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Vietnam – Currency Devaluation & Economic Outlook

While most of the Asian currencies are facing appreciation pressures, Vietnam dong is doing the opposite. On Nov 26, the State Bank of Vietnam (SBV) devalued its currency by setting the reference rate 5.2% lower at 17,961 against USD, after the gap between spot and black market rates widened to the most in a decade. The central banks also narrowed the dong's daily trading band to 3% from 5% and raised the interest rate to 8% from 7%. The news shocked investors and triggered massive sell-off. The benchmark VN index dropped 4.5% to 480.69, which would be the biggest decline since the period ended March 21, 2008. This article shows our view on the SBV's action and with reference to Standard Chartered Bank's research report, it also discusses the recent economic growth, long-term trends and the downside risks of Vietnam.

Reasons behind SBV's action We believe that the central bank's action can ease part of the depreciation pressure of dong, however it also trigger expectations of further depreciation. It seems that the policy maker think that it will help boost exports, which account for more than 60% of country's GDP, so further devaluation is possible. On the other hand, in order to control accelerating inflation and restore investor confidence, we expect that the interest rate will be raised to 11% by the end of 2010.

Recent economic growth Vietnam's economy grew by 5.8% y/y in Q3 2009, after growth bottomed at 3.1% in Q1 2009. Domestic demand is doing much of the heavy lifting in driving growth, while export performance remains lackluster. Exports contracted by 14% y/y in January-September 2009, although industrial production growth has rebounded considerably on the back of local demand. Retail sales are a strong point in the economy. While we do not see demand-pull inflation as a significant threat in 2009, the year-on-year reading bottomed in August and is likely to climb back up to mid-single digits by the end of 2009. By sectors, the outperformers are construction, transportation and communications, financial intermediation, and retail and wholesale trade. Meanwhile, agriculture, manufacturing, hotels and restaurants and real-estate services are underperforming.

Long-term trends While 2009 has been a year of great challenges for the domestic and regional economy, we remain positive in our medium-term outlook for Vietnam. Several structural factors will drive the country's development, some of which will remain in place even at times of weak growth in the advanced economies.

1. Favorable demographics

UN projections suggest that Vietnam's population will grow from 85million currently to 110million by 2035, with two-thirds of the population being economically active. This represents a formidable force in supporting labor-intensive manufacturing and domestic consumption. Based on the development experiences of other Asian economies, Vietnam's purchasing power could double in the next 6 to 7 years.

2. Regional trade patterns

Risk diversification and China's move up the manufacturing value chain imply that international business will be increasingly looking for a second manufacturing base. Vietnam, due to its stable political environment and low production costs, is often regarded by Asian businesses (particularly those from Japan, Korea, Taiwan, and increasingly China) as a good alternative. Interest from the West is also on the rise. In addition to manufacturing, agriculture is another industry where Vietnam has a competitive advantage, and it is expected to be a key driver of growth.

3. Learning from its neighbors

The experiences of other Asian economies often serve as an example for policy makers in Vietnam as they determine the best approach to facilitating growth. These examples include the execution of monetary policy, the development of financial markets, and the balancing of economic development and sustainability. The domestic market turmoil in Q2 and Q3-2008, as well as the global financial crisis, demonstrated that the authorities are quick to learn and adapt.

Downside risk Despite the positive long term outlook on Vietnam market, certain considerations remain:

1. Lack of infrastructure

A crucial hurdle faced by Vietnam in the coming years will be to improve its infrastructure to meet foreign investors' expectations. The country's current physical infrastructure is unlikely to be sufficient to accommodate the rapid growth anticipated ahead, or supply chain management which increasingly demands seamless connections between producers and consumers.

2. SBV's action damages its credibility

SBV's decision of currency depreciation poses further challenges to the central bank's credibility. The central bank pledged only on middle of November that it did not plan to devalue the dong. The rate hike also contradicts the prime minister's comments that monetary policy could possibly be relaxed in 2010. The risk is that local investors will pay little attention to official comments going forward, which may exacerbate devaluation pressure on the currency.

3. External vulnerabilities

Vietnam's weak balance-of-payments position is still on investors' radar screens. The central bank has suggested that the country's foreign-exchange reserves are around USD 15 – 20 billion, or approximately 4 months worth of imports – a healthy level, though relatively low compared with the region. Meanwhile, the country's trade deficit in the first half year stood at USD 2.1 billion, much healthier than the USD 14.2 billion in the same period last year. However, the deficit began to widen again in Q3 2009 as domestic demand pushed up imports while export performance remained lackluster.

Besides outflows of investment are overwhelming inflows. According to the International Monetary Fund, the deficit in Vietnam's financial account rose to \$5 billion in the first half, compared with \$1.6 billion for all of 2008. direct foreign investment commitments also fell 73% in the first 10 months and the central bank is forecasting a drop of as much as 20% in remittances from overseas Vietnamese.

Conclusion

Although further devaluation of dong is possible, we believe that the long term outlook of Vietnam remains positive. As Warren Buffett said, "A terrible market or a terrible economy is your friend, it's a terrible mistake to look at what's going on in the economy today and decide whether to buy or sell stocks."

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