VN Dong Depreciation Pressures Are Increasing

The Vietnam Dong (VND) has depreciated by about 3% YTD, versus circa 5-12% depreciations of the Indian Rupee, Indonesian Rupee, and the Philippines Peso. The central banks of the latter two countries both raised policy interest rates by 1.75 percentage points this year in order to support their countries’ currencies (the YTD depreciations of each approached double digits earlier in the year), but higher interest rates will weigh on the GDP growth of Indonesia and the Philippines going forward.

The two primary reasons that Vietnam’s currency has been more stable than those of most of its Emerging Market peers this year are:

1) Vietnam’s superior macroeconomic fundamentals, including persistent Current Account (C/A) surpluses over the last six years, averaging 4% of GDP (we expect Vietnam’s C/A surplus to exceed 4%/GDP in 2018).

2) The State Bank of Vietnam’s prudent policies, which aim to stabilize the USD-VND exchange rate.

Further to that last point, 2018 has been a very challenging year for Emerging Market central bankers, as illustrated by the current tensions between India’s government and the country’s central bank.
All of that said, we believe depreciation pressures on the VND are mounting, and that the market is currently too complacent about the possibility of a large depreciation of Vietnam’s currency (i.e., over 5%) in 2019.

We expect the USD-VND exchange rate to depreciate by 2-3% in both 2018 and in 2019, which is in line with the market consensus, and which would also be more-or-less consistent with the expected inflation differential between the US and Vietnam, but we also believe market participants are underestimating the probability of a much larger weakening in the USD-VND exchange rate next year.

THE SBV’S LIMITED DEGREES-OF-FREEDOM

Vietnam is pursuing the same FX rate management strategy that was instrumental to China attracting massive FDI inflows in the early 2000s. In short, China spent a huge amount of its national resources protecting the value of the Yuan in the aftermath of the Asian Financial Crisis, when the currencies of Thailand/Indonesia/Philippines plunged.

China’s government strived to maintain the value of the country’s currency in order to reassure foreign investors that it was willing to do whatever it took to mitigate the risk of those investors suddenly loosing half of their money in the China due to precipitous FX depreciation.

In its pursuit of an analogous strategy, Vietnam has two options to support the VND: 1) raise interest rates, or 2) use FX reserves to buy VND in the interbank FX market. The government seems to prefer the latter option, as evidenced by the Prime Minister’s comments at the end of last month that he does not want interbank interest rates to increase from their current level (this was the first time the Prime Minister has talked about interbank interest rates publicly).

Regarding Vietnam’s FX reserves, last year the State Bank of Vietnam (SBV) took advantage of weakness in the value of the US Dollar, as well as the enormous inflow of capital into Vietnam that was driven by privatizations/SOE stake sales, in order to increase Vietnam’s FX reserves from about USD37 billion at end-2016, to a peak of about USD64 billion as of the end of June 2018.

However, starting in July, the SBV subsequently sold about USD6 billion of its FX reserves (and bought VN Dong) in order to support the value of Vietnam’s currency in the face of the rising USD, due to Fed hikes, the trade war, and a shortage of USD outside the US.

To put that USD6 billion figure in context, this is roughly equivalent to the amount of FX reserves that the SBV sold in 2015 in order to stem the depreciation of the USD-VND exchange rate when China’s currency unexpectedly depreciated.

Despite the fairly pronounced decrease in Vietnam’s FX reserves over the last few months (FX reserves fell by about USD1.8 billion in October), there has not been a lot written about this topic in the local business press, even though the level of Vietnam’s FX reserves is now back below the widely recommended minimum of three months’ worth of imports.

The SBV’s diminishing reserves, coupled with the government’s unwillingness to dampen economic growth by raising interest rates reduce the central bank’s degrees-of-freedom to achieve its goal of maintaining the value of the country’s currency – thus making the VND vulnerable to a bigger-than-expected depreciation if the USD were to experience another round

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1 The SBV does not clearly disclose the amount of FX reserves it has, so these estimates are pieced together, based on SBV press conferences together with data from the IMF and others.
2 Vietnam’s central bank is not yet fully independent from the government.
of appreciation (following a 9% increase in the US Dollar, DXY index since February), or if China’s currency was to endure an acceleration of its on-going depreciation if-and-when the USD-CNY exchange rate breaks the widely watched ‘7’ level.

**DEPRECIATION PRESSURES ARE BUILDING**

Depreciation pressures on the VN Dong are building because the level of real interest in Vietnam is very low, and because the “Errors & Omissions” line item in Vietnam’s Balance of Payments (BoP) account increased from USD3 billion in 2015 to USD14 billion in 2017 - and is likely to reach USD15 billion this year.

The “Errors & Omissions” in the BoP accounts is essentially the amount of money that is either slipping out of the country, “under the radar”, or that is being converted into USD/gold in the informal market – but still kept inside Vietnam. An increase in the “Errors & Omissions” of Vietnam’s balance of payments account indicates that money is either flowing out of the country, and/or that local savers are converting their VND into USD and gold due to a diminution of their confidence in the VN Dong, which increases the depreciation risk for the VN Dong.

![Net Errors & Omissions (USDb)]

The low level of Vietnam’s real interest rates also increases the risk of a major depreciation in the value of Vietnam’s currency by reducing the attractiveness of holding the currency. Short term interbank interest rates are still only about 1% in real terms (i.e., stripping out inflation), despite a 200bp increase in interbank interest rates last month, and Vietnam Government Bond (VGB) 10Y yields are considerably below government bond yields in Indonesia/Philippines, which are both around 8% versus circa 5% for Vietnam – while Indonesia even has an investment grade credit rating compared to Vietnam’s BB- rating!

**DEPRECIATION SCENARIOS**

If the SBV continues to deplete its FX reserves without raising interest rates, it can maintain the value of the country’s currency for the time being, but most analysts believe that if the level of the SBV’s FX reserves falls from the current, 2.9 months’ of exports, to a level below 2.5 months, then the SBV will be forced to curtail its VND purchases, which would then cause confidence in Vietnam’s currency to evaporate.

Furthermore, while the World Bank, IMF, and others recommend that countries hold FX reserves equivalent to at least three months’ worth of imports, the IMF also has another, more
sophisticated recommended FX reserves requirement benchmark, and Vietnam only achieved 80% of that metric at the time the SBV’s FX reserves peaked earlier this year.

In lieu of depleting its reserves, the central bank could hike VND interest rates by 200 bps, thus raising Vietnam’s real short-term interest rates to a more realistic ~3% level, but in that case Vietnam’s GDP growth would probably slow from 7% to 5%.

The resulting slowdown in the country’s GDP growth would be acceptable for most foreign FDI investors because those investors typically pour money into Vietnam in order to take advantage of the country’s low wages to produce exports; the slowdown in Vietnam’s economic growth would also slow the current ~7% pace of Vietnam’s factory wage growth, which would also benefit foreign investors setting up new factories in Vietnam.

That said, while raising interest rates to protect Vietnam’s currency would slow the domestic economy in order to benefit foreign investors, many government policymakers would probably find this unpalatable, even though this strategy would ultimately benefit Vietnam in the long run.

Is Time Running Out Before the Next Big VND Depreciation?

Given the unsustainability / unpalatability of the two options above, it is possible that the government might choose not to respond to the rising USD, and simply stop spending its reserves to support the VND while simultaneously refusing to raise interest rates. In that case, the VND could plummet, as outlined in the scenario table below, although it is unlikely that such a plunge is imminent because policy makers would not be willing to endure a steep depreciation in the VND this close to the year-end, given their individual performance targets for the year.

The net conclusion of the above is that the VN Dong could be setting up for a significant depreciation after the New Year.

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<thead>
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<th></th>
<th>FX Reserves</th>
<th>Interest Rates</th>
<th>VND</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>↓</td>
<td>Flat</td>
<td>Flat</td>
<td>Unsustainable, if FX Reserves &lt;2.5 months’ imports</td>
</tr>
<tr>
<td>2</td>
<td>Flat</td>
<td>↑</td>
<td>Flat</td>
<td>GDP Growth slows from ~7% to ~5%</td>
</tr>
<tr>
<td>3</td>
<td>Flat</td>
<td>Flat</td>
<td>↓</td>
<td>Government ministers incentivized to avoid this outcome until after the New Year</td>
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</tbody>
</table>
APPENDIX: WHY VIETNAM’S INTEREST RATES ARE SO LOW

Depreciation pressures on the VN Dong are partly attributable to the consistently low level of real interest rates in the country in recent years - unlike in 2010, when hyperinflation prompted capital flight from Vietnam, which in turn drove a 25% depreciation in the VN Dong over 2009-11. Historically, Emerging Markets need real interest rates of at least 3-4% to attract investment capital - although that threshold was artificially depressed by excessive Quantitative Easing (QE) by central banks after the 2008 Global Financial Crises.

Vietnam’s unreasonably low level of real, short-term interest rates, which ranged from about -2% to 1% over the last few years, is ultimately attributable to the abundance of foreign capital inflows into the country that are motivated by factors besides investors’ directly earning returns on the money they bring into the country. For example, Japan ran out of factory workers at home, so Japanese companies needed to set up factories in Southeast Asia (i.e., the Japanese are not overly concerned if Vietnamese real investment returns are artificially low because they have a different objective than earning returns in the domestic market).

Excess Foreign Capital Lowers Interest Rates

Excess foreign capital inflows eventually spill over into the rest of the economy, which in turn lowers VND interest rates for all participants in the economy. Some economists call spillovers from one sector of an economy that impact the rest of the domestic economy, “Dutch Disease” (the discovery of natural gas reserves in the 1960s caused the Netherlands’ currency to soar in the 1970s, which killed the country’s manufacturing industry).

Vietnam, China and Thailand all face this same situation of excess foreign capital inflows depressing their domestic interest rates. In Thailand’s case, this effect has been enormously helpful to foster the development of the country’s domestic economy, because Thailand’s bond yields have been below 4% for the last decade. However, Thailand’s FDI inflows/GDP ratio averaged ~2% over the last five years, versus Vietnam’s circa 8% ratio, so the distortionary impact of excess capital inflows on Thai interest rates is not as big as it is for China and Vietnam.

China’s central bank mitigated some of the impact of excess foreign capital inflows by continually raising local banks’ Reserve Ratio Requirements (RRR), as the country’s FX reserves swelled, which can be seen in the chart below. Note that when China/Vietnam’s central bank buys FX reserves it usually pays for those reserves with newly printed Yuan/Dong, which increases liquidity in the banking system, but increasing banks’ RRR forces those banks to retain additional Yuan/Dong, effectively draining liquidity from the system.
The People’s Bank of China (PBOC) was able to offset some of the country’s resulting excess liquidity by raising local commercial banks’ RRR (which Vietnam did not do), but the PBOC’s RRR hikes did not drain enough liquidity from the system to raise China’s interest rates up to a proper, free market equilibrium level. As a result, the country’s shadow banking system, which essentially pays free market interest rates, is now about as big as the commercial banking system itself.

In Vietnam’s case, the excess liquidity indirectly generated by excess foreign capital inflows helped drive a circa 50% increase in stock prices last year, led to the drop of 10Y VGB yields to 4% in early March 2018, and resulted in interbank interest rates remaining below 2% nearly continuously in 1H18. Further to that last point, the SBV’s sale of circa USD6 billion of FX reserves since end-1H18 drained sufficient liquidity from the banking system that interbank interest rates have nearly rebounded to 5%.

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