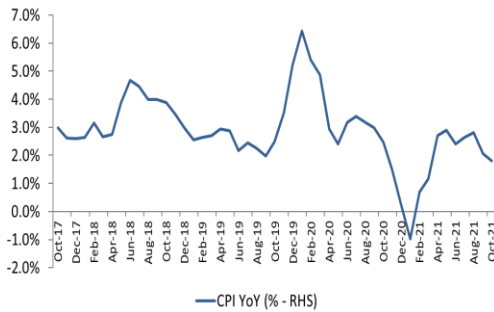
Vietnam Macro: Inflation

4 November 2021



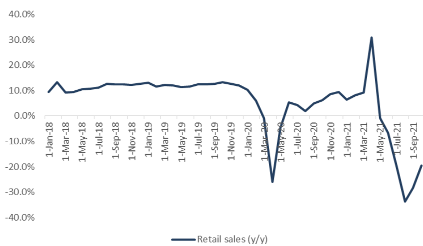
What's new?

- Consumer inflation is tame, as food and housing costs have declined.
- Producer prices have increased sharply, in line with global trends.
- Retail spending has collapsed due to lockdowns, not because of inflation.
- C.70% of bank loans are to COVID-impacted borrowers, whose loan rates have been slashed.

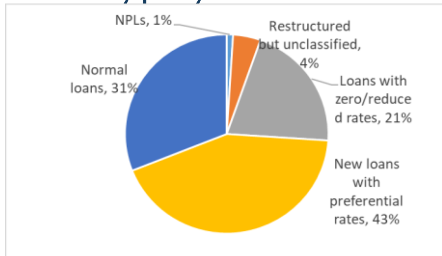
Our View

- Global inflation is not a problem that Vietnam monetary policy can solve.
- Global inflation has not impacted Vietnam CPI yet, but it will eventually.
- Further VND appreciate is the most likely offset – not a hike in interest rates.
- Our sense is that manufacturers are successfully handing increased input prices by passing the costs on to downstream buyers.

Domestic demand is still very weak…



…and debt sustainability requires loose monetary policy in the medium term.



Continued VND appreciation is the more likely offset to cost-push inflation.

Sources: GSO, SBV, various domestic media (for bank data), Bloomberg, Yuanta Vietnam

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Inflation risks appear limited for now

Global inflation represents substantial risk to asset prices and the rather extreme policies of global central banks over the past 12 years. Vietnam's linkages to global trade mean that manufacturers are highly exposed but able to pass the costs on to downstream buyers.

But the problem is not Vietnam's to solve. Concerns about imminent policy tightening by the monetary authorities are unwarranted, in our view, given that 1) domestic CPI remains subdued, 2) retail spending has collapsed, 3) COVID-impacted borrowers require the support of low rates to avert a crisis, and 4) even if the SBV ignored the preceding factors (which it won't), monetary tightening would have zero impact on global commodities pricing. We think VND appreciation is the more likely path.

Inflation has not set in to domestic consumer prices. CPI increased by just +1.8% YoY in October; this result is down from the YTD peak of +2.8% in August. This reflects YoY declines in prices of food and housing, which together represent 52% of the CPI basket. Transport (9% of the basket) is the only major component to be posting price increases, largely due to increased fuel prices.

The economy needs support, not tightening. Retail spending (-10% YoY in Oct) plummeted during the 3Q21 lockdowns and did not recover as quickly as we thought it would in October. Credit growth has failed to keep pace with the government's plans, and roughly two-thirds of bank assets are COVID-impacted loans that are likely to require regulator-mandated low rates for at least another year.

Cost-push inflation mandates a different response than demand-led inflation. Increasing interest rates in Vietnam would have essentially zero effect on global commodity/energy prices and would exacerbate the logistical frictions for export manufacturing. We think the more rational policy response to global inflation is already on display: a gradual but sustained appreciation of the Vietnam dong. The VND has appreciated 1.52% YTD, and we think it will continue to move higher given the long-term structural macro drivers and the realities of US trade relations. This keeps a lid on prices in VND terms without generating undesirable effects on domestic demand and credit sustainability.

Persistently low rates should boost liquidity flows into risk assets broadly, with currency appreciation as an upside kicker. Among the major sectors, we are positive on residential & industrial property, green energy, and consumer. By contrast, we are neutral on banks.

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Inflation risks appear limited, for now

Global prices are on the rise, and will inevitably impact consumer prices in Vietnam...

Global inflation represents substantial risk to asset prices given the implications for a potential reversal of the highly extreme policies implemented by global central banks since the GFC in 2009.

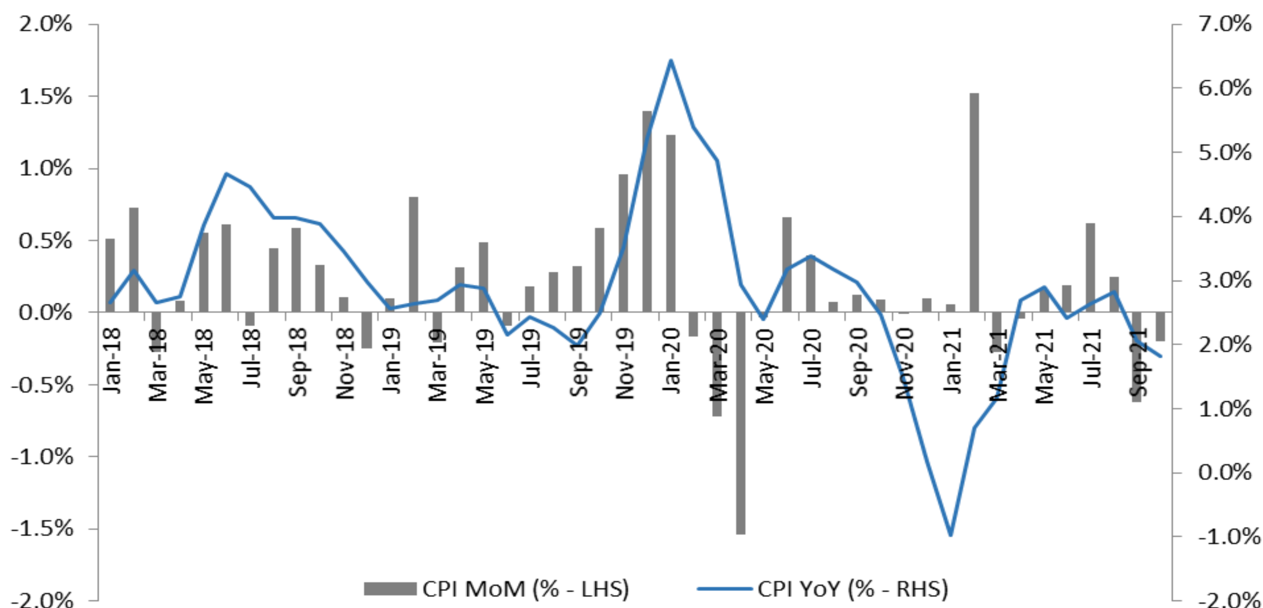
Vietnam's linkages to global trade mean that manufacturers are highly exposed to global inflation. However, most manufacturing is for export markets, and our sense is that makers are broadly able to pass their increased input costs for items such as energy, materials, and components through to their downstream buyers in the form of increased export prices.

Interestingly, global inflation has so far failed to seep through into the official CPI numbers. One can never be certain that the present conditions will continue in the future, and our sense is that increased prices will eventually seep through into higher CPI. However, this has not occurred so far.

… but for now, consumer prices remain subdued.

October CPI slid by -0.2% MoM and rose by +1.8% YoY. Core inflation was even lower at just 0.5% YoY. This is in large part due to the heavy basket weights of food (where prices have contracted after a sharp spike in pork prices last year) and housing (urban rents have come under particular pressure thanks to COVID). In total, three of the 11 items in the CPI baskets recorded MoM declines in October, while most of the other items ticked up only slightly (close to 0%).

Inflation (as measured by CPI) has bucked the global trend



Source: GSO

Nationwide transportation services were resumed in October as social distancing eased, supply constraints have eased, demand for restocking has slowed, and rents have continued trending down. Price levels for the nation as a whole thus declined MoM and rose only marginally YoY in October.

Food and catering services, which account for 36% of the CPI basket, saw the most significant decline of -1.28% MoM as urban food supply recovered after removing the COVID policy-induced transportation bottlenecks.

Housing and building materials, which account for 15.7% of the CPI basket, slid by -0.26% MoM in October as rents declined by -4.7% MoM; electricity prices slid -1% MoM, and water prices declined by -2.5%.

We still believe that CPI faces upside risk going forward as producers will face higher commodity prices once production resumes. Although the implied increase in export pricing should offset higher input costs without affecting domestic inflation directly, increased energy and commodity prices are likely to seep through to domestic prices eventually.

The policy response to cost-push inflation is very unlikely to involve interest rate hikes in the immediate future.

However, any inflationary pressures that do emerge in the months ahead (as Vietnam are unlikely low inflation figures create ample room for accommodative expansionary policies to trigger economic growth (and weak retail spending and the need to ensure the debt sustainability of COVID-impacted borrowers mean that rates will be kept low for the foreseeable future, in our opinion).

Retail consumer has barely staggered back to life after lockdowns were eased in October

The GSO reported October retail sales of VND 357.9tn, +18.1% MoM. This was an impressive recovery, but we expected it to be even stronger than this. Our sense is that the damage done to consumer confidence will take a while to repair; there is no on–off switch for domestic demand.

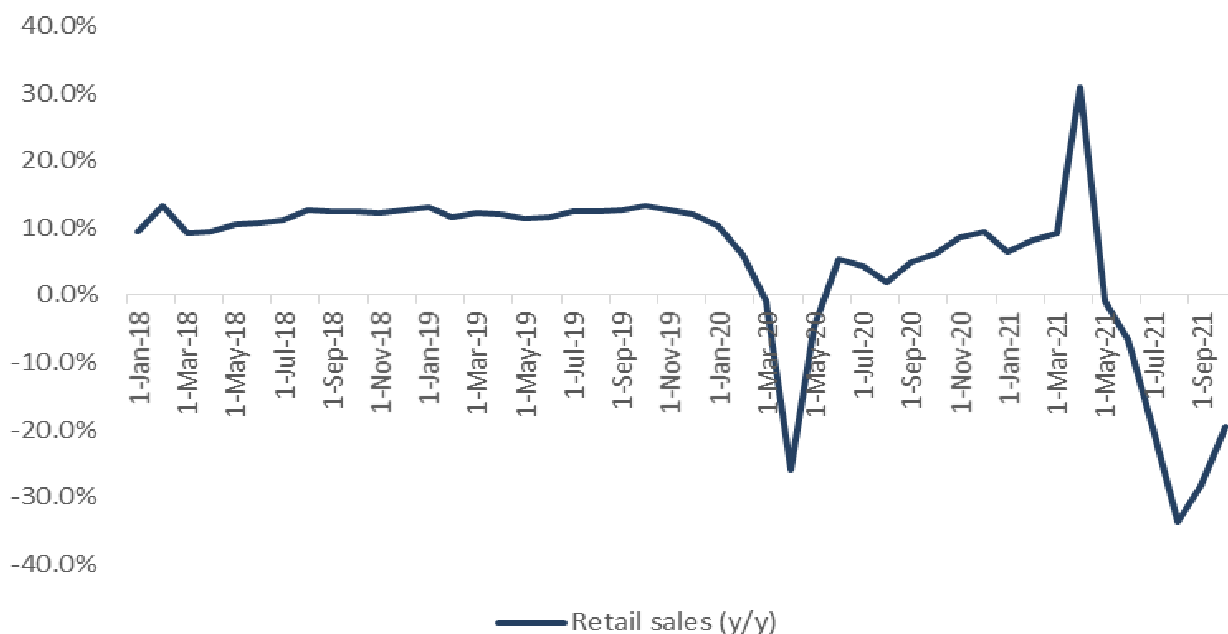
More specifically, retail sales in Octover were still down 19.5% YoY despite the MoM recovery. We believe that the annual declines of the 3Q21 nadir (-33.7% YoY in Aug and -28.4% YoY in Jul) are now history as the lockdowns have been broadly eased, but there is a long road ahead to achieve a full recovery.

Retail consumption has fallen off a cliff, confirming that overheated demand is not an issue…

10M21 retail sales reached VND3,720 trillion, -8.6% YoY (that of 10M2020 declined by -0.2% YoY). Factoring in inflation, real growth in retail spending is estimated at -10.3% YoY in 10M21 vs a decline of -4.5% in 10M20.

HCMC recorded the worst 10M21 retail sales growth of -26.2% YoY, which is clearly due to the pandemic and lockdowns. This was followed by tourism-centric Khanh Hoa province (-18.6% YoY) and Mekong Delta business hub Can Tho (-4.8% YoY).

Retail demand remains in the doldrums



Source: GSO

Loose monetary policy is entirely appropriate given the need to support debt sustainability.

The bank sector's 3Q21 results were not disastrously bad – roughly in line with our expectation of a -16% QoQ decline. However, the QoQ declines in earnings appear to have thrown cold water on the notion that bank profit growth would continue to soar ever higher in 3Q, amid the worst quarterly macroeconomic conditions in at least the past two decades.

The commercial banking sector is first and foremost a macro proxy, so a sharp divergence between economic activity and financial industry profitability would have been a surprise, to us. With the banks' full financial reports posted by Nov 1, sector analyst Tanh Tran will update his quarterly CAMEL framework rankings soon.

… and borrowing costs are likely to remain low as a regulatory mandate to support COVID-impacted borrowers.

Perhaps the sequential weakness is by now baked into expectations, if not yet sell side forecasts, as the listed banks have largely cooled down in terms of share price performance.

From a top-down strategy perspective, we would remain cautious on the sector as a macro call. We have little doubt that the economy bottomed out in 3Q21 and should see a recovery from 4Q21, but a return to the pre-Covid (and lockdown) track will take time.

More specifically, the scale of bank assets deemed to have been affected by COVID is simply enormous, and the affected assets unsurprisingly expanded sharply during the 3Q21 lockdown. Loans classified as NPLs represent roughly 1% of total bank assets, but this obscures the impact of COVID because loans deemed to be impacted by the pandemic are not classified as NPLs.

For example, loans that have been restructured but not classified represent around 4% of total bank assets. If we add these in to the official NPLs, total problematic loans would be 5% of bank assets. This is a problem, but we should emphasize that it does not represent a crisis, and the nonclassified restructured loan amount appears to have flattened, at least in September.

But there is more to the story. Loans that have had interest rates reduced or exempted due to borrower difficulties during the pandemic now represent 21% of assets, and new loans with preferential rates are 43% of system assets. Both of these figures grew markedly in September.

COVID-Impacted loans

	31-Aug-21		30-Sep-21		Change	
	Value (VND bn)	No. of clients (k)	Value (VND bn)	No. of clients (k)	Value	No. of clients
Restructured but unclassified loans	520,000	227	531,000	278	2%	22%
Loans with exempted/reduced rate	1,580,000	1,130	2,500,000	1,700	58%	50%
News loans with preferential rate	4,460,000	629	5,200,000	800	17%	27%
Total impacted loans	**6,560,000**	**1,986**	**8,231,000**	**2,778**	25%	40%
Impacted loans to total system assets* (2Q21)	54%		68%		+14ppt	
Impacted loans to total system equity** (2Q21)	708%		889%		+181ppt	

*This assumes that the 23 listed banks represent 80% of total assets

*This assumes (generously) that non-listed banks have the same 13x assets / equity leverage that the 23 listed banks have.

Source: NDH, thoibaonganhang.vn, thanhnien.vn, tapchitaichinh.vn Yuanta Vietnam

Altogether, this represents more than two-thirds of total bank assets and close to 9x bank equity.

This represents a substantial asset quality issue that is not reflected in the official NPL data (or, for that matter, the banks' loan loss reserve coverage ratios). The need to support borrowers' debt sustainability means that interest rate increases ahead of any inflationary pressures (which, again, have not yet impacted CPI) are both inappropriate and extremely unlikely to occur.

This large-scale forbearance is quite reasonable in the current environment, but that doesn't mean it will have no effect on the commercial banks. We believe that provisioning should increase going forward to reflect the reality that not all of these loans will be repaid. Additionally, declining yields on renegotiated loan terms have been partially offset by reduced deposit rates, but the extent of NIM support is likely to be limited, especially as banks seek to increase their longer-term stable funding.

The silver lining? Bank deposit rates are likely to remain lower for longer as banks require cheap funding to offset the yield impact of the lower-rate loans to COVID-impacted borrowers. We see bank deposits as the de-facto risk free rate for Vietnamese investors; so the relatively unattractive deposit rates are likely to boost inflows into risk assets, including stocks, in the years ahead.

VND appreciation is the most likely tool to offset cost-push inflation

This suggests that rates will stay lower for longer, and that VND appreciation is the more appropriate tool to offset imported inflation.

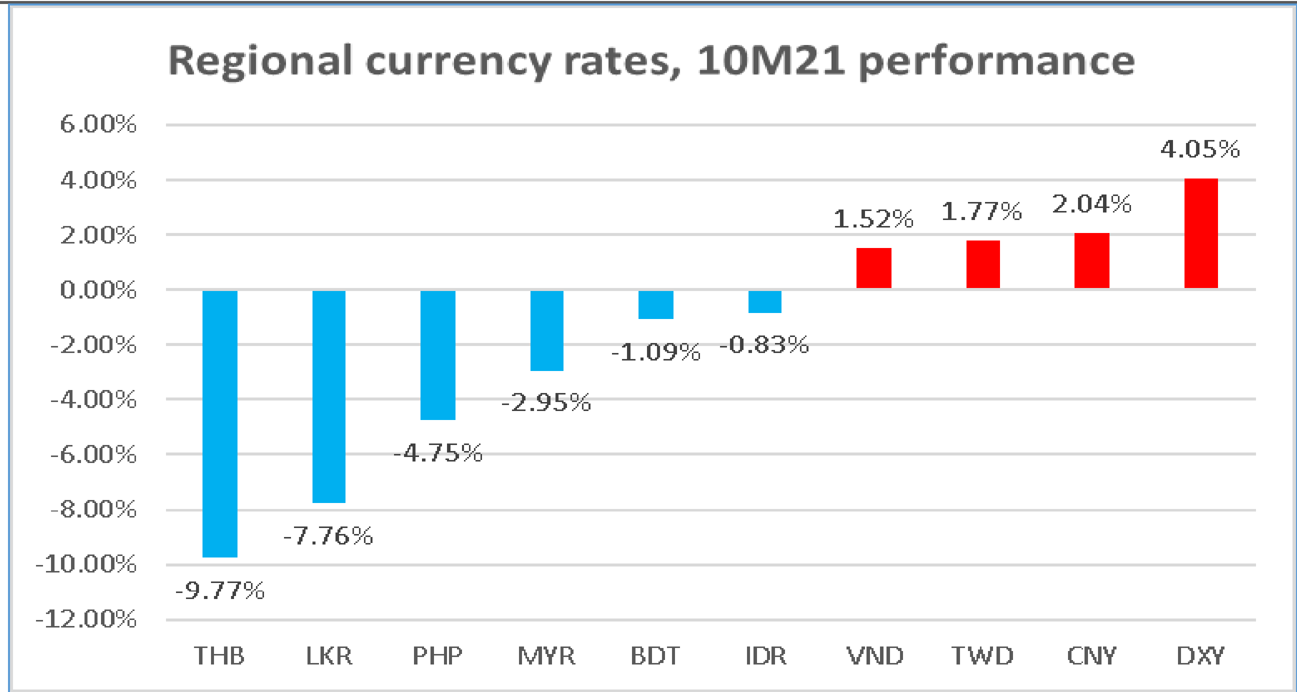
Monetary tightening by interest rate increases in Vietnam would have essentially zero effect on global commodity/energy prices.

So even if the SBV were to ignore the abysmal retail spending figures and enormous bank system implications (which it most definitely won't do, in our opinion), tightening purely through interest rates and other financial liquidity mechanisms would not help to offset cost-push inflation when it eventually seeps into Vietnam's CPI.

Indeed, tightening monetary conditions would only exacerbate the frictions for manufacturers, the majority of whom are exporters who are in a strong position to transfer increased input costs to their downstream buyers in the form of higher export prices.

However, this is not to argue that the SBV can ignore (or is ignoring) the issue of inflation. Indeed, we think that the rational policy response to global inflation is already on display in the form of the gradual but sustained appreciation of the Vietnam dong, which has increased by 1.52% against a resurgent US dollar in 10M21.

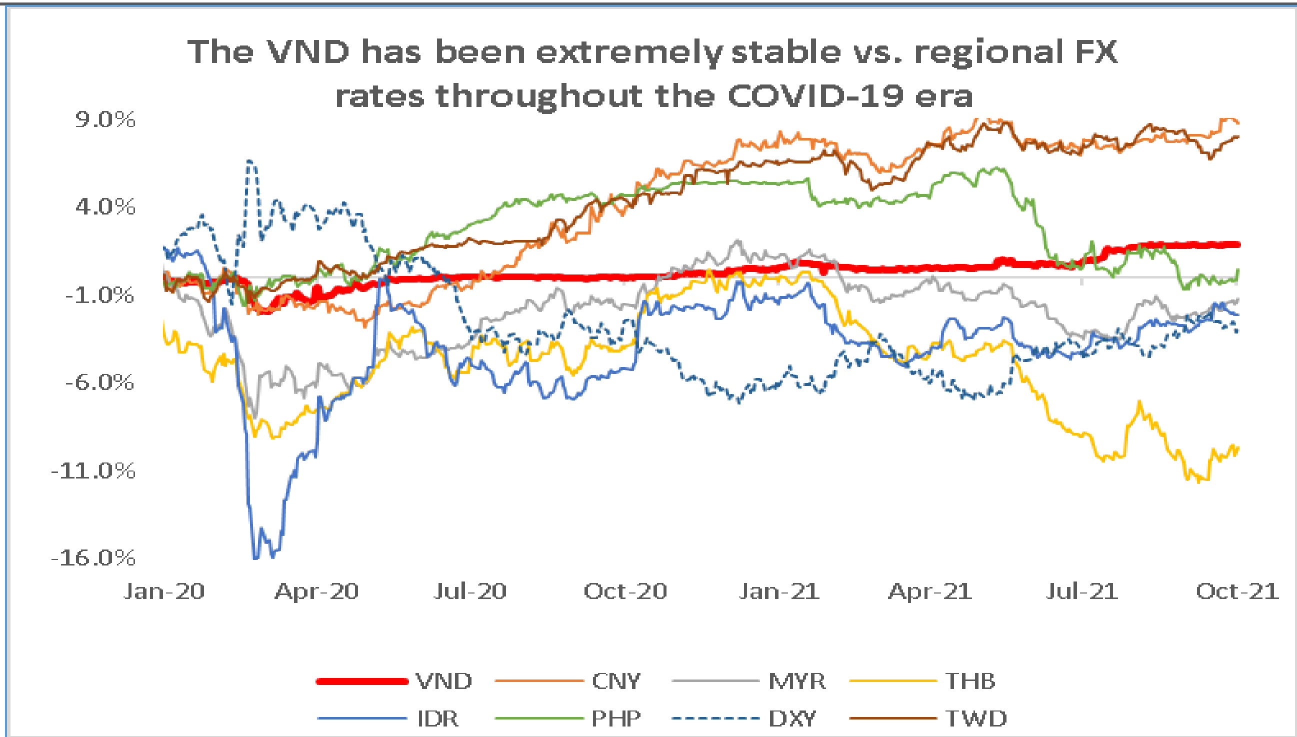
The Vietnamese dong has appreciated by 1.52% YTD against a relatively strong US dollar



Source: Bloomberg (updated to end-October)

Much of the YTD dong appreciation has occurred since July, which is in line with the gradual adoption by global policymakers of the view that what the Fed was hoping would be "transitory" inflation might actually be with us for the medium to long term.

The VND (red line) is highly stable. We continue to expect annual appreciation of 1-2ppt going forward.



Source: Bloomberg (updated to end-October)

From the SBV's perspective, dong appreciation is another form of tightening that is a far more effective tool than raising interest rates in the face of cost-push inflation. A stronger currency helps to cap price increases in VND terms, and it doesn't directly generate undesirable effects on domestic demand or credit sustainability.

As for the impact on labor competitiveness, we tend to doubt that a few percentage points will move the dial for global exporters. Their cost and revenue structure are currently far more sensitive to their ability to retain staff and overcome logistical bottlenecks, issues that are likely to be far more critical than currency impacts on labor costs in the medium term.

Moreover, allowing the currency to appreciate is also an offset to geopolitical pressure; the Biden administration appears to have taken a far more conciliatory tone and has removed Vietnam from the list of currency manipulators. However, US trade relations remain a critical issue and the slow but steady appreciation should help to ease future pressures on this front.

We understand that some clients view the VND as an unstable currency after experiencing the sharp devaluations of 2008-12. However, the times have changed: the central bank has managed the banking system and the overall economy for stability with policies in place since 2014. The credit bubble of the early 2000s has not been repeated, there is no sign of overheated domestic demand, inflation is still extremely low, and FX reserves are more than sufficient to sustain imports for the domestic sector.

Although global trade disruptions and Vietnam's specific lockdowns could result in a trade deficit in 2021, we see this as a one-off. We believe that the current account balance should return to a structural surplus in 2022 after this year's COVID-related disruptions are history.

For further details of our overall positive view on the Vietnamese dong, please see our macro outlook report of March 2021 titled "VND's resilience is set to persist".

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