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August 8, 2008

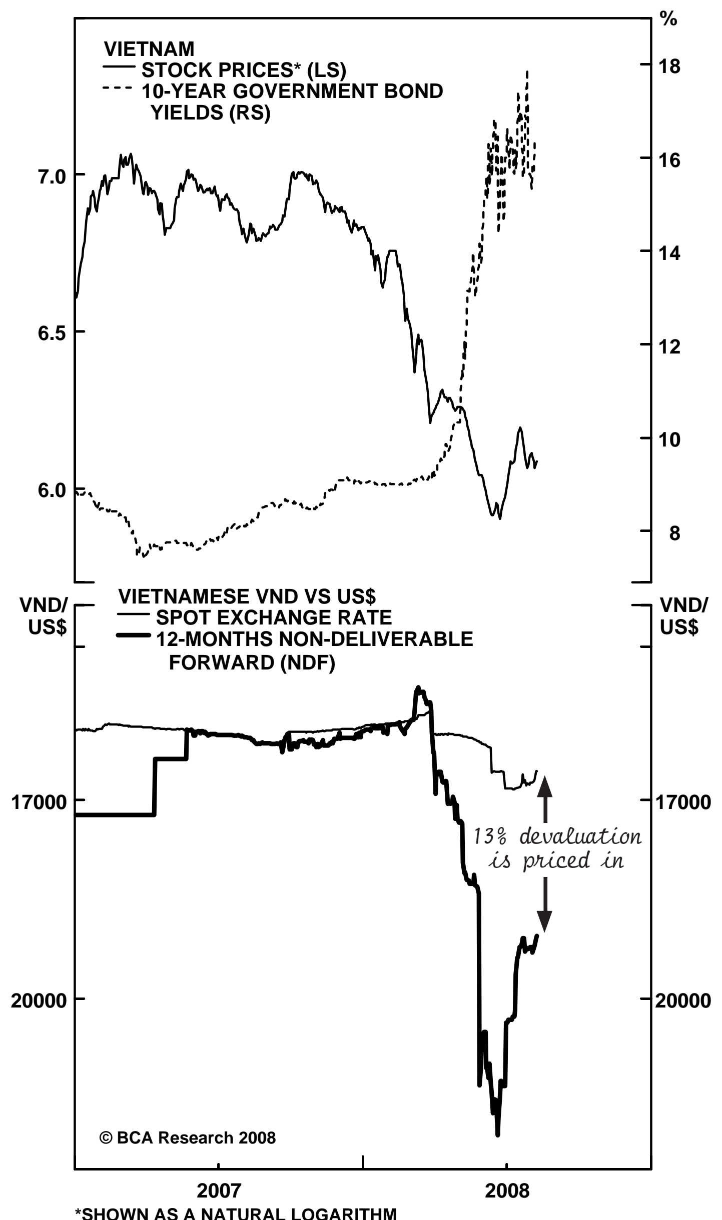
Special Report

VIETNAM: A CYCLICAL CRISIS IN A STRUCTURAL UPTREND

HIGHLIGHTS

- Vietnam is undergoing a typical emerging market crisis, but its long-term growth prospects remain better than in many other emerging economies.
- Moderate currency depreciation (no more than 10%) is likely in Vietnam by the end of this year, but a massive devaluation should be avoided.
- The Vietnamese dong's depreciation holds the potential to limit the upside in emerging Asian currencies including the Chinese RMB.
- Asset allocators and investors with a longer time horizon and ability to tolerate high volatility in share prices may consider accumulating Vietnamese stocks on further weakness.
- Go long Vietnamese sovereign spreads versus their Philippine counterparts.

CHART 1
Vietnam: Financial Markets



*SHOWN AS A NATURAL LOGARITHM

Many features of Vietnam's economic dynamics are typical of past emerging market crises. Over the past couple of years the economy has been overheating; money and credit have boomed and the country has run a large current account deficit. As a result, inflation has surged, interest rates have skyrocketed, the equity market has collapsed, property prices are deflating rapidly and the foreign exchange market is still discounting a 13% plunge in the currency value, even after the recent rebound (**Chart 1**).

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The critical issue is whether the crisis is in a late stage or Vietnam's strong growth was an aberration and a prolonged period of economic underperformance is in the cards.

The key to assessing the severity of Vietnam's ongoing crisis dynamics is to determine whether currency devaluation is inevitable, like China in 1994 or Asia in 1997, or the country can avoid the fate of its fellow Asian tigers of the past decade.

Our assessment is that, while risks of moderate currency devaluation and a banking crisis are still present, investors should maintain a positive stance on the economy in the long run.

Vietnam Today Versus China 15 Years Ago

There are a number of similarities between Vietnam today and China in 1993-94 when the latter devaluated its currency by 33%.

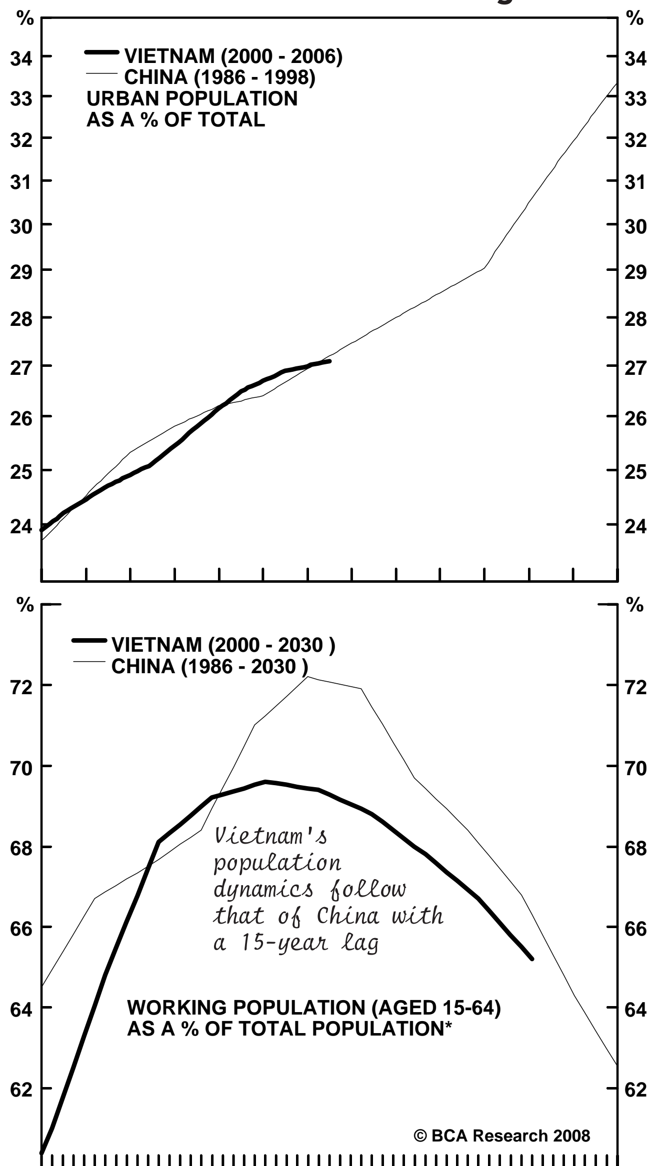
Similarities:

- As in China in the early 1990s, Vietnam has been transforming from a socialist-command economic system with a dominant state role into a market-based system.

  From a global perspective, Vietnam has become a low-cost producer of manufacturing goods, taking market share away from various other Asian countries – another similarity to China 15 years ago.

  Structurally, Vietnam is also in a similar phase of industrialization as China was in the mid-1990s. The share of urban population is rising rapidly but is still below 30% (**Chart 2**) and the shares of the working-age population in Vietnam today and in China 15 years ago are reasonably similar (**Chart 2**, bottom panel).

CHART 2
Vietnam Is Like China 15 Years Ago



*UNITED NATIONS

- Growth is driven by industrialization, and investments in both Vietnam and China account for about 40% of each country's GDP.
- FDI has been accelerating in Vietnam as was the case in China back in 1993-94 (**Chart 3**).
- Income per capita is the lowest among other industrializing emerging Asian countries, while China was the second lowest in 1994, save for India. Monthly average wages per capita for Vietnam are currently about US$50 similar to those that prevailed in China in the middle of the last decade.

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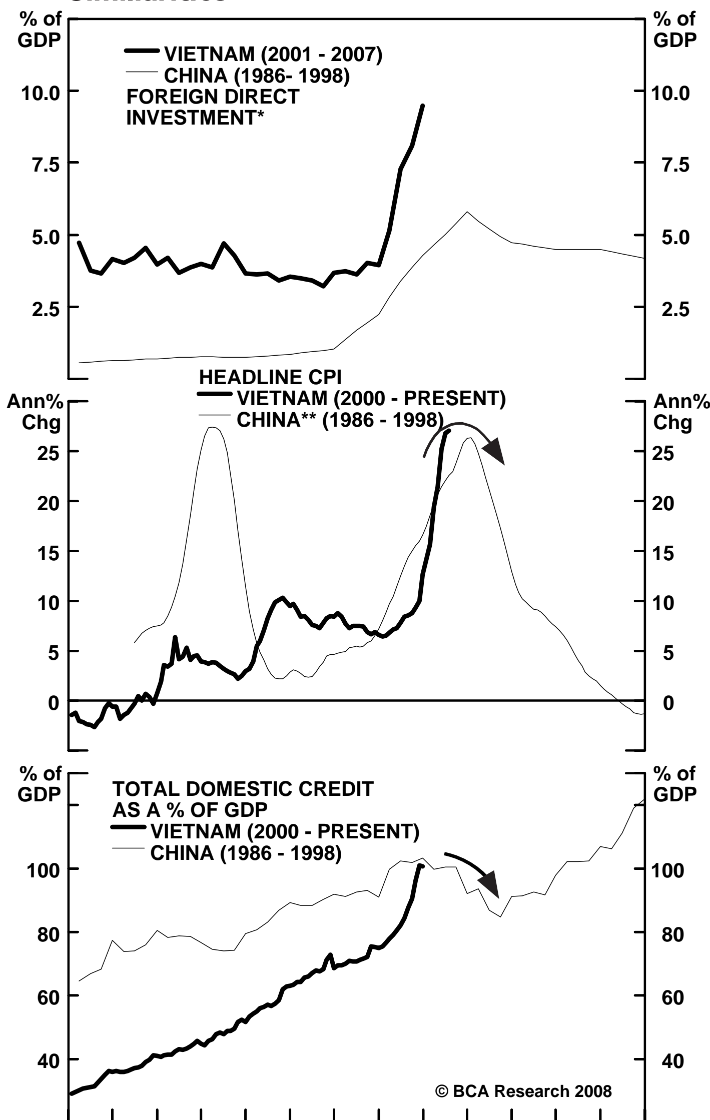
CHART 3
Vietnam Versus China In 1993/94: Similiarities



*SOURCE: IMF
**SHOWN AS A 6-MONTH MOVING AVERAGE

- Vietnam is overheating like China was in 1993, with inflation skyrocketing (**Chart 3**, the middle panel) and the external balance worsening due to surging import growth (in excess of 50% year-on-year).
- Money and credit have boomed in Vietnam and the credit-to-GDP ratio has surged to 100%, which was also the case in China back in 1993 (**Chart 3**, bottom panel).
- The fiscal position in both countries is reasonably benign, with a budget deficit at 1-2% of GDP.

Differences:

- Today's Vietnam is a much more open economy than China was 15 years ago. Consequently, with exports and imports larger than GDP (68% and 86% respectively, for 2007), the current account deficit accounts for a larger share of GDP in Vietnam than it did for China in 1994 (**Chart 4**).
- Vietnam's national savings rate is lower than China's was in 1993 (**Chart 4**, middle panels). Consistently, Vietnam has had to borrow externally to finance capital spending, resulting in a much larger foreign debt-to-GDP ratio (31%) than China had (14%). Therefore, currency devaluation will be more costly in Vietnam than it was for China in the mid-1990s.
- China's state sector's investment accounted for 23% of GDP in the middle of the last decade, but that of its Vietnamese counterpart is much smaller at just 7% of GDP (**Chart 4**, bottom panel). The share of state enterprises in Vietnam is now 22% compared with 60% in China 15 years ago.

  Government-led capital spending is always less productive and efficient, so the current Vietnamese structure indicates a more efficient economic system than China had.
- Vietnamese export prices are very strong thanks to the surging prices of certain commodities such as rice, oil and coffee, despite the contraction in these commodities' export volumes (**Chart 5**, bottom panel).

  By contrast, Chinese export prices were deflating in 1993 preceding the RMB devaluation (**Chart 6**, bottom panel).
- The Vietnamese central bank's reserves are higher now than they were in China in relative terms. The import coverage of international reserves, a traditional measure of currency vulnerability in economies with controlled exchange rates, was around three months in China in late 1993, while it is currently close to five months in

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CHART 4
Vietnam Versus China In 1993/94: Differences

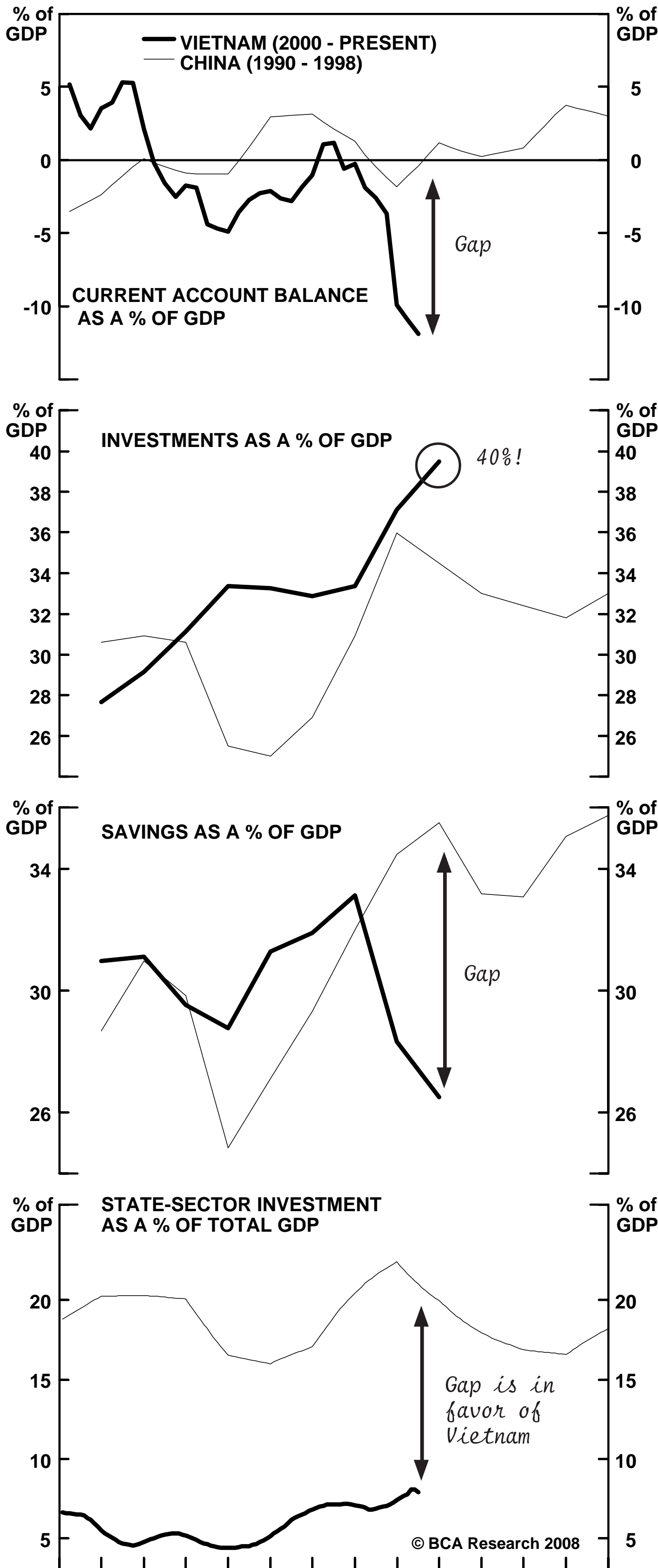

CHART 5
Vietnam: Exports Profile

Ann% Chg

VIETNAM TOTAL EXPORTS VALUE

Strong

EXPORT VOLUME - RICE

EXPORT VOLUME - CRUDE PETROLEUM

EXPORT VOLUME - COFFEE

Commodity export volumes are contracting

EXPORT VOLUME - COAL

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2004 2006 2008

NOTE: ALL SERIES SHOWN AS 12-MONTH MOVING AVERAGES

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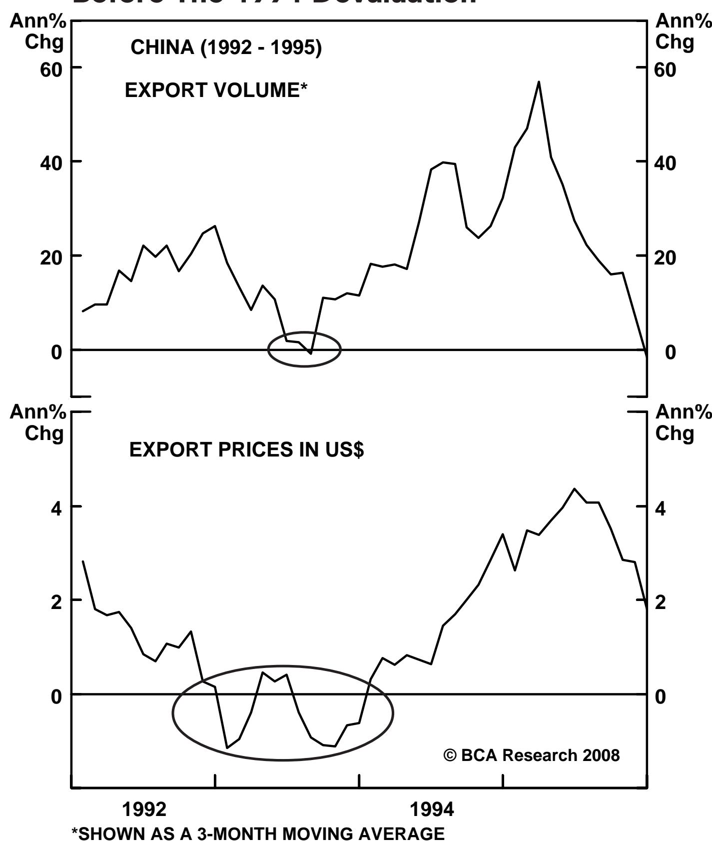
CHART 6
Chinese Exports Were Weak Before The 1994 Devaluation



Vietnam. The same is true for the international reserves-to-foreign debt ratio.

The most significant commonality between Vietnam and its Asian peers (Thailand, Korea, etc.) that experienced the 1997-'98 crisis is a large current account deficit. Actually, Vietnam's deficit is enormous, at around 11% of GDP. What is different is the financing structure: The crisis-hit Asian economies back then were relying on short-term financing, while Vietnam's financing is spread out between long- and short-term sources and is therefore less vulnerable.

Bottom Line: Vietnam's cyclical backdrop is similar to that of China 15 years ago, but the structural backdrop (competitiveness, efficiency/productivity gains, the large private sector) is better. However, the balance-of-payment position is weaker than in China in 1993.

Pros And Cons Of Devaluation

Pros of currency devaluation in general and for Vietnam in particular are as follows:

- To reduce/eliminate the current account deficit – i.e. boost savings;
- To enhance competitiveness of exports in the long run;
- To stimulate growth cyclically via increased exports at a time when domestic demand is getting very weak.

However, devaluation also has cons:

- It will markedly worsen the inflation picture;
- Foreign debt servicing costs will skyrocket;
- Like other countries' past experiences, currency devaluation could lead to a banking crisis as both banks and their clients suffer from increased foreign debt-servicing costs. Furthermore, a weaker currency could lead to a short-term spike in interest rates, which will reinforce the weakness in domestic sectors.

The reason why China opted for the massive (33%) currency devaluation in 1994 was because it had a very low foreign debt burden. Also, China was experiencing weakness in both export volumes and export prices (**Chart 6**). Overall, the 1994 currency devaluation was a low-cost option for China to move forward on its path of export-led growth.

In the case of Vietnam, a large devaluation will be more costly due to the fact that Vietnam has a higher foreign debt-to-GDP ratio.

On the whole, **a decision to allow for currency depreciation (and by how much) in the face of balance-of-payment pressures depends on the authorities' assessment of (1) the desired growth mix between domestic demand and exports, and (2) their own ability to maintain the current exchange rate regime.**

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CHART 7
Vietnam's Manufacturing Exports Are Strong

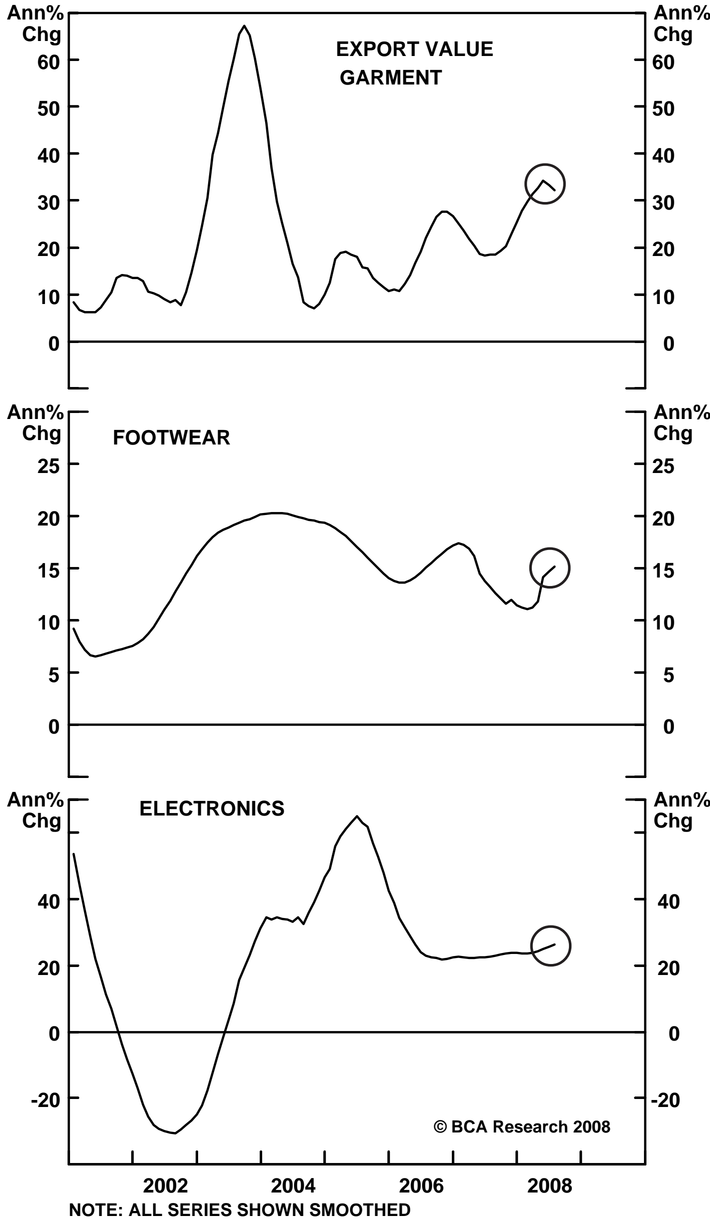
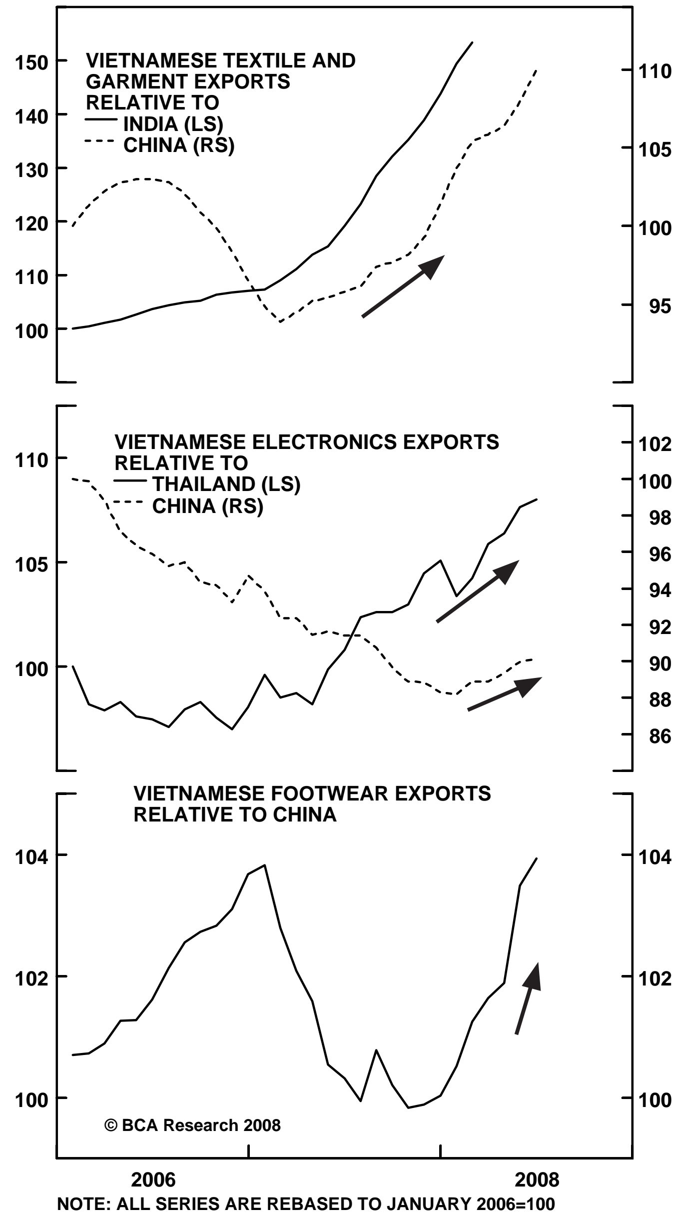


CHART 8
Vietnam Is Gaining Market Share



Moderate Depreciation Or Massive Devaluation?

Our bias is to believe that the Vietnamese authorities will likely opt for currency depreciation, but in a less dramatic way (no more than 10% versus the U.S. dollar). A collapse in the currency, as China experienced in 1994 and Thailand in 1997, should be avoided, for the following reasons:

- Vietnam's export sector is competitive, and overall exports are doing well. While commodities export volume is contracting, it is being compensated by high commodities prices.

  Meanwhile, manufacturing goods exports are growing rapidly (**Chart 7**). Besides, Vietnam is gaining market share from China, Thailand and India in low-cost products such as textiles and footwear as well as in some areas of electronics (**Chart 8**).

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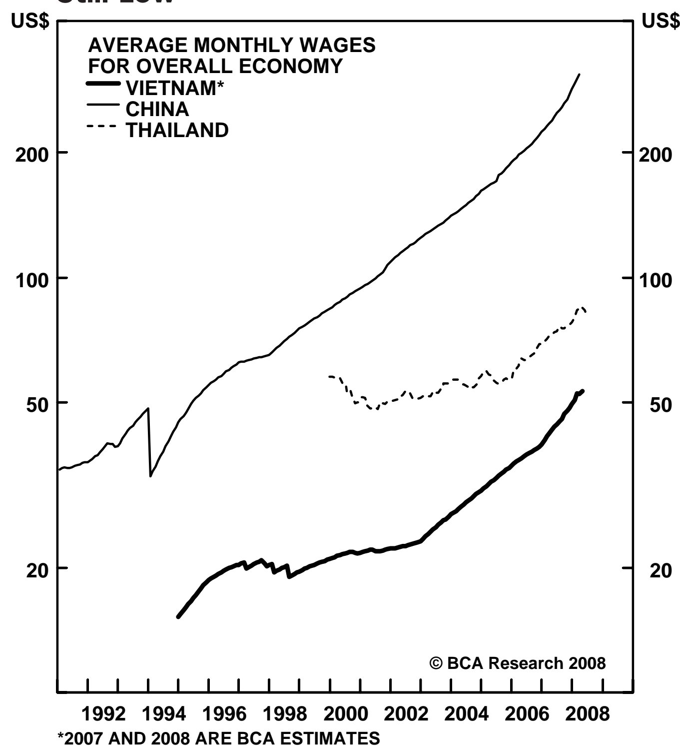
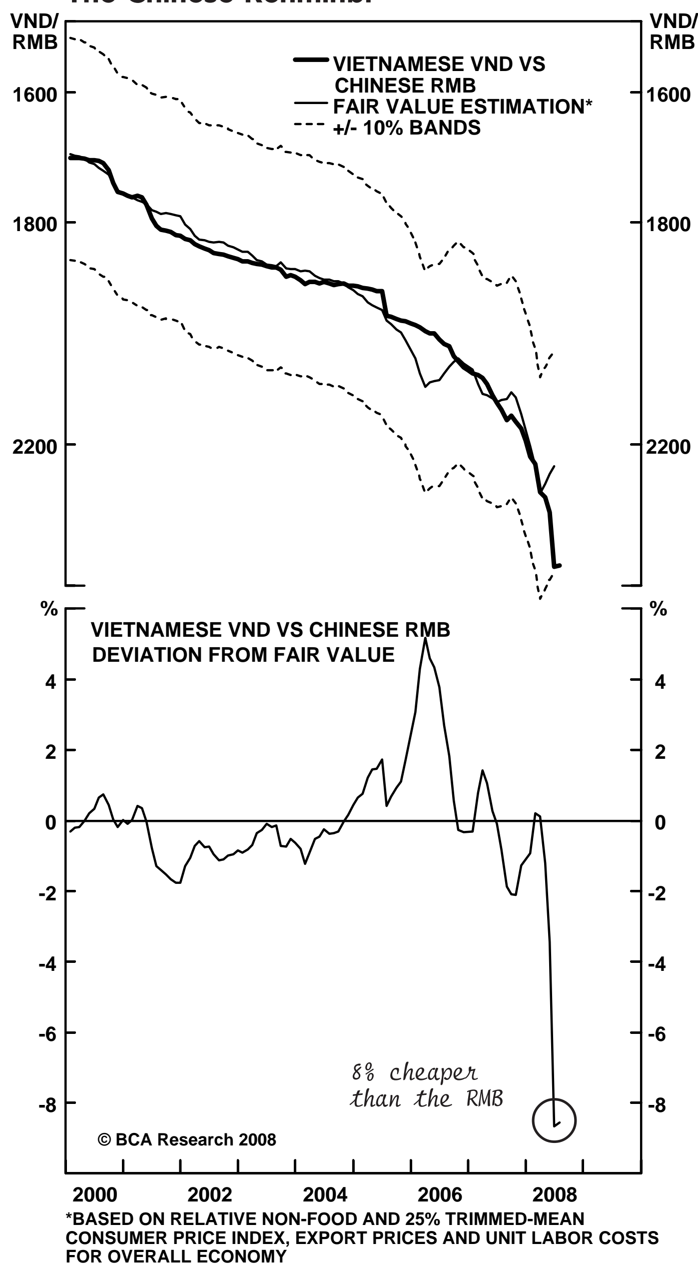
CHART 9
Vietnamese Wages Are Still Low



*2007 AND 2008 ARE BCA ESTIMATES

- Wages in Vietnam have been rising rapidly but are still well below other emerging Asian economies (**Chart 9**). Anecdotal reports from companies also confirm that production costs in Vietnam are still cheaper than in China and other places.
- Our currency valuation model implies that the Vietnamese currency is about 10% undervalued versus the Chinese RMB based on relative trends in inflation, export prices and unit labor costs (**Chart 10**).
- Foreign businesses are responsible for more than 30% of Vietnamese imports and financing this portion of imports is not a problem. Imports by foreign enterprises are either capital goods for investment (i.e., the financing is already provided) or semi-processed/raw materials for processing and subsequent re-export (i.e., they are backed up by future export receipts) (**Chart 11**).

CHART 10
Vietnam's Currency Is Cheap Versus The Chinese Renminbi



*BASED ON RELATIVE NON-FOOD AND 25% TRIMMED-MEAN CONSUMER PRICE INDEX, EXPORT PRICES AND UNIT LABOR COSTS FOR OVERALL ECONOMY

- 95% of the current account deficit was covered by net FDI and the rest by long-term borrowing in 2007 (**Chart 12**). This is a major departure from the crisis-stricken Asian economies in 1997 that had an excessive reliance on short-term financing.
- Moreover, with Vietnamese share prices already down 45% in US$ terms from their February peak

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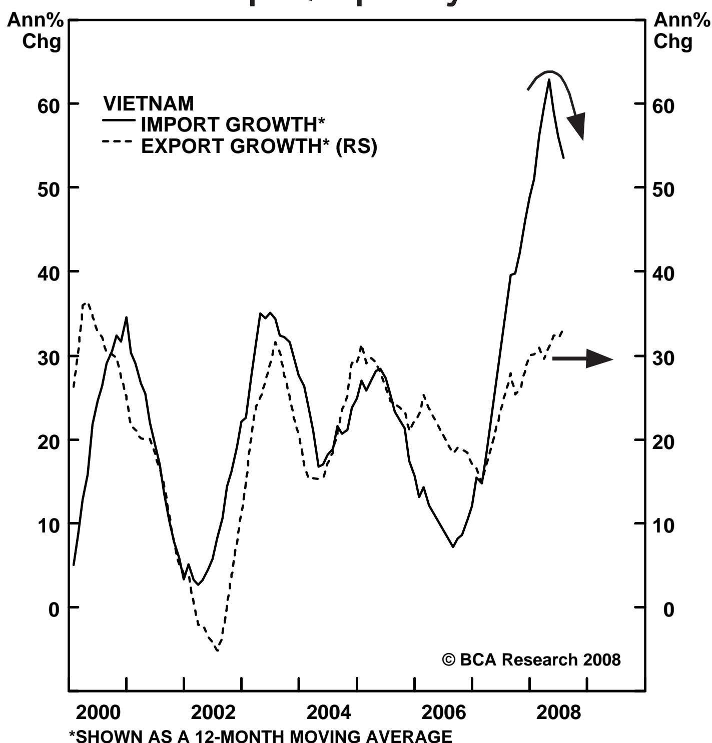
CHART 11
Vietnam's Import/Export Dynamics

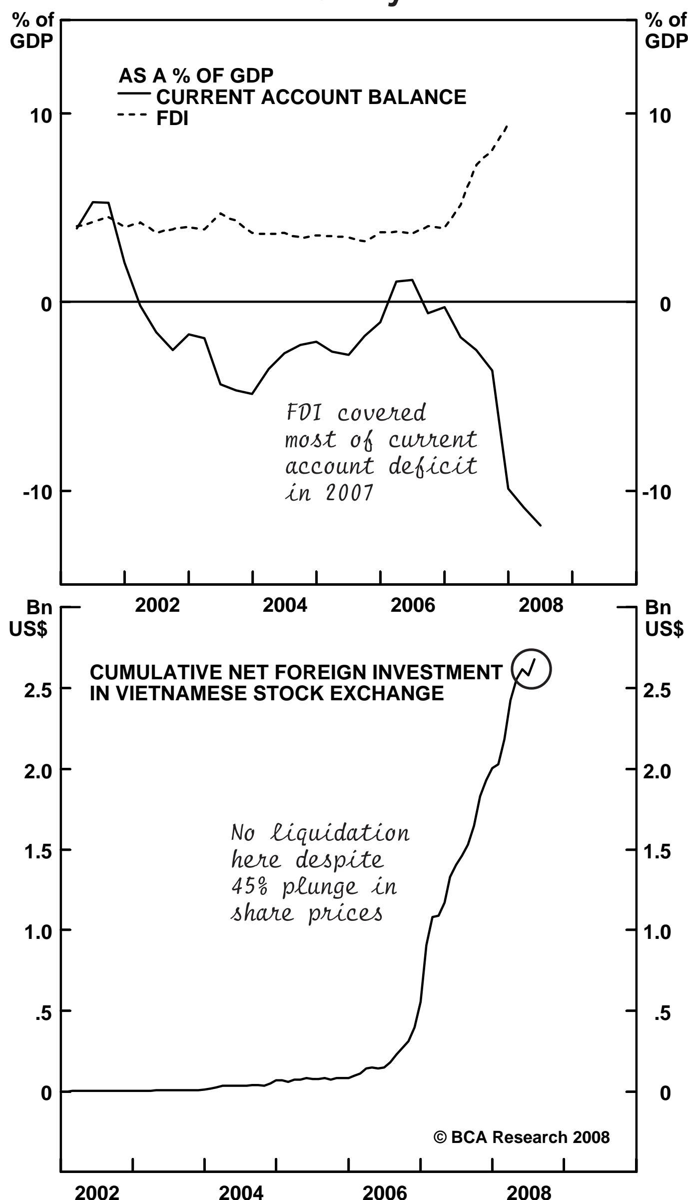


and property prices having deflated 40% this year, there are fewer incentives for foreigners to sell Vietnamese assets at current levels and repatriate capital, considering the economy's positive long-term prospects. Meanwhile the country's restrictions on capital account transactions also serve to limit capital outflows. In fact, foreign equity investors have so far not been net sellers of Vietnamese stocks (**Chart 12**, bottom panel).

- Interest rates in real terms (deflated by core CPI) have become positive for the first time in many years, another supporting factor for the Vietnamese dong.
- Finally, the government has tightened fiscal policy and state investments have dropped sharply, which in turn have begun to have a positive impact on the trade balance (**Chart 13**).

Overall, **Vietnam does not suffer from a lack of competitiveness and therefore does not need to devalue its currency by a significant amount in order to gain market share from its competitors.** In addition, the slowdown in domestic demand already underway is helping to compress the trade imbalance.

CHART 12
Vietnam: Balance Of Payments



That said, as the domestic economic slump deepens and inflation moderates, the authorities' incentives to allow for moderate currency weakness will grow.

Notably, raising interest rates to lend support to the currency is no longer a policy option because of property price deflation, lingering vulnerabilities

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CHART 13
Improving Trade Balance

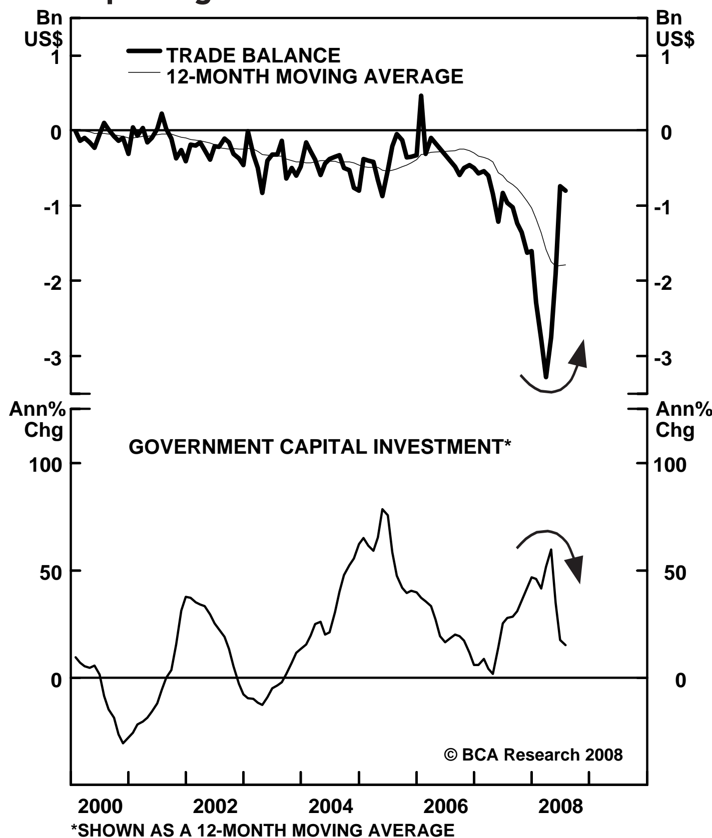
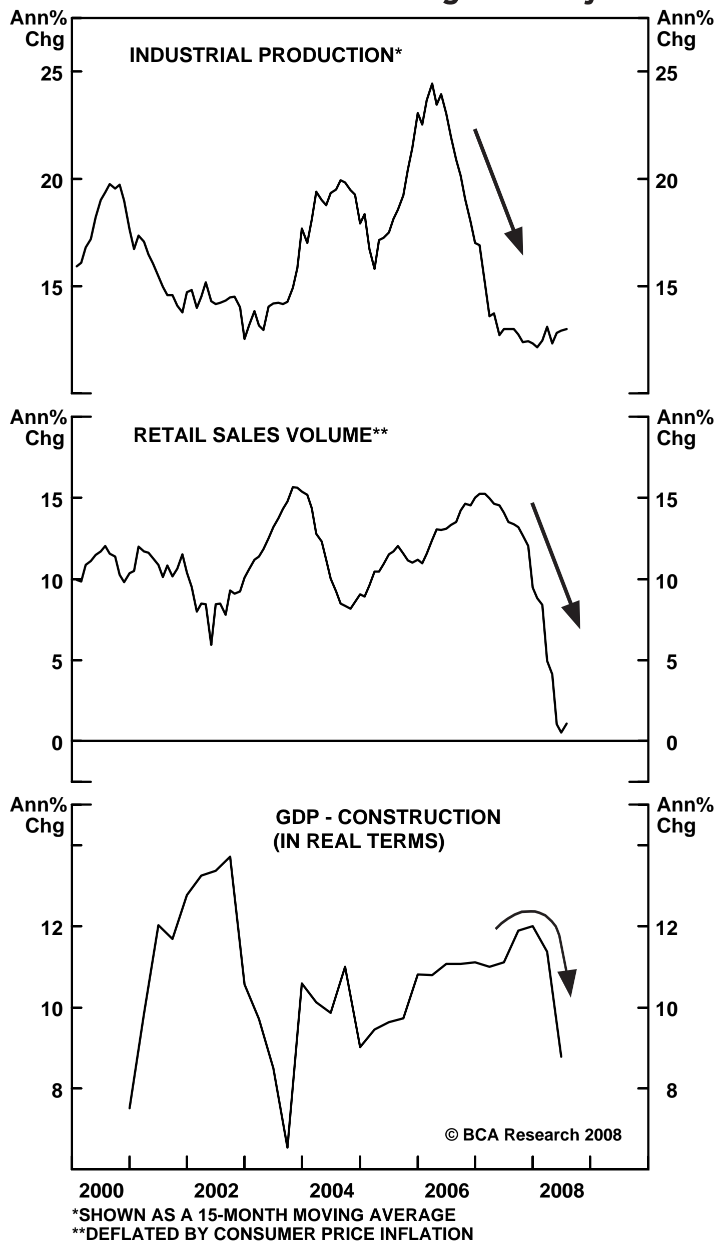


CHART 14
Vietnam: Growth Is Slowing Markedly



in the banking system and a developing growth slump in the economy (**Chart 14**).

In fact, the case for lower interest rates is building, because of the worsening in cyclical growth conditions and moderation in inflationary pressures (**Chart 15**). Notably, this week the government resorted to administrative measures to control inflation by ordering the largest state companies not to raise prices.

The implication is that, given the rapidly developing growth slump, the authorities are reluctant to jack up interest rates further. Borrowing costs for the private sector are already excessive and will have to fall sometime next year.

Policymakers cannot control both monetary variables (the exchange rate and interest rates) at the same time. If their focus shifts from a willingness to prevent the currency from devaluing to minimizing risks to growth, the central bank will have to allow for some currency flexibility (depreciation) to maintain interest rates at current levels and eventually drop borrowing costs.

So far, rising inflation has been a concern and policymakers have been tightening policy by hiking interest rates, supporting the currency and cutting back government spending. Going forward, inflation will roll over and the pace of expansion is already dropping precipitously. This will herald a change in policy to a less-restrictive stance, which

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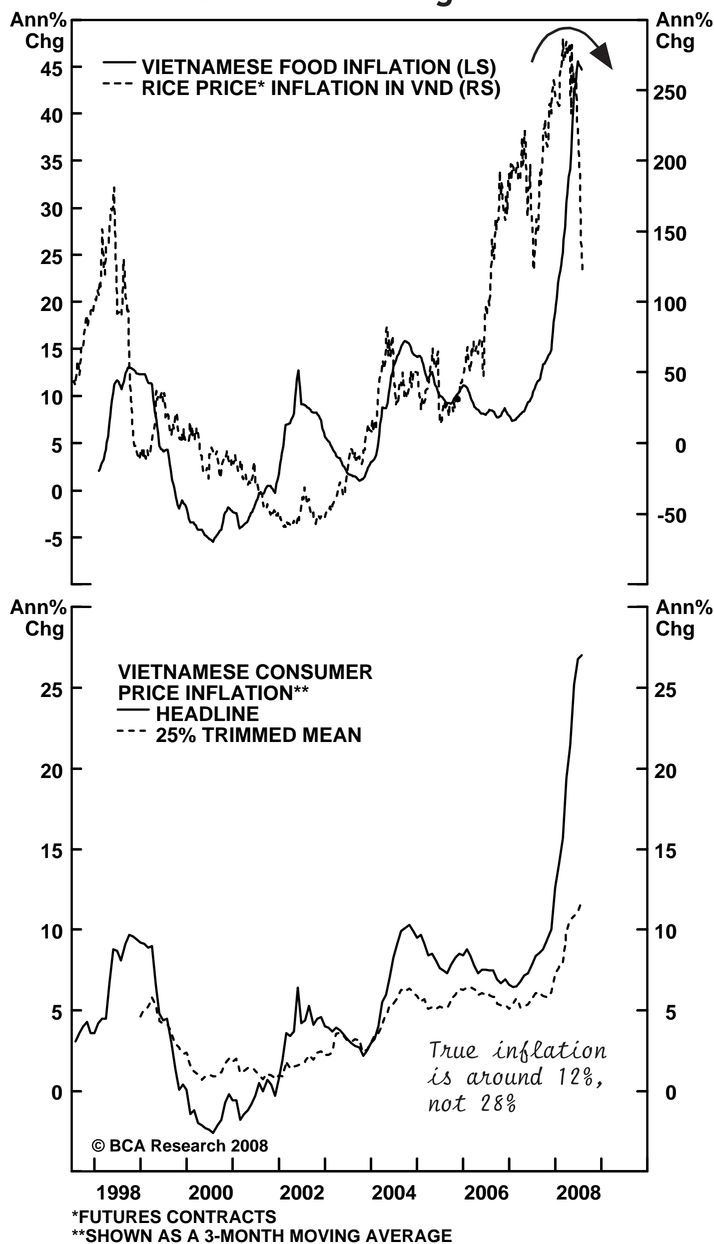

will translate into no further hikes in borrowing costs (and eventual easing next year) and increased tolerance for currency depreciation.

Bottom Line: Moderate currency depreciation (no more than 10%) is likely in Vietnam by the end of this year, given the downward pressure on the currency from the balance-of-payment flows and the need to boost exports at a time of weakness in domestic demand and the global slowdown.

However, the country is competitive in global trade, In general, the odds of a massive currency collapse in a country that has a competitive exchange rate are historically low. Furthermore, lingering and probably further escalating tensions in the banking system will make the Vietnamese authorities less prone to devaluing the currency significantly to avoid a foreign-debt crisis.

Financial Crisis Is Part Of The Learning Curve

Almost all emerging economies (and certainly more than a few developed ones) have undergone similar financial crises at some point in their development. Therefore, investors should not be surprised to see stress in Vietnam's banking system as well as property and equity markets, especially given the lack of financial market culture in this country:

- Private sector credit has risen too far too fast (over ninefold in the past eight years), suggesting that lending practices have been too relaxed and many inexperienced borrowers have obtained credit. Banks were providing credit to equity investors until last December, fuelling the stock market bubble. Consequently, the deflation in equity and property prices will ensure rising delinquencies among borrowers.
- Interest rates have risen by 850 basis points this year, which along with the ensuing growth slump, will also be stressing the banking system via a deterioration in credit portfolios.
- There are 91 banks and about 1000 financial companies operating in the country, many of which have been established only in the last few years. Many lack proper risk management processes and have not experienced economic and financial booms and busts.
- Finally, foreigners' rush to own a piece of Vietnam's growth story has exaggerated the bubbles in the equity and property markets.

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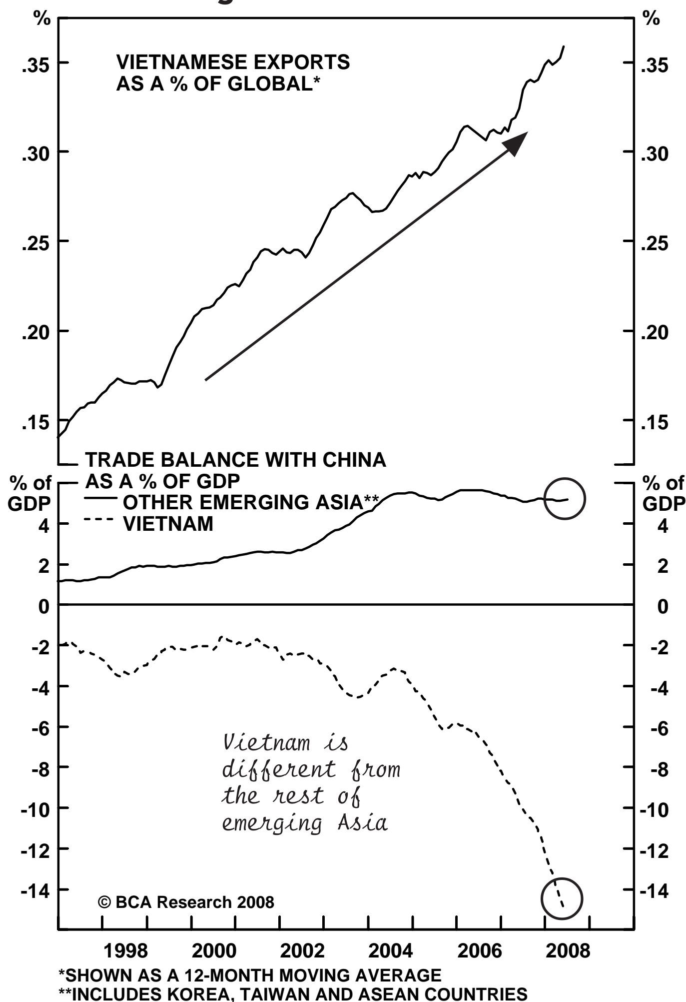
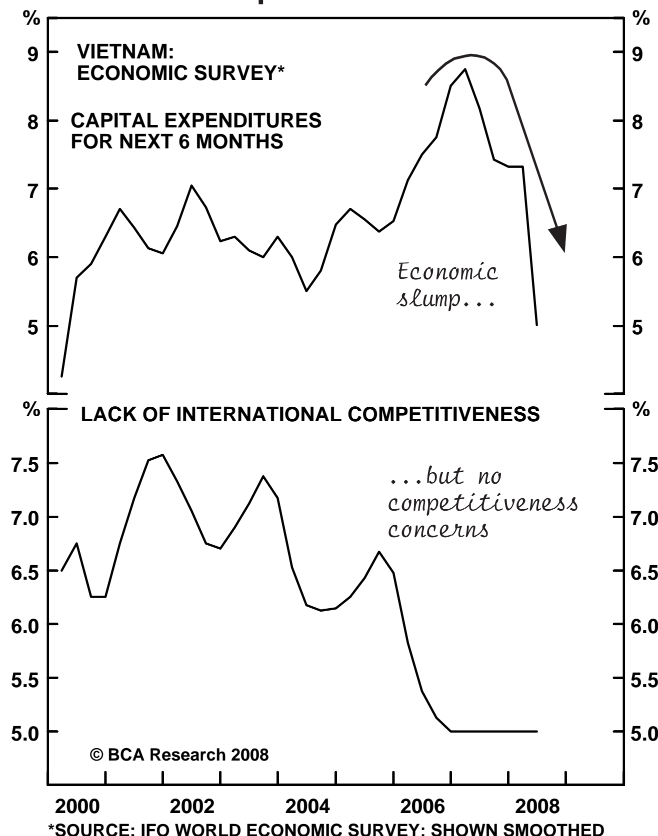
CHART 16
Vietnam: Tiger Of The Future



*SHOWN AS A 12-MONTH MOVING AVERAGE
**INCLUDES KOREA, TAIWAN AND ASEAN COUNTRIES

CHART 17
Economic Slump But No Structural Headwinds



*SOURCE: IFO WORLD ECONOMIC SURVEY; SHOWN SMOOTHED

Bottom Line: Economic and financial excesses of the past several years in Vietnam are typical of an emerging market's development process. They are the outcome of years of strong growth and low borrowing costs. In fact, investors should view them as part of the learning curve that almost all nations usually go through in their development process, rather than problems unique to Vietnam.

Structurally Bullish

It is too early to get bullish on Vietnam's cyclical growth outlook, but investors should keep the long-term trend in perspective:

- Vietnam is undergoing rapid industrialization. Its competitive edge allows it to attract FDI, boost productivity/efficiency and gain market share in global trade (**Chart 16**).
- The country is quickly replacing China as the lowest-cost producer for various products. While China has, for years, been the sole country that has run trade deficits with other Asian economies, Vietnam is the only emerging Asian country that runs a trade deficit with China (**Chart 16**, bottom panel).

  This is due to the fact that Chinese companies, or foreign businesses operating in China, are outsourcing some parts of production to Vietnam, just as others in Asia in the past were outsourcing to China. This is a confirmation of Vietnam's competitive edge.
- The decline in Vietnam's manufacturing investment in response to the authorities' tightening measures will prove to be temporary, not structural. **Chart 17** shows that, while capital

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CHART 18
Vietnam Is Structurally Better Placed Than China

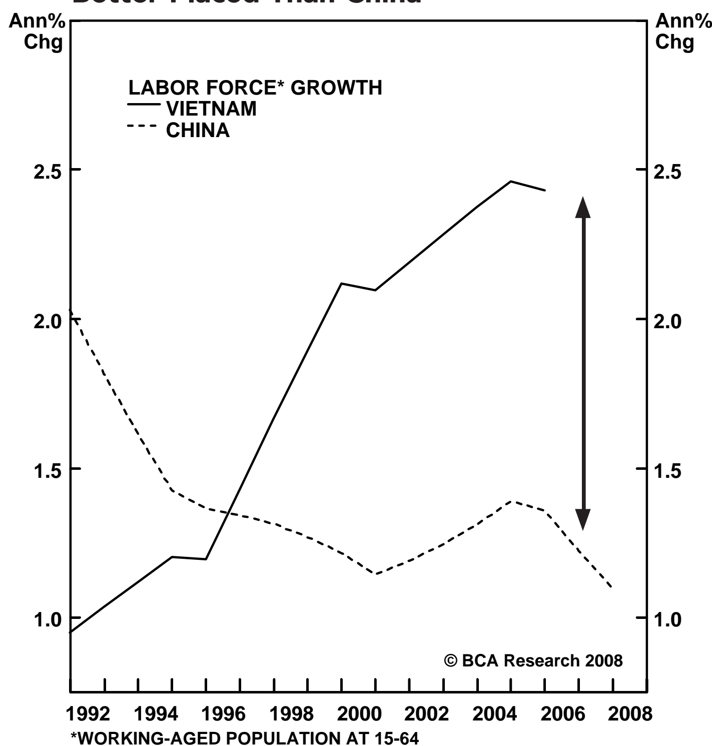
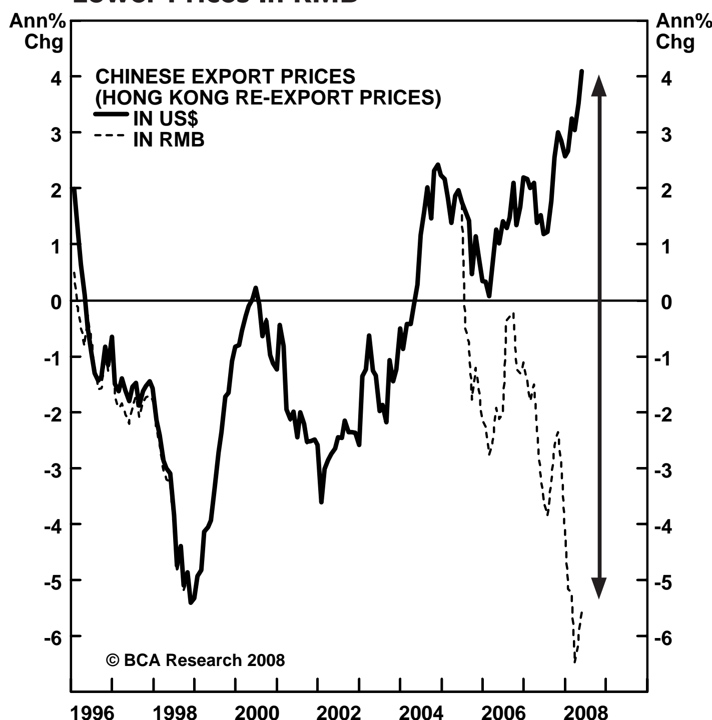


CHART 19
Chinese Exporters Are Getting Lower Prices In RMB



spending plans have been curtailed, the assessment of Vietnamese competitiveness has not been altered.

- This nation has a very competitive labor force, given its high literacy rate and work discipline. In addition, Vietnam is a much smaller country than China, which makes regulating and managing the economy much easier.
- The growth/inflation mix in Vietnam will stay benign beyond the near run. High investment levels imply rapid productivity gains and relatively low inflation by Vietnamese standards. The current inflation outbreak is cyclical, not structural.
- Finally, **Chart 18** highlights that the working age population is growing faster in Vietnam than in China. This implies that potential GDP growth, which is the sum of labor force growth and productivity gains, will stay high in Vietnam.

Bottom Line: Deflation in Vietnam's equity and property markets should not cast a pall on the country's strong long-term growth potential.

Competitive Devaluation Revisited

Vietnamese currency depreciation will make China and other Asian exporters less competitive in relative terms. In turn, this will make policymakers in other Asian countries including China reluctant to tolerate further significant currency strength.

Notably, the appreciation in the Chinese RMB has led to a contraction in China's export prices in local currency terms (**Chart 19**).

In the midst of increasing stress among exporters stemming from a profit margin squeeze, the Chinese authorities have already begun to support certain groups of exporters by increasing value-added rebates and easing loan quotas for small and medium-sized businesses.

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CHART 20
Vietnamese Stocks: A Long-Term Perspective

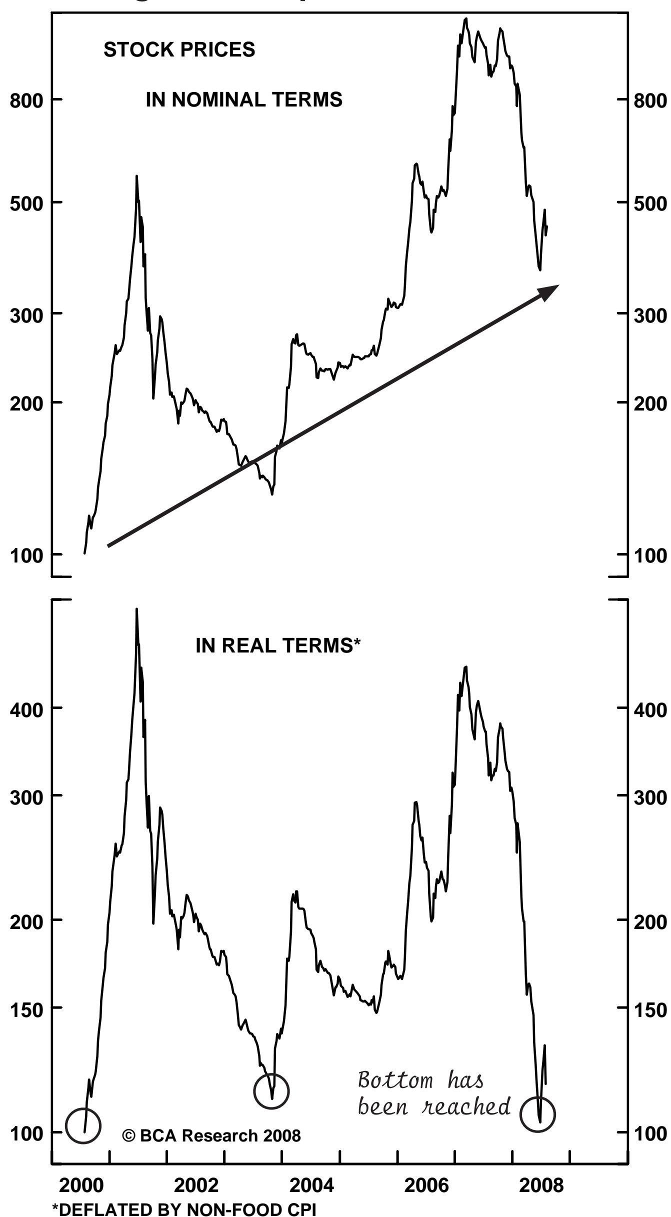
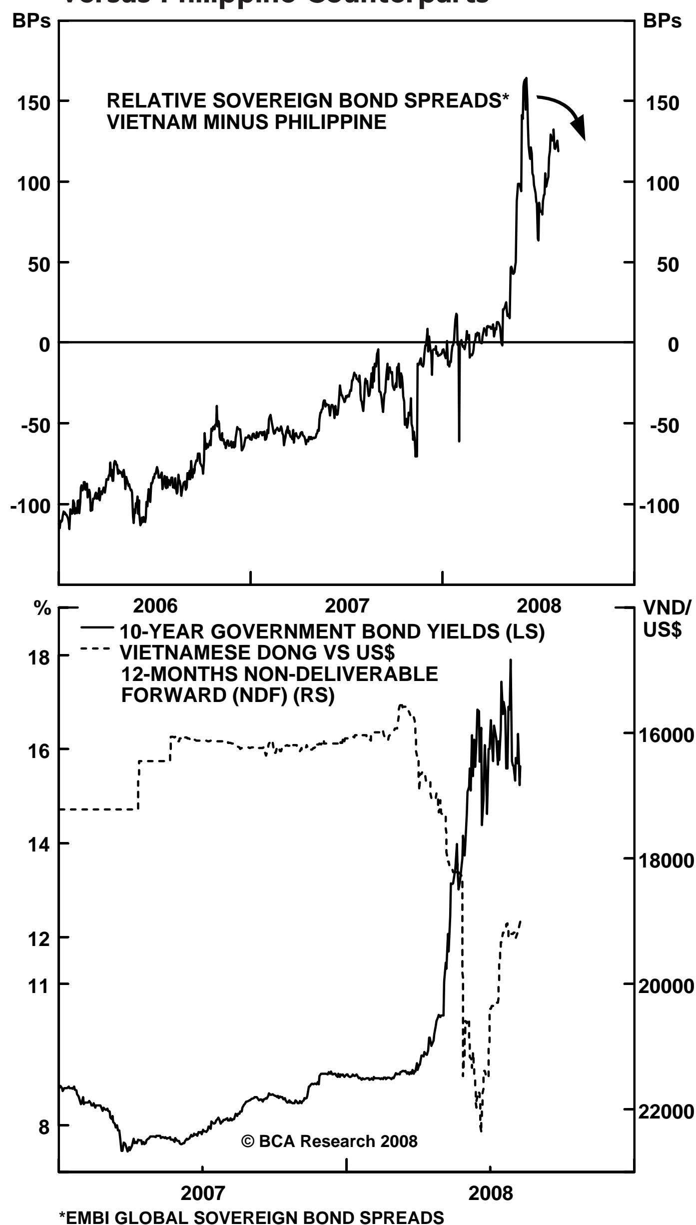


CHART 21
Buy Vietnamese Sovereign Spreads Versus Philippine Counterparts



Bottom Line: A depreciation in the Vietnamese dong holds the potential to cap/limit the upside in emerging Asian currencies including the Chinese RMB.

Investment Conclusions

- Asset allocators and investors with a longer time horizon and higher tolerance for volatility should consider accumulating Vietnamese stocks on weakness. P/E and price-to-book ratios have fallen to 15 and 3.8 respectively, while the dividend yield is at 2.9%. Although profits could contract cyclically, foreigners' desire to own a piece of a true long-term growth story, which Vietnam promises, will mitigate the downside (**Chart 20**).
- Among stocks, exporters should initially do better because domestic demand will stay weak for a while, and banking system stress is possible. Exporters are poised to benefit from moderate

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currency depreciation and from the country's competitive position globally.

- Go long Vietnamese sovereign spreads versus their Philippine counterparts (**Chart 21**). There is minimal sovereign credit default risk in Vietnam, while the Philippines is a structural underperformer with fiscal position among the weakest in emerging Asia.
- Bond yields offer value at current levels; however, only a sustainable bottom in the currency market will trigger a marked decline in yields (**Chart 21**, bottom panel).
- Finally, the Vietnamese dong's depreciation will limit the upside in other emerging Asian currencies, including the Chinese yuan.

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