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Vietnam – Pulling out all the stops

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- Latest data shows exports and economic growth are weakening
- Inflation, both food and non-food, is declining
- Authorities are likely to cut rates further and allow VND to weaken gradually

The beginning of a stream of weak data

The authorities took aggressive action in Q4 2008 to sustain growth, including interest rate cuts and currency devaluation. These moves were corroborated by the Q4 GDP data and the December 2008 trade figures, with exports contracting by 10.2% year-on-year. Vietnam's high exports-to-GDP ratio is finally biting, combined with further consolidation in the real estate and construction industry.

This is reflected in our 5% real GDP growth forecast for 2009, compared with the government's 6.5% target. Given the current circumstances, further rate cuts are on the cards following a very aggressive reduction in the base rate in Q4 2008. Now that inflation is less threatening, a weaker Vietnam dong (VND) is likely to take on the task of boosting exports and helping to reduce the trade deficit.

Table 1: Growth, inflation, base rate, and USD-VND forecasts

	Q1-09	Q2-09	Q3-09	Q4-09	2008	2009	2010
GDP growth	5.30	4.20	4.50	6.00	6.20	5.00	7.00
Inflation	14.50	7.00	2.50	2.00	22.00	6.50	4.00
Base rate	7.00	7.00	7.00	7.00	8.50	7.00	8.00
USD-VND	17,600	18,000	18,500	18,500	17,485	18,500	17,800

Source: SCB Global Research

Manufacturing and construction reduced Q4-08 growth to 5.7%

Real GDP growth slowed to 6.2% in 2008, the weakest since 1998, from 8.5% in 2007. Our calculations show that growth in Q4 alone dropped to 5.7% y/y from 6.5% in Q3 (see Chart 1). The slowdown can be attributed to the secondary sector, which includes manufacturing and construction – it expanded by just 4.8% y/y in Q4, compared with its usual high single-digit or even double-digit performance in the past several years. We believe this reflects the impact of high local interest rates and credit tightening.

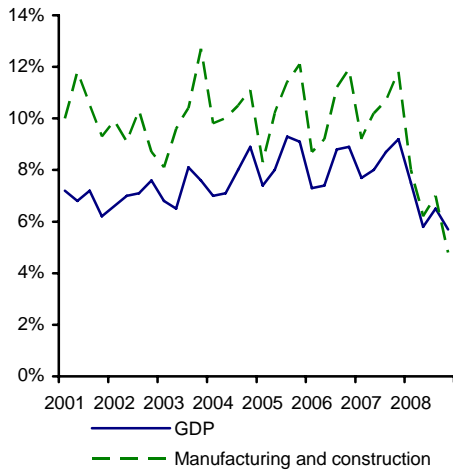
Going forward, the sector is likely to remain in slow growth mode due to the external environment and the risk of stagnation in the domestic real-estate sector. In contrast with the secondary sector, the services sector has held up well, expanding by 7.1% y/y in Q4 2008. The primary sector, mainly comprised of agriculture and mining, also performed above trend with growth of 4.8% y/y, but this sector is also at risk considering the rapid collapse in commodity prices.

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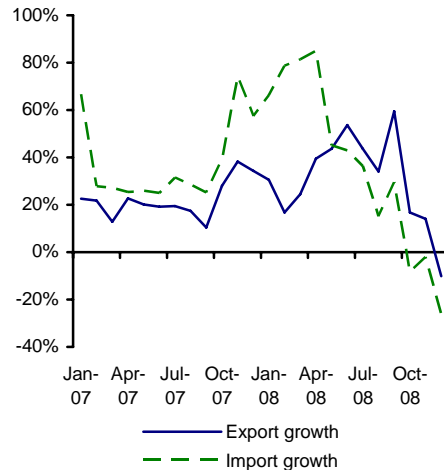
In 2009, we expect economic growth to slow further to 5%. The manufacturing and construction sectors are likely to remain depressed. As mentioned above, declining commodity prices will hurt the primary sector, especially farming and mining. While recent aggressive rate cuts by the State Bank of Vietnam (SBV) and other measures to provide liquidity may provide some relief, the headwinds from the global slowdown are likely to be the primary factor in Vietnam's (and the region's) economic performance.

Chart 1: Weak construction and manufacturing weighed on headline GDP growth



Sources: CEIC, SCB Global Research

Chart 2: Exports contracted in Dec-08 due to weak oil and textile exports



Sources: CEIC, SCB Global Research

Trade performance converging with regional trend

December 2008 export data also offers little comfort (see Chart 2). Our calculations put export growth in the month at -10.2% y/y, compared with +14.1% in November. Exports of crude oil, traditionally Vietnam's top export item, fell 47.5% y/y in December. Worryingly, exports of textiles and garments, now the country's biggest export item, contracted by 8% y/y. Imports also saw a sharp fall in the month (-26.2% y/y), with contractions seen in major categories such as machinery and parts (-7.2% y/y), garments (-7.6%), steel products (-41.7%), automobiles (-43.1%), and petroleum products (-55.3%). This partly reflects low commodity prices and inventory rundown after stockpiling earlier in the year. Yet we also believe that a slowdown in domestic activity, both consumption and capital investment, is responsible for weaker import demand.

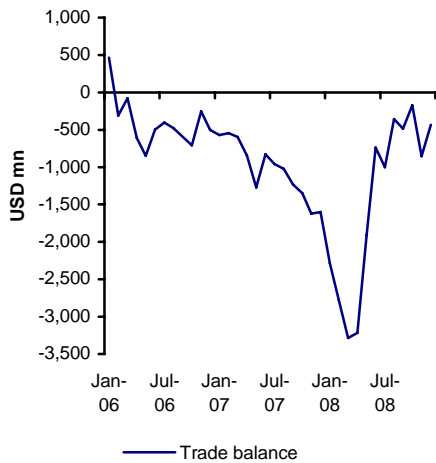
The good news is that the trade deficit is still under control. The deficit stood at USD 1.46bn in Q4 2008, a significant improvement from USD 8.35bn in Q1. The annual deficit was USD 17.5bn. Curiously, despite the recent improvement, the government is forecasting that the trade deficit will widen further to USD 19.2bn in 2009. This implies a quarterly run rate of USD 4.8bn, more than three times the level seen in Q4 2008. We believe this forecast is too high, even taking into account weaker export performance ahead, and would require a surge in domestic demand for imports or a resumption of higher commodity prices. Hence, we see the huge trade deficit of 2008 as an exception. We expect a 2009 deficit of around USD 12bn-15bn, or 12-15% of GDP, down from 20% in 2008.

Vietnam would likely find it difficult to finance a trade deficit of the size forecast by the government. Actual disbursed foreign direct investment (FDI) was around USD 11.5bn in 2008, while contracted FDI inflows totalled USD 64bn. We can reasonably expect these inflows to decline in 2009 in line with the recession in the developed world – not only are international companies likely to rethink their expansion plans, but their sources of funding will also be constrained. Remittances from overseas Vietnamese, estimated at around



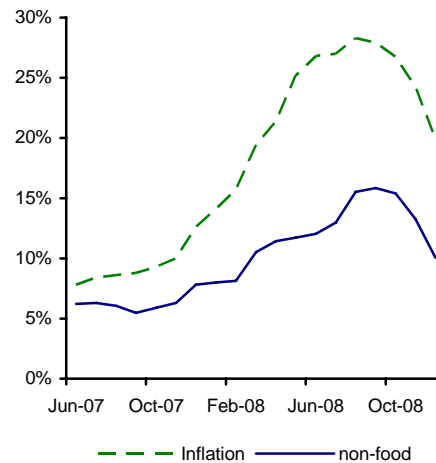
USD 8bn in 2008, are also expected to contract as the global job market slows. Given our current estimate for the 2009 trade deficit, inflows and outflows are already at a fine balance. If the deficit does widen to the government's estimate, concerns about external payment difficulties are likely to return.

Chart 3: Gradual improvement in trade deficit as imports slow



Sources: CEIC, SCB Global Research

Chart 4: Inflation expected to drop to single digits by mid-2009



Sources: CEIC, SCB Global Research

Policy options – pulling out all the stops

Since 22 October 2008, SBV has cut its base rate by a total of 550bps, to 8.5% from 14%. It also raised the USD-VND reference rate to 16,989 on 25 December from 16,494 the previous day. USD-VND has traded at around 17,500 since the announcement, at the top end of the +/-3% trading band. This is a de facto devaluation of the VND by 3% and reflects the central bank's strategy of employing the exchange rate as a tool to boost exports.

Rate cuts and VND weakening are justified by the gradual decrease seen in inflation. Headline inflation dropped to 19.9% y/y in December 2008 (Chart 4), the first sub-20% reading since April. Non-food inflation also eased to 10% y/y, according to our calculations. We expect a further slowdown in coming months. In terms of fiscal policy, the government has pledged a USD 6bn fiscal stimulus package to boost growth, with about one-third funded by government borrowing. We expect key themes of the fiscal package to be infrastructure projects and social protection for the jobless.



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