

From a prominent position of 'China/India plus one', Vietnam now risks sinking into a full-fledged economic crisis.

Vietnam is struggling with very serious double-digit inflation. Quite surprisingly, as the country is the second largest rice exporter after Thailand, and a net exporter of crude oil. The country is at risk of a full-fledged economic crisis, and some sections of the market are expecting a 30-40% devaluation of the Vietnamese Dong, as the country could sink into a BoP crisis.

The issue is not capital flight, but the lack of capital inflows. Note that the system is on tightly controlled grounds, with very little capital account convertibility. Also, it is a rather dollarised economy – legal tenders include Vietnamese dong, the greenback and even gold. As such we expect depreciation of 10-15% on the VND while interest rate about 300-500bps higher.

While devaluation is not a policy choice, given that the current policy is the result of an undervalued FX over the last few years, the lack of inflows may mean that State Bank of Vietnam (SBV) might not have a choice.

In terms of contagion risks across the region, unless it is a 30-40% devaluation, a 10-15% dong adjustment should not lead to another round of pan-Asian devaluation. Also, most Asian systems are running a current account surplus.

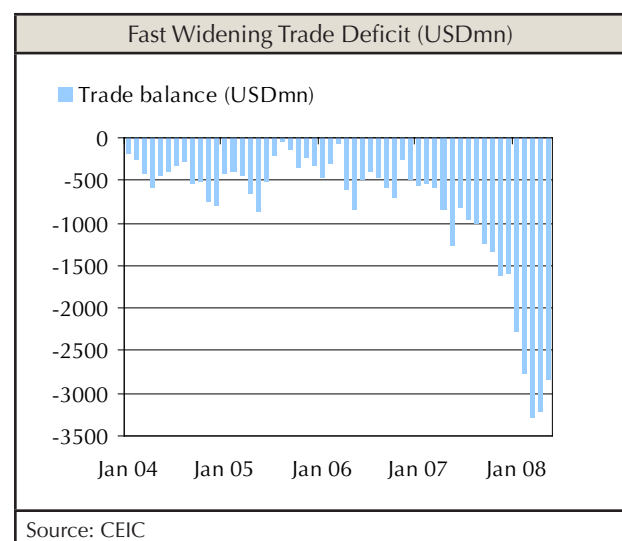
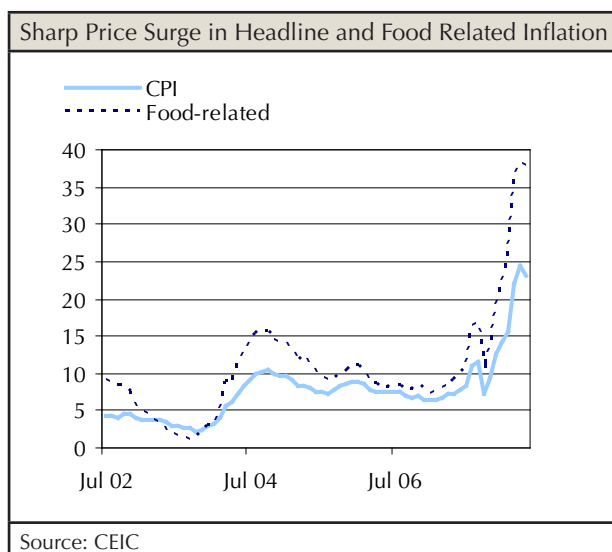
Inflation: Surging to 16-Year Highs

While the region is seeing a build-up of inflationary pressures, Vietnam is struggling with very serious double-digit inflation. Against an average of 8% in 2007, inflation surged to an average of 16.4% in 1Q-2008, and then a 16-year high of 27%/y/y in June after sky-rocketing 25.6%/y/y in May. Food-related inflation was even more worrying, at 45.6%/y/y in June. This is quite puzzling given that Vietnam is the world's second largest rice exporter after Thailand, and also a net crude oil exporter. Clearly, one key factor is an overheated economy, and a deliberate policy of gradual dong depreciation over the past few years — even amid an environment of Asia FX

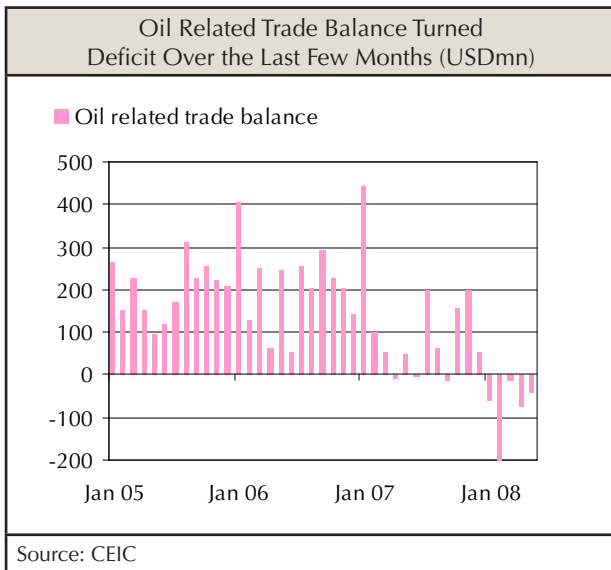
strengthening. Such overheated situation is clearly reflected in money supply growth of close to 40%/y/y end-2007, after an average of 30%/y/y in 2005 and 2006.

Trade Gap: An Overly Extended Economy

Besides the ballooning inflation picture, widening trade gap is another big concern. In the first half of 2008, the trade deficit widened to \$16.9bn, well above \$12.4bn recorded for the entire 2007. In the latest figure, exports continued to perform, up 27.5%/y/y, but imports rose a staggering 70.6%/y/y. While a rice exporter, Vietnam is a net importer for processed food. And, although a net crude oil exporter, it imports refined oil. With the inflated



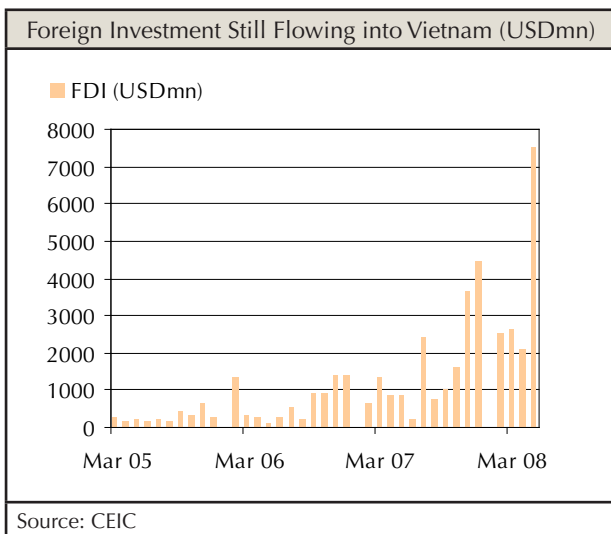
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economy, the country has turned into a net oil importer since Jan 2008. As a result, the country is likely to record a deficit of more than \$20bn this year, and current account gap of more than \$10bn.

Risk of BoP Short-fall

While FDI is expected around \$10bn this year, which should help the country to achieve a balanced external account, the question is if these flows will materialise given the currency problem. Well, perhaps not, given the current negative mood. Newswire reports indicated that a local shipbuilding company has withdrawn its \$1bn share in a joint venture worth \$5bn with a Korean conglomerate. Another Vietnamese shipbuilding company has also delayed more than 30 projects worth \$400m.



Still, import narrowing following the past months of austerity measures should help alleviate the need for capital inflows. Indeed, the bulk of the imports was that of capital goods such as steel. Reports are that FX reserves now stand at about \$22bn, and that the BoP position achieved a surplus of \$1bn in the first five months of 2008.

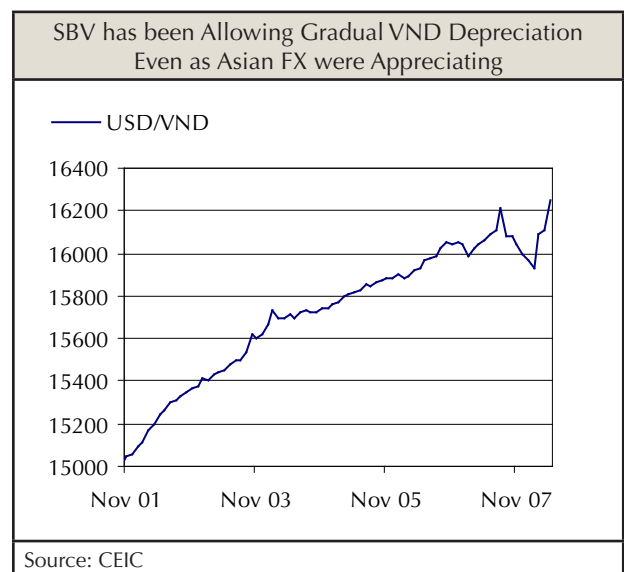
Meanwhile, investors are operating under a very restrictive capital account, which will prevent capital flight. Also, legal tenders in Vietnam include the dong, the greenback as well as gold (used for the purchase of big ticket items). Thus, capital flights, such as those seen during the Asian crisis, are unlikely to be repeated. Indeed, the current Vietnam episode is more akin to the overheated Chinese situation in 1993-95.

Policy Implication:

Right Direction, but will be Painful

Vietnam appears to be in the right policy direction – that is, aggressive monetary tightening to combat fears of runaway inflation, and possible social implications. After the aggressive tightening on 19 May, SBV has again hiked its policy rate by 200bps in June-2008, with the base rate now at 14% -- capping lending rates at 21% (1.5x base rate). With inflation at 27%/y/y, and probably towards 30% over the next few months, there is certainly room for further rate hikes of 300-500bps in the coming months. Full-year inflation is probably closer to 26% from 8% in 2007.

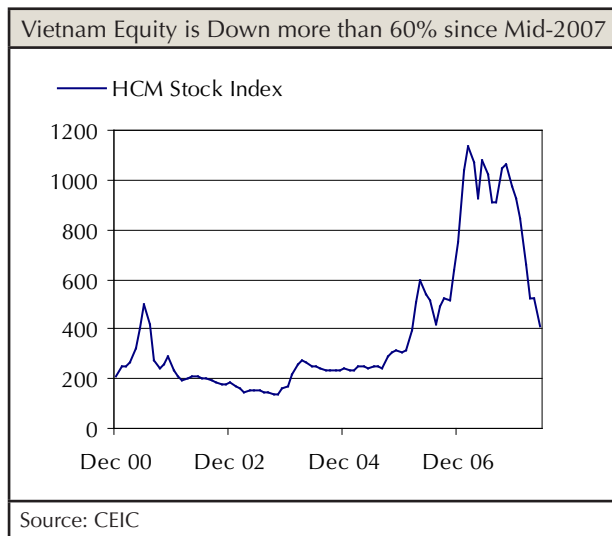
Administrative measures are also in place, with the govt introducing solutions to curb inflation, and also to stabi-



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lise the macro-economy. Various price controls on items such as water, electricity and steel, are also in place.

FX adjustment is not exactly the right policy move, although the on-going risks indicate that SBV may not have much of a choice. After the recent 2% one-off devaluation, the CB has widened its policy band to $-/+2\%$ from $-/+1\%$ previously last week. In all, we expect to see about 10-15% depreciation over the next 6 months, reflecting



the increasing risk premia surrounding Vietnamese assets and the economy. As said, any move will be more policy motivated and not speculators' activities. Black market rates are currently quoted at around 19,000, as compared to 16,450 in the official market.

One risk is the health of the banking sector, which could trigger a massive loss of confidence. So far, the 6 large banks are reportedly in good shape, with NPLs at less than 6%. The question is the state of the smaller banks amid possible sharp corrections in the local real estate market, and many that might have provided credit lines for the purchase of local equities – which are down more than 60% since their peak last year.

Impact on Economy

This time next year, we should see the economy slowing to close to 6% from 8.5% for the whole of 2007.

Contagion Risks: Not Again

Risk is building up given that most Asian economies are also on rather fragile ground – most also struggling with inflationary pressures and slower domestic growth. Indeed, our call is that Asian FX looks to weaken somewhat over the next few months, before ending the year around current levels or slightly stronger.