 6)** provides significant scope to depreciate without triggering concerns about debt servicing and external payments.

Only when inflation returns to a more benign level would the time be right for such a move, however. There are two reasons for this: first, to help foster expectations that inflation will stay steady, even after absorbing the impact of devaluation; second, to avoid another cycle of high inflation followed by anticipation of further depreciation.

The current elevated inflation level has been driven by various one-off factors including the delayed withdrawal last year of monetary and fiscal stimulus, the impact of the 9.3% depreciation under Resolution 11 and a government structural reform earlier this year whereby the setting of key commodity prices such as electricity, gas and fuel moved from an administrative model to a more market-based mechanism. When these distortions wear off and a higher base starts to kick in, inflation will recede notably, in our view. Consequently, we expect the SBV to defend the dong until early next year.

Despite this, we still think that Vietnam could easily fall into another episode of macroeconomic instability unless it meets the following conditions:

First, the government needs to prioritize and restrain public investment. Given the fact that Vietnam's exports remain concentrated on low-skill, labour-intensive manufactured products and agricultural outputs, there is limited leeway to expand production capacity in the short run, and the scope to increase exports through another one-off depreciation is limited. Containing imports growth, therefore, is the key to restoring a sustainable current account position. Apart from intermediate goods for production, Vietnam's imports consist mainly of capital goods (15.9%) and steel (7.2%), which are consumed mainly by the public sector and foreign manufacturers (although the increase in imports incurred by the latter is offset by FDI inflows in the external balance).

Display 6

External Debt Remains Manageable

Through October 20, 2011
Source: CEIC Data and AllianceBernstein forecasts

Second, the real deposit rate, which remains negative, needs to improve. A higher real deposit rate would raise the opportunity cost of holding gold and US dollars and reduce the dollarization problem. Raising the policy rate and depreciating further under a more benign inflationary environment would be a convincing way to demonstrate the government's commitment to achieving macroeconomic stability. The SBV, meanwhile, should simplify its monetary policy toolkit and improve its communications to make it easier for the public to interpret the rationale behind future policy moves. ■