

Why Vietnam's economy is in need of cooling down

Vietnam remains the poster child for the China Plus One investment trend, but it may need some dampening policy measures to cool the economy



Things are heating up for the Vietnamese economy. Could squeezing growth to cool off inflation be a worthwhile trade-off? We think so

4.4

May CPI inflation YoY%

Target rate of 4.5%

As expected

The FDI story still looks good - but strains are emerging

Foreign Direct Investment (FDI) data is some of the economics profession's most disreputable. The term evokes the notion of sticky and reliable capital flows, investing in productive capacity and boosting the efficiency and productivity of local enterprises. And there is considerable empirical support for this.

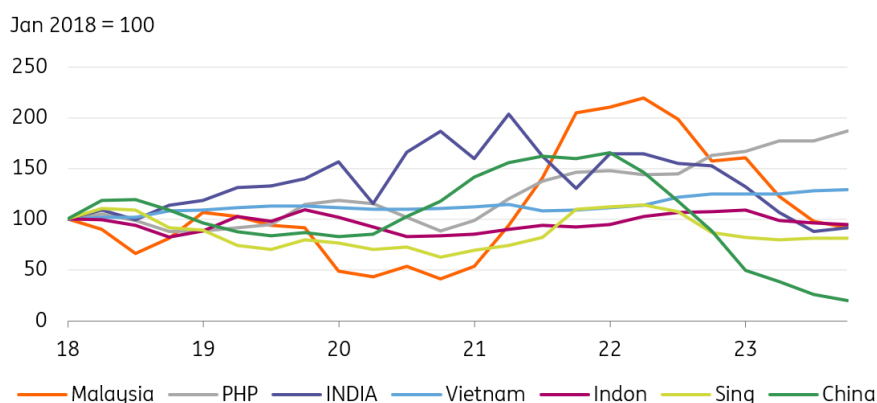
However, this data – typically expressed in net terms – encompasses retained earnings,

intracompany transfers, and equity flows. Little of this may result in any new capacity. Though arguably, shifts in the nature of corporate ownership could be a positive factor.

Southeast Asia, and in particular the Association of Southeast Asian Nations (ASEAN), has seen its share of global FDI increase in recent years, [according to the ASEAN's own research](#). And within the ASEAN region, Vietnam has become synonymous with the China Plus One concept, whereby international investors (and even some Chinese companies) have sought to diversify the risk of their manufacturing supply chains while not losing access to the region's largest market.

While such investment is generally a very positive development, boosting the supply of quality jobs and improving living standards, there are some signs of strain beginning to emerge.

FDI inflows remain better than most of its ASEAN peers



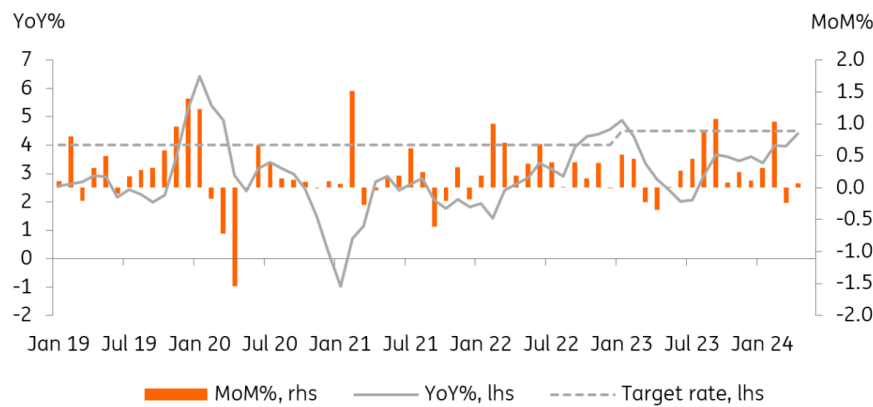
Source: CEIC, ING

Inflation data looks like it needs a policy response

These strains are most obvious in rising rates of inflation. Vietnam's central bank has an inflation target of 4.5%. At 4.4% in May, inflation is right up against that target and trending higher. Like many economies in the region, higher food prices (mainly reflecting supply issues) have contributed to the increase in prices. But the larger portion of the increase has come from increased service prices. And that mainly reflects higher domestic demand. May retail sales, for example, accelerated to a 9.5% year-on-year rate.

Vietnam's policy refinancing rate is currently 4.5%, which suggests a very low realised real rate compared to the inflation rate. With inflation already knocking on the government's target rate, you might expect that a hike in policy rates would only be a matter of time – and that may well be the case. The State Bank Of Vietnam hiked the overnight reverse repo rate recently in what may be a precursor to policy rate hikes. Some drop in domestic confidence in the Vietnamese dong may also be reflected in high domestic gold prices above international prices. And a rise in rates may help to assuage this, as too might recent official gold sales to local banks. However, there are several other issues to consider that wouldn't make a response with higher rates totally without repercussions.

Inflation is right up against the target



Source: CEIC, ING

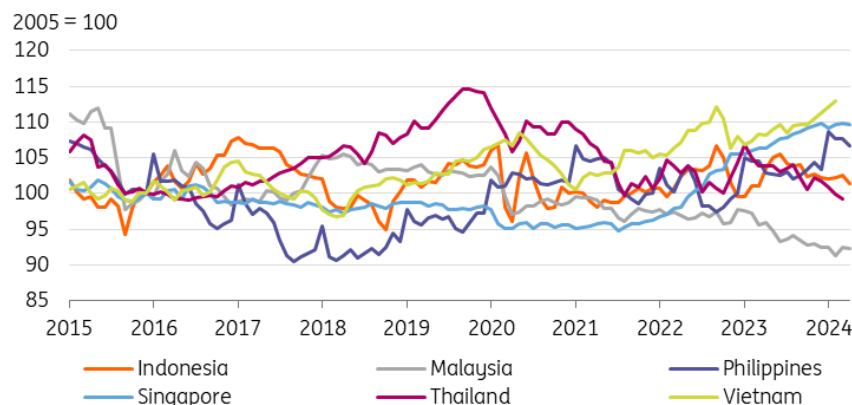
Competitiveness is eroding

One of these issues is that non-performing bank loans have been rising steadily over the last year, and any further increase in rates may push that in an unwelcome direction.

An increase in policy rates may also cause the VND to appreciate. That might not sound too alarming, with the VND down by more than 4.5% year-to-date. But this is less than most of the other currencies in Southeast Asia, and Vietnam's competitiveness has been steadily eroded over the last few years by inflation above that of its trading partners. Vietnam's competitiveness, as measured by its real effective exchange rate (REER), now looks to be a regional outlier. It is perhaps not surprising that the trade balance in May registered a deficit.

A staged devaluation could be one way to resolve this, bringing the nominal exchange rate back in line with other regional currencies. But doing so would almost certainly make the inflation problem worse at a time when the VND is already under pressure to weaken. Such a depreciation seems unlikely.

SE Asian Real Effective Exchange rates (REER)



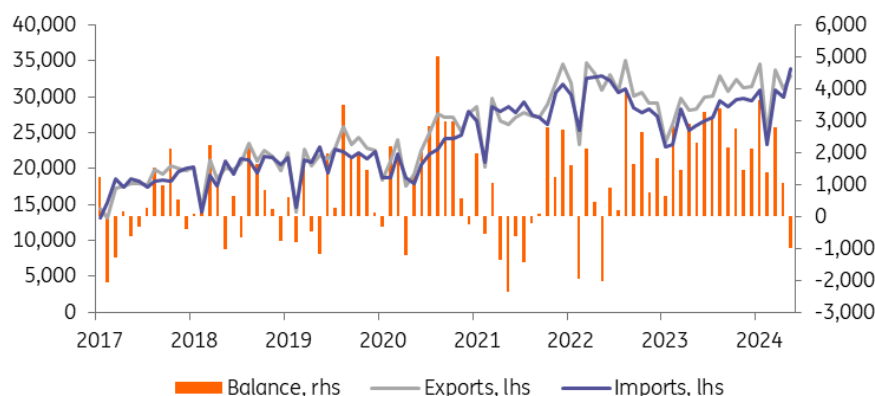
Source: CEIC, ING

Squeezing growth to bring down inflation is a worthwhile trade-off

A roundabout way of bringing about the same outcome might be a more direct curb on credit growth, which might have fewer exchange rate ramifications while still helping to squeeze out inflation. This would most likely also weigh on economic growth. This is something that Vietnam can afford to allow. With the consensus forecast for 2024 GDP growth of 6.0%, this is one of the highest growth rates in the region and is projected to rise to 6.5% in 2025. Shedding half a per cent or thereabouts of GDP growth to bring it back to a more sustainable footing is an affordable trade-off when growth is not the main issue.

Vietnam remains an attractive investment destination, with decent infrastructure and a young and well-educated workforce. The authorities have some work to do in the short term, either with higher rates or other dampening measures. A slightly slower pace of growth should be considered a worthwhile price to pay to maintain that attractiveness in the longer term.

Vietnam's trade balance (USDm)



Source: CEIC, ING

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