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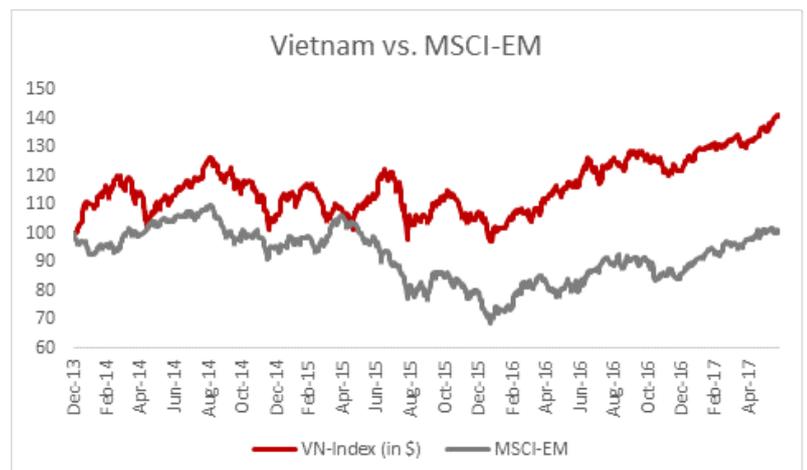
## Global Monetary Tightening and its Impact on Vietnam

Recently, central banks in the US, EU and China have all taken actions that indicate that the days of further loosening of monetary policy are over – and the US Fed guided that it will begin shrinking its USD4.5 trillion balance sheet later this year. The US and the EU have different motivations for tightening monetary policy than China has, but one commonality is the potential to affect Vietnam. The US Fed and the ECB are responding to perceived improvements in GDP growth (out of concerns that accelerating growth will stoke inflation), while the People's Bank of China (PBOC) aims to deleverage China's economy following an epic debt binge over the past ten years that rocketed the country's debt-to-GDP ratio from 150% to nearly 280%.

If GDP growth in the US and the EU accelerates as much as most policy makers expect, Vietnam's economy will benefit significantly. Vietnam is highly geared to global growth as evidenced by the country's 85% export-to-GDP ratio. Exports to the US account for nearly a quarter of Vietnam's overall exports (exports to the US grew 10% yoy in the first five months of 2017), while exports to the EU account for approximately 20% of overall exports (exports to the EU also grew 10% yoy in the first five months of 2017). Faster GDP growth in these markets would drive interest rates there higher, but USD and Euro rates rises probably would not lead to significant increases in Vietnam's interest rates; lending rates in Vietnam are already fairly high and inflation is under control (which is discussed below).

In contrast, Chinese monetary tightening could have a moderate, malignant effect on Vietnam's stock market because China is fostering higher interest rates in order to pop a real estate bubble and to clean-up the country's so-called "shadow banking system". We believe China's ongoing monetary tightening – which is likely to accelerate after the Communist Party Congress in November – poses a greater threat to the 20% YTD bull market in Emerging Market stock prices than interest rate hikes in the US.

That said, a Chinese-prompted EM stock market correction would have a muted effect on Vietnam's market as Vietnamese stock prices have not benefitted from "hot money" inflows in recent years. Year to date, foreign inflows to Vietnam's USD100b market cap stock market total around USD350 million, which has created quite a bit of excitement among local investors because this modest sum is the largest foreign inflow to Vietnam's stock market in recent years.



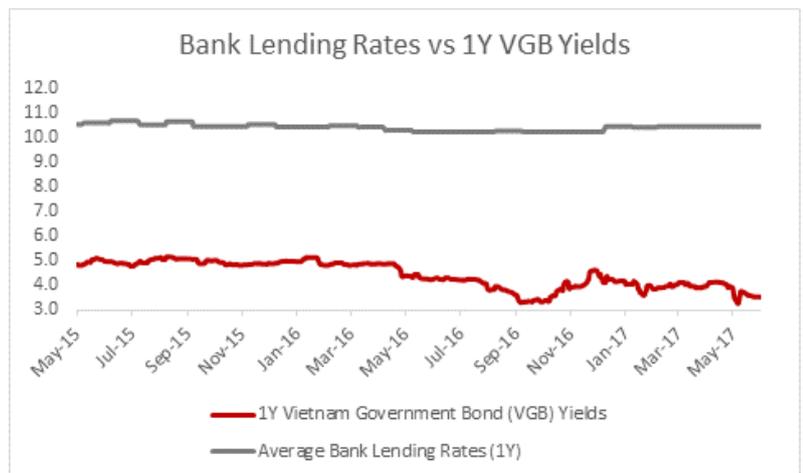
### Rising USD interest rates shouldn't boost VND rates much

Rising USD interest rates coupled with a contemporaneous acceleration of US GDP growth would probably be a net positive for investors in Vietnamese assets. Vietnam runs a sizeable ~14%/GDP trade surplus with the US. Furthermore, higher USD interest rates are unlikely to pressure VND

interest rates higher because inflation in Vietnam is well under control, and because Vietnam’s lending rates are already fairly high due to anomalies in the local banking system discussed below. In short, the government has the ability to significantly influence both inflation and VND interest rates without introducing malevolent distortions into the economy, and we would expect government officials to exert this ability if USD interest rates climbed significantly.

Inflation is currently around 3-4%, and core inflation (stripping out food and energy price hikes) is well below 2%. However, a 46% yoy government-mandated hike in medical prices essentially accounts for the increase in core CPI because medical prices represent 5% of Vietnam’s CPI basket. The government could delay the ongoing province-by-province medical price hikes to rein in inflation, or it could assign a lower weighting to medical prices in the CPI basket, since medical expenses are predominately covered by social health insurance for most Vietnamese citizens.

Regarding interest rates, the government could accelerate banking sector reforms to eliminate anomalies that help perpetuate a wide spread between Vietnam’s risk-free and lending interest rates; one year Vietnam Government Bond Yields currently yield 3.5%, but one-year deposit rates and lending rates are around 6.5% and 10.5% respectively.



Vietnam’s banks are thinly capitalized, which helps perpetuate high VND free market interest rates. The system-wide Capital Adequacy Ratio (CAR) is likely to fall

to 9% in early 2018 (9% is the statutory minimum CAR for individual banks), but Vietnamese banks face difficulties raising capital owing to the government’s 30% foreign ownership limit on most banks. Another factor that distorts market interest rates is the government’s gradualist approach to dealing with the Vietnam’s legacy non-performing loan (NPL) issue; less than 20% of the NPLs purchased by the Vietnam Asset Management “bad bank” have been resolved, although the National Assembly passed legislation this week to expedite this.

The government has the wherewithal to reduce the market level of interest rates in Vietnam by addressing these and other anomalies. In the past, Vietnam’s government only endorsed meaningful structural reforms when it was coerced to do so by circumstances; a significant rise in USD interest rates could prompt concrete action by local policy makers, although we do not expect USD interest rates to increase significantly over the next two years (the Fed guided market participants to expect four more policy rate hikes by the end of next year, but the markets currently only price-in one more hike by the end of 2018).

### The Fed’s likely “Glidepath” is benign for Vietnam

Diminishing expectations for future USD rate hikes, the falling value of the USD, and investors’ increasing confidence in Vietnam – as evidenced by an 80bp decline in Vietnam’s Credit Default Swap rate over the last year – have enabled local policymakers to ramp up monetary policy with impunity; money supply (M2) grew 18% yoy and abundant liquidity led to a plunge in interbank interest rates from 5% at the end of 2016 to 2% at present.

The benign global backdrop enabling Vietnam’s greater reliance on monetary policy is a godsend for local policymakers who have run out of fiscal room to stimulate GDP; the government instructed policymakers to achieve an (overly) ambitious 6.7% growth target for 2017. Vietnam’s public debt

has already reached the statutory 65% maximum - and the country's privatization program is not progressing as quickly as it needs to in order to pay for Vietnam's 6%/GDP infrastructure spending program.

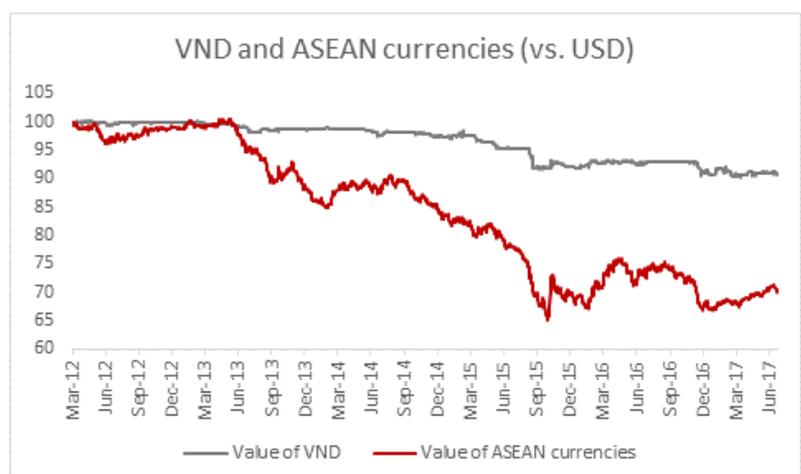
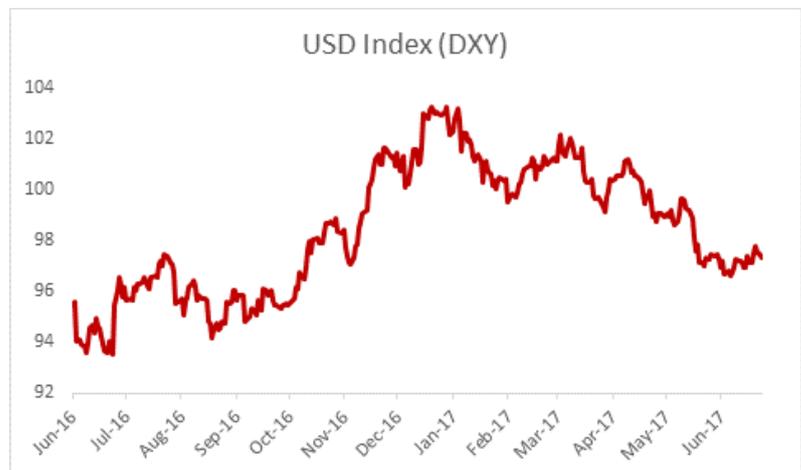
At the beginning of this year, it seemed highly unlikely that the government would be able to rely on monetary policy to stimulate the economy. At that time, local policymakers fretted about consensus forecasts for a surge in both USD interest rates, and the value of the dollar (which would have severely constrained the central bank's degrees-of-freedom). Those concerns prompted the State Bank of Vietnam to steadily devalue the VND all year in order to get "ahead of the curve". However, instead of *appreciating*, the DXY index actually *fell* 5% YTD, alleviating pressure on the VND and leading to a situation in which the free market value of the VND is persistently trading at a value that is more than 1% above the official value of the Dong!

This enabled local policymakers – who are vigilant about preserving Vietnam's macroeconomic stability - to open the liquidity spigots without risking a precipitous drop in Vietnam's currency like those suffered by Vietnam's Asean peers in recent years.

The caveat to this benign picture is that Vietnam's transmission mechanism by which loose monetary policy drives increased aggregate demand is imperfect, as evidenced by the fact that system-wide credit grew at a pace of about 1.8x nominal GDP growth in 2016, and in 5M17 (credit grew approximately 20% yoy in 5M17). That said, Vietnam's outstanding consumer credit is still less than 25% of GDP and local banks' aggregate loans to consumers grew by about 30% last year, and in the first five months of 2017 (yoy). Consumption is two-thirds of Vietnam's GDP, and banks have ample room to continue growing their consumer loans, so we expect 8% consumption growth in 2017 (comparable to 2016 and 5M17), which should help drive GDP growth of at least 6.3% this year.

Finally, loose monetary policy always raises concerns about the possibility of emergent asset bubbles so we note that:

- 1) Credit growth (20% yoy) is comfortably outpacing M2 growth (18%), implying that the banks are lending to the "real economy" rather than fueling asset price increases.
- 2) Vietnam's stock market is trading at a reasonable valuation of 15x forward PE (versus 15% expected EPS growth).
- 3) Real estate prices are only increasing at about a 5-6% annual pace, the price of mid-tier housing products continue to be affordable for most middle-class buyers, and demand is still strong.



Further to that last point, Vietnam's real estate sector enjoyed a fairly vigorous bull run over the last three years, during which the amount of development activity (but not the level of local real estate prices) surged, so some observers believe the market is due for a correction. While it is true that there has been a loss of momentum in the high-end luxury residential segment, Vietnam's rapidly growing urban, middle class has a seemingly insatiable demand for affordable and mid-tier housing products – and these segments of the market are still undersupplied. We do not see much risk of a major correction unless rising USD interest rates were to lead to an increase in mortgage rates from circa 11% at present to 13%, but as we have outlined above, we do not expect VND rates to increase significantly within the next two years.

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