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What's Next for Interest Rates in Vietnam?

A minor tug-of-war is emerging between Vietnam's commercial banks and the nation's government leaders over the direction of VND interest rates for the rest of 2017:

- Yields on 5-Year Vietnam Government Bonds (VGB) have fallen by about 90 bps YTD, and short-term interbank interest rates fell from 5% earlier this year to around 1% at present.

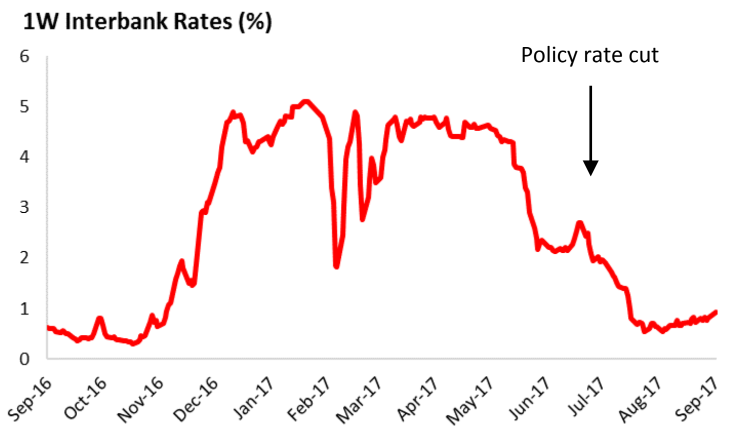
- However, the lending and deposit rates encountered by most economic actors (i.e., individuals and businesses) have not changed much, with borrowers outside "preferred sectors" such as agriculture typically paying circa 10% interest rates on loans (and mortgages) with maturities over one year.

- The government is pushing for lower lending rates and higher credit growth, but nearly every weekly VGB auction since mid-July has essentially failed, signaling that interest rates in Vietnam are at an equilibrium.

In recent weeks, Vietnam's Prime Minister has repeatedly prodded the State Bank of Vietnam (SBV) to raise the country's 2017 credit growth target from 18% to 21-22%. Accordingly, credit growth accelerated from 10.2% YTD in 8M16 to 11.5% in 8M17, but this acceleration has done little to close the gap between Vietnam's current 6.3—6.4% pace of GDP growth, and the 6.7% growth rate the government would like to achieve in 2017.

Accelerated credit growth has also not succeeded in lowering the lending rates paid by businesses and consumers because of issues with Vietnam's banking system "transmission mechanism," which also inhibit liquidity trickling down to the parts of Vietnam's economy that need it the most. Both of these issues are illustrated by the facts that: 1) the top complaint of Vietnamese small and medium enterprises (SMEs) continues to be their inability to access credit, and 2) commercial banks' short-term deposit rates (which are currently around 4.5%) and lending rates barely budged over the last year – despite wild fluctuations in interbank interest rates.

In short, the SBV fostered an abundance of liquidity in the banking system earlier this year with the stated hope that this would reduce lending rates for businesses and individuals. Strong anecdotal evidence suggests that the SBV fostered the creation of excess liquidity by conducting unsterilized interventions in the FX market, and that the central bank purchased USD on the open market with freshly printed VND notes (the People's Bank of China is widely known to employ a similar strategy).



Source: Bloomberg

In addition, liquidity in the system was augmented by a 68% YTD increase in deposits from the state treasury to the commercial banks, which is attributable to better-than-expected issuance of government bonds earlier in the year (the government has already achieved about 80% of its full-year funding plan), and worse-than-expected performance on the disbursement of government investment funds (only 38% of the government's 2017 investment plan was achieved at the end of 8M17). An acceleration of government investment into infrastructure and other projects would obviously lead to a reversal of this source of funds to the banking system.

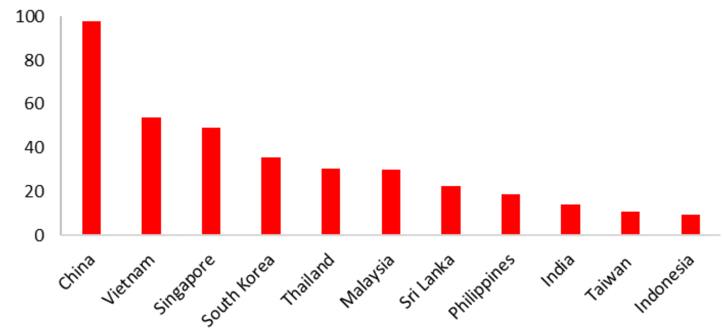
Unfortunately, the drop in interbank bank rates that resulted from excess liquidity in the banks only drove bond yields lower - but not the interest rates banks charge their customers - the central bank explicitly cut policy interest rates by 25 bps on July 10 (to 6.25% for the refinancing rate), but also conducted open market operations to drain USD1.7 billion from Vietnam's money market by issuing treasury bills. This helped nudge interbank rates back up from nearly zero to around 1%, where they sit today.

All of this gives the SBV ample room to loosen monetary policy further, but in our opinion, the real question is whether such a move would actually help boost Vietnam's GDP growth. What follows below is a two-faceted discussion about whether Vietnam should loosen monetary policy further. Will cutting rates help achieve the achieve the government's 6.7% 2017 GDP growth target (we believe the answer is "no")? Are interest rates in Vietnam currently at a sustainable equilibrium (we believe the answer is "yes")?

The preoccupation of policymakers with the 6.7% GDP growth target for 2017 stems from the fact that failure to meet the target this year would make it the second year in a row that the government – which assumed leadership last year - failed to achieve its stated goal of growing Vietnam's economy at what is perceived to be a sufficiently swift pace. Unfortunately, the so-called "credit intensity" of Vietnam's growth has deteriorated in recent years to the point that Vietnam's nominal GDP growth is now roughly half the rate of its system-wide bank credit growth rate, meaning that faster credit growth or additional interest rate cuts are unlikely to have much of an impact.

Some observers believe higher credit growth risks fueling asset bubbles and a resumption of inflation in Vietnam because the country's current credit-to-GDP ratio has reached the ~125% level that has typically triggered macro-stability issues for the country in the past. The IMF believes an 80% credit-to-GDP level is appropriate for Vietnam while others note that the increase in Vietnam's credit-to-GDP ratio over the last decade from trough-to-peak is second only to China's – further raising concerns that risks of future policy mistakes are rising.

Credit-to-GDP Increases Across Asia over the Last Decade (% Points of GDP)



Source: CEIC

We believe Vietnam's current growth rate is already near the country's potential growth rate (i.e., the "output gap" between actual and potential GDP growth is negligible) because consumption – which accounts for about two-thirds of Vietnam's GDP – is already growing at an estimated 9% pace (in real terms). Vietnam already has one of the highest consumer confidence rankings in the world (number five, according to Nielsen), and consumer credit is growing at a circa 30% pace, so it is hard to imagine consumption growing at an even quicker pace.

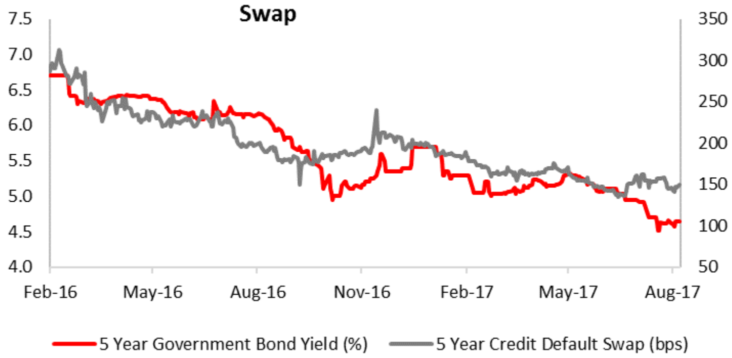
Likewise, Vietnam's manufacturing output is already growing at a robust 11-12% pace – which also seems a difficult feat to top – but here again the current rapid rate of growth seems sustainable. Manufacturing still contributes just 16% of Vietnam's GDP, and no country has become reasonably wealthy without the manufacturing's contribution to GDP reaching at least 30%, which implies ample growth for the sector ahead. Furthermore, registered foreign direct investment (FDI) surged

45% in 8M17 to USD23 billion, auguring well for the future development of Vietnam's industrial base, since manufacturing sees the majority of FDI.

In contrast to the above, GDP growth continues to be held back by a couple of factors, including a circa 10% drop in oil and natural gas production, and the sluggish pace of public investment / infrastructure construction mentioned earlier (although the mining and construction sectors only contribute about 6% to the country's overall GDP). Furthermore, private sector construction is still robust, as evidenced by a 17% increase in steel production in 8M17, and an 8% increase in cement production.

Finally, as mentioned above, Vietnam government bond yields have fallen precipitously YTD. The drop has primarily been driven by falling expectations for future inflation and by Vietnam's falling risk premium, which can be deduced by tracking the country's credit default swap rate (Vietnam's credit rating outlook was recently upgraded from "stable" to "positive" by Fitch and Moody's, which helped ease the country's CDS rate lower).

5-Year Government Bond Yield and Credit Default Swap



Source: Bloomberg

However, in our opinion interest rates have reached sustainable equilibrium, as evidenced by the fact that nearly every VGB auction since mid-July has essentially failed, although yields in the secondary market have only backed up by about 30 bps since that time.

The SBV's July policy rate cut seemed out of sync with the rest of the world's central banks, but in light of a recent loosening monetary bias by Asian central banks, now looks prescient. Some government officials and local economists have called for an additional 50 bps of rate cuts this year, a move they believe will allow the government to reach its 6.7% target. We doubt that such a move would achieve the desired effect.