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Vietnam's inflation: The price of stability

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More pain before the potential gain

- **We see less growth, stronger inflation and higher interest rates.** While we think the government is finally moving in the right direction, its recent policy changes will likely result in short-term pain. We forecast sub-consensus 6.2% real GDP growth, average year-on-year CPI inflation of 14.8% (from 13.6% earlier) for 2011, and an end-year repo/open market operation (OMO) interest rate of 14% (from 12.5% earlier).
- **Why is inflation so high?** Our modeling work suggests that, apart from global food prices, real service sector GDP growth, money supply growth and exchange rate changes are the main drivers of headline inflation. This suggests that, in contrast to the views expressed by many market analysts, rising inflation is not just a symptom of higher global commodity food prices but also reflects strong GDP and monetary expansion over the years.
- **The economy is caught in an inflationary vicious circle, in our view**. High inflation erodes trust in the dong, fuelling flights to USD and gold, which in turn puts the currency under further pressure, exacerbating inflation. We think the recent electricity, fuel price, and minimum wage hikes along with devaluations will likely add to current double-digit inflation in the near term.
- **We think the State Bank of Vietnam (SBV) will keep monetary policy tight**. To avoid this vicious circle, we think the SBV must keep interest rates high to compensate holders of the dong for the inflation risk they face as well as to bring down expected and actual inflation. To this end, we think the SBV will lift the 14% ceiling on dong deposit rates and will raise the repo rate another 100bps.
- **We believe the government will employ quantitative controls over credits**. In addition to hiking the repo/OMO rate (now at 13%), we expect the government to continue to use quantitative credit controls (e.g., the recent cut in the credit growth target from 23% to 20% for 2011), reserves ratios, and regulations to direct lending away from non-trade sectors. This partly reflects our view that the SBV might be concerned about the risk that raising interest rates too aggressively will hurt state-owned enterprises with high gearing ratios, triggering a fear of defaults.
- **Inflation will likely rise further before falling, in our view.** Provided that the government does not reverse its course as and when growth softens, we should see a fall in inflation and narrowing of the trade deficit before the end of the year. However, in the near term, we expect inflation to rise significantly, potentially reaching 17% yoy before receding.

How serious is inflation problem in Vietnam?

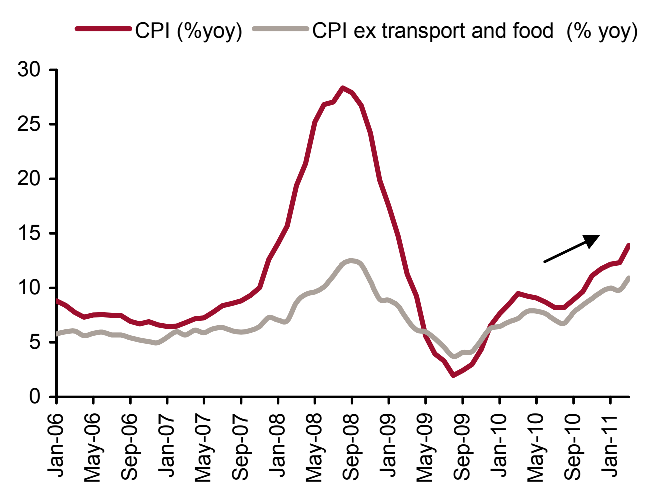
While it is well known that Vietnam is experiencing double-digit CPI inflation again, it is important to understand what has been driving this high inflation. The answer will have significant bearing on the macroeconomic as well as the policy outlook this year. If inflation simply reflects potentially temporary factors, such as higher commodity prices, then we would not expect to see much more in the way of monetary and fiscal tightening measures, with inflation coming down to a manageable level soon enough. However, if inflation is largely driven by strong domestic demand, then we are likely to see more tightening measures resulting in lower growth, with hopefully some signs of inflation easing around the end of the year. This report argues that the latter is likely true, which means the economy will ultimately have to go through more “pain” in 2011 before potentially reaping the gain in the longer run.

Why is inflation so high?

It is not just food

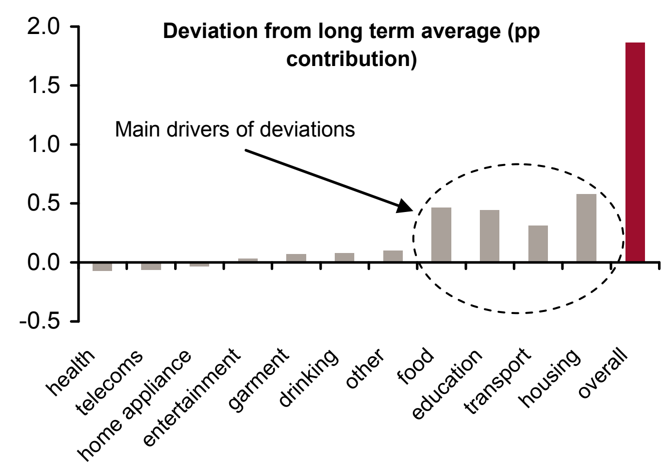
In contrast to popular belief, the current high level of inflation is not being driven by the food component alone. In fact, headline inflation that strips out food and transport (the best measure of core inflation we can calculate given data limitations) was rising even before the recent hike in electricity prices, which added to the housing and construction component (see Exhibit 1). To see which components have been driving inflation higher than the long-term average level, we calculated the percentage-point contribution to CPI of the different components and compared them to their historical averages over the period 2005-10. The results shown in Exhibit 2 tell us that along with food, housing, transport, and education have also been adding to the headline inflation rate more than they have done on average over the past five years. The main message from this analysis is clear: inflation is not just a temporary problem caused by higher commodity prices, but rather a more general issue requiring immediate government attention and actions.

Exhibit 1: CPI ex-food and transport has been climbing



Source: the BLOOMBERG PROFESSIONAL™ service, CEIC, Credit Suisse

Exhibit 2: Headline inflation higher than the five-year average came from a broad set of components



Source: the BLOOMBERG PROFESSIONAL™ service, CEIC, Credit Suisse

Demand-driven as well as cost-push inflation

We utilize a so-called Error-Correction Model (ECM) to analyze the relevance of five factors in driving inflation: international food and oil prices, the dong/USD rate, real GDP growth and monetary growth. Exhibit 3 shows the results of our work, while Exhibit 4 illustrates that the model produces a very close fit to the actual data. Consistent with our expectation, we found that while international commodity food prices are one of the important drivers of headline CPI inflation, other factors have come up as statistically more significant, including service sector GDP growth, the exchange rate and monetary growth. We discuss these factors in turn.

Exhibit 3: Drivers of headline CPI inflation

All the coefficients are expressed in percentage point changes per 1% increase in the explanatory variable. For example, a 1% increase in M2 growth adds about 0.2 to headline CPI inflation in four quarters. The model is estimated using quarterly data over the period 2003-2010. The ECM approach captures both the long-term relationship between variables as well as the impact of the short-term movement in explanatory variables on the dependent variable. All the variables here are in year-on-year changes, and the maximum lags are chosen using the likelihood ratio test. The error correction term tells us how fast the inflation is adjusted back to its long run value.

Variables	Statistically significant?	Impact of a 1% increase in the variable on CPI inflation	Time lags (until delivering maximum effects)
FAO Food price index	Yes	0.17	1 quarter
Dubai Oil price	No	0.02	2 quarters
USD/Dong	Yes	0.23	1 quarter
Real GDP (service sector)	Yes	2.10	5 quarters
M2	Yes	0.21	4 quarters
Error correction term	Yes	0.32	

Source: Credit Suisse

1. **Global commodity prices.** Given that food accounts for over 30% of the CPI basket, it is no real surprise that movements in global food commodity prices have a material impact on headline CPI inflation. While Vietnam is an important rice exporter, it is an importer of other food items, such as animal feeds, wheat, and vegetable oil. Thus the rise in global food prices can also increase imported inflation. Oil prices do not have a statistically significant impact during the sample period, as the government regulates domestic prices.

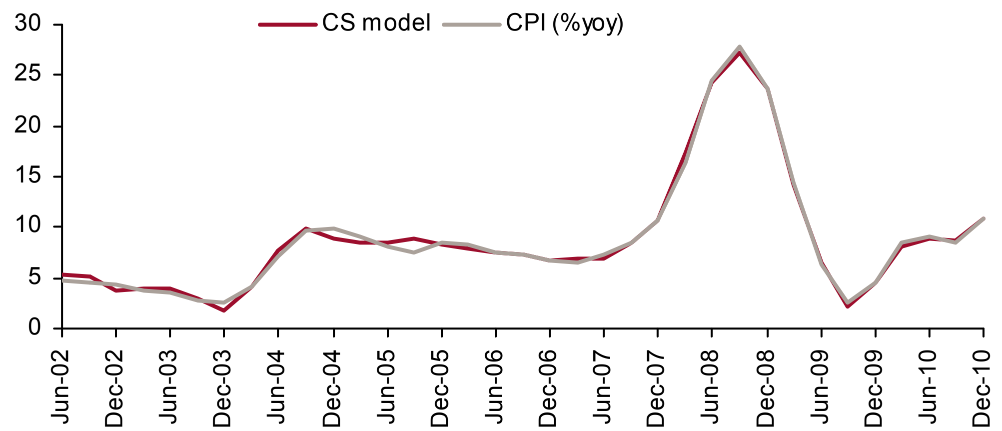
2. **Service sector real GDP growth**. Interestingly, we found growth of the service sector to be most relevant for explaining movements in inflation, better than overall GDP itself. This is probably because service sector GDP is a better proxy for the strength of domestic demand (e.g., domestic retail sales, spending on property, for example), whereas industrial GDP reflects the performance of the export sector. Strong domestic demand growth tends to result in demand-pull inflation as producers are more willing to pass on higher input costs to consumers, which also fits well with the fact that the housing, transport, and education components have been adding to the inflation (Exhibit 4).

3. **Money growth**. On top of real economic growth, strong expansion in money supply caused by loose monetary policy and excessive credit growth (which has been above 20% in the past few years in Vietnam) also leads to higher inflation. This is yet another indication that the inflation we are seeing in Vietnam is not simply imported inflation, but rather a demand-driven phenomenon that needs to be tackled by monetary policy.

4. **USD/dong.** Lastly, we found a statistically significant impact from the official exchange rate on headline CPI inflation, despite the widespread belief that most people have been using the grey market exchange rate and US dollars for many

transactions[1]. We suspect this is because many importers of products, including petroleum, fertilizers, and pesticides, are still using the official exchange rate and hence are passing on the higher costs of inputs to retail prices.

Exhibit 4: Our model explains the variation in CPI inflation well



Source: CEIC, Credit Suisse

What has been done and will (likely) be pursued

Since February the government has announced various policy measures aimed at combating inflation and trade deficits. Exhibit 5 summarizes the key measures, categorized into groups according to our interpretation of what the government's policy objectives might be. We think there are a few policy dilemmas that the government is facing, the outcome of which will likely determine the choices of policy tools going forward.

We are expecting another 100bp hike in the OMO rate to bring the policy rate to 14%

While devaluation of the dong, together with fuel and electricity price hikes, are important policies to improve the trade and fiscal deficits, they will likely add to an already high inflation risk (Exhibit 6). The recent announcement of a 14% increase in the minimum wage effective in May can further worsen the problem, although at the time of writing we still do not know the details of the policy measures. The danger is that the higher inflation then worsens the lack of trust in the currency, fuelling flight to USD and gold, which in turn might force the currency to weaken further, potentially placing the economy into a vicious cycle. While the government has sought various measures to stop banks and businesses hoarding gold and USD, we think their success hinges critically on the ability to offer "carrots" for holding dong. Hence, to reduce risks of this vicious cycle, the government needs to raise interest rates and lower expected inflation to boost expected real returns for holding the dong.

In our view, this partly explains why the SBV has raised the repo or Open Market Operation (OMO) rate, the key policy rate, by 200bps since January 2011 (bringing the rate up from 11% to 13%). The refinancing rate was also raised to match the OMO rate. We are still looking for another 100bps in both rates by the end of this year. In light of the need to raise interest rates, we also think it is possible that the government may lift the current 14% cap on deposit rates. Even with this hike, however, we still expect the real policy rate, calculated as nominal OMO rate minus headline CPI inflation, to be negative for most of the year. So the question is: Why are we not expecting an even higher policy rate this year? This is due to another policy dilemma we think the government is facing.

[1] The regression results hold even when we are controlling for the market exchange rate, determined by calculating dong/EUR and EUR/USD, as the dong is not fixed against EUR.

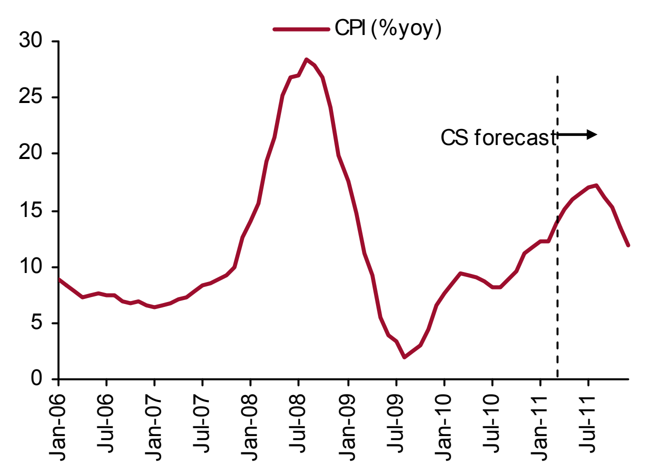
Exhibit 5: Summary of key policy measures

Types of measures	Examples of key policy measures
Quantitative and prudential controls on credit and money expansion	Reducing M2 growth in 2011 to 15%-16% (from 21-24%)
	Restraining lending growth to below 20% (from 23%)
Signal a tough stance against inflation, normalize the interest rate structure and regain demand for dong	Raising refinancing rate to 12% from 11% and discount rate from 7% to 12% in March and more recently hiking the refinancing rate to 13% in April
	Raising 7-day repo rate (in open market operation – OMO rate) from 11% to 12% in February and more recently to 13% on 1st April.
Ensure that funds go to productive and export-oriented sectors	Cutting credit to non-manufacturing sectors such as those investing in the stock and property markets to 22% of total loans by June 30th and 16% by year-end
	Limiting credits made in foreign currencies with priority for loans given to export companies that have foreign-currency resources to repay banks
	Limiting loans in Vietnam dong to importers to buy the dollar for payment of non-essential goods.
Tighten grip of fiscal spending and debt to reduce unproductive spending and public debt, which can complicate the monetary policy	Reducing the budget deficit to 5% of GDP (reduces "leakages" into consumption).
	Requesting state-owned enterprises to focus on their core business.
Normalization of exchange rate regime	Requesting state-owned enterprises not to "hoard" foreign currencies and "gradually" restrict and ban the trading of non-jewellery gold
	Devaluation against USD and narrowing of trading band
Move towards market-oriented pricing regime	February 24th: raising the average fuel prices by 19.7%, petrol (A92) by 17.7% to USD0.92 per litre March 30th: increasing fuel price - 92-RON gasoline price raised 10%, diesel 15%, kerosene 14%
	Raising electricity prices by 15.28% as of March 1st.

Source: the BLOOMBERG PROFESSIONAL™ service, Credit Suisse

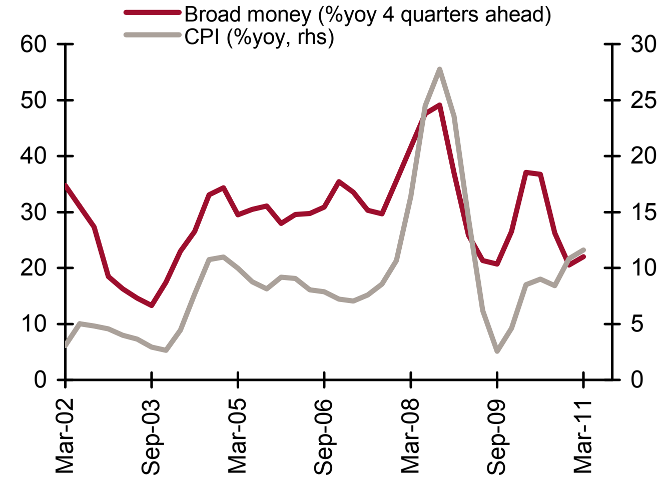
On the one hand, higher interest rates have the benefit of signaling the government's commitment to bring down inflation as well as compensating depositors for the risk they may face carrying dong. On the other hand, it can also have significant negative balance sheet effects, increasing debt burdens for several SOEs. We suspect this concern will put a cap on how high the SBV is willing raise interest rates, forcing them to use other tools to tighten monetary policy – including quantitative controls on credit and money growth, policies to prioritize loans to export sectors as well as limiting credits to the real estate sector and importers of non-essential goods. We expect the policy strategy going forward to be a mix of an OMO rate hike, quantitative credit controls, and regulations to discourage banks' lending to non-export sectors.

Exhibit 6: Inflation is set to move higher in the near term even if the tightening measures work



Source: the BLOOMBERG PROFESSIONAL™ service, CEIC, Credit Suisse

Exhibit 7: Monetary growth is often an important driver of inflation



Source: the BLOOMBERG PROFESSIONAL™ service, CEIC, Credit Suisse

In light of our findings above that inflation is being driven largely by strong real GDP and monetary growth (Exhibit 7), we expect the combination of interest rate hikes and quantitative credit and money controls to help to bring down inflation later in the year. By then, in the absence of further weather-related shocks, we should also see global food commodity prices coming down, thus further easing inflationary pressure in Vietnam. However, there remain questions concerning the enforcement of these various monetary policies and whether the government will stick with them as and when growth softens.

Conclusion: the pain before (hopefully) the gain

In summary, we find that, contrary to what many market commentators have argued, high inflation in Vietnam is not just a function of higher commodity prices but also reflects strong growth in real service sector GDP and money supply. Worse still, we fear that if Vietnam is not careful it will face a "vicious circle", whereby high inflation will erode confidence in the dong, causing people to switch to holding USD and gold, weakening the local currency further, and hence adding to inflation.

This vicious circle also complicates the government's policy options for combating trade deficits and inflation, in our view. While an official devaluation of the dong and hikes in electricity and fuel prices are important policies to bring down trade deficits and restore fiscal discipline, it will add to already high inflation, potentially placing the economy into the aforementioned vicious cycle. To avoid this, the government has to continue with its policy program of the past month – hiking interest rates and trying to bring down inflation expectations. Our central scenario is that the government will hike the OMO and refinancing rate by another 100bp to bring the policy rate to 14%, while it may also adjust the ceiling on dong deposit rates, which is currently set at 14%. We also think it will complement the rate hikes with the use of quantitative credit controls, a reserves ratio hike[2], and regulations to direct lending away from speculative non-export sectors. This partly reflects concerns about the risk that raising interest rates too aggressively would hurt highly geared SOEs, triggering fear of defaults, in our view.

[2] In our view, SBV is more likely to hike the reserve ratios for foreign currencies that are currently 200bps lower than the ratio for local currency. It should be noted also that current stipulations under Circular 13 and 19 effectively prevent banks from lending more than 80% of their raised funds (but they can use the 20% of funds to buy corporate bonds).

Because these tightening measures will take time to bring down inflation, while the most recent fuel price hikes will add to inflation immediately, we are revising upwards our year average inflation forecast from 13.6% to 14.8%. We think inflation could reach as high as 17% before coming down in Q4 as and when the effects of the tightening measures become more visible. The government's focus on bringing down inflation underpins our lower-than-market estimates of GDP growth for 2011 (6.2% versus 7% in the March edition of *Consensus Economic*) – the "price" the country has to pay to restore stability. If these measures are successfully implemented, then we could see improvements in both the trade balance and inflation around the end of this year and in 2012, which would encourage inflows of FDI and remittances, supporting the balance of payments and the foreign reserve position.

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Disclosure Appendix

Analyst Certification

I, Santitarn Sathirathai, certify that (1) the views expressed in this report accurately reflect my personal views about all of the subject companies and securities and (2) no part of my compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this report.

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