KB Securities

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VIETNAM MACRO - ECONOMIC OVERVIEW 4Q2018 AND OUTLOOK 2019

STABLE MACRO, SUSTAINABLE GROWTH

GDP: GDP in 2018 grew by 7.08% thanks to significant contribution from processing and manufacturing industries. GDP growth is expected to gain 6.6 – 6.8% in 2019.

Inflation: Average headline CPI in 2018 was 3.54% due to the pressure of climing prices of oil, healthcare services and food. 2019 CPI is forecast to be around 3.8 – 4.0%.

Monetary policy: M2 and credit growth in 2018 dropped due to the SBV's prudent monetary policy. In 2019, monetary policy continues to manage prudently, M2 and credit growth are supposed to be 11- 13% and 13 - 15% respectively.

Exchange rates: VND depreciated by 2.4% in 2018 because of external factors. In 2019, VND could depreciate by 2.3 - 2.5%.

VIETNAM MACRO ECONOMIC OUTLOOK 4Q.2018

RISKS AND OPPORTUNITIES

CONTENT

Table 1: Key Vietnam macro indicators

	Unit	2015	2016	2017	2018	2019F
GDP growth	%YoY	6.68	6.21	6.81	7.08	6.6 – 6.8
Average CPI	%YoY	0.62	2.67	3.52	3.54	3.8 - 4.0
Credit growth	%YoY	17.3	18.3	18.2	13.30	13 – 15
M2 growth	%YoY	16.2	18.4	16.9	11.34	11 - 13
10-year government bond yield	%	7.1	5.4	5.2	5.1	5.2
Export growth	%YoY	7.9	9.0	21.2	13.8	10 – 12
Import growth	%YoY	12	5.2	20.8	11.5	12
Average interbank interest rate	USDVND	22,485	22,761	22,698	23,240	23,820

Source: SBV, GSO, KBSV

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GDP GROWTH

❖ GDP growth rate in 2018 displayed prospective

In 2018, Vietnam's economy has achieved the highest growth speed since 2008 thanks to the performance of manufacturing sector. In addition, agriculture – forestry and fishing recovered in this year. According to the General Statistics Office of Vietnam (GSO), in 2018, GDP was estimated to increase by 7.08% YoY, which was the highest level since 2008.

In 2018, industry and construction sector had the largest contribution in GDP growth (48.7%). In particular, industrial and construction sector expanded by 8.85% YoY, which was higher than that in 2017 (7.17%). However, there was a significant change in this area when the growth of electronic devices manufacturing slowed down to make place for other industries such as coke and refined oil manufacturing (up by 65.5% YoY as Nghi Son Petrochemical Refinery has started operating in May 2018); automobile and medicine industries (up by 16.8% and 20% YoY respectively).

Processing and manufacturing sector was the main driver for economic growth, but the pace was slowed down

Processing - manufacturing industry was still the main lever of economic growth with an increase of 12.98% YoY, and also had the largest proportion in GDP structure (16.02%). However, on a quarterly basis, there was a slowdown in this industry growth since 4Q 2017 due to the deceleration of electronic devices manufacturing industry (Figure 2).

Construction saw improvement due to the disbursement of public capital

Improvement was seen in construction industry this year, especially in 3Q and 4Q (due to the aceleration in disbursement of public investment capital), the total growth of the whole year was 9.16% YoY (8.70% in 2017).

Mining industry was still in a downturn

Mining industry recored a negative growth (-3.11% YoY), but less severe than the figure in the same period in 2017 (-7.1%). The production of crude oil decreased by 11.3% to 12 million of tons, the lowest in many years. Compensating for the decline of crude oil, coal and aluminum mining and liquefied gas witnessed positive growth (reached 9.1%; 23.3%; 29.8% respectively).

Figure 1: GDP growth by quarters

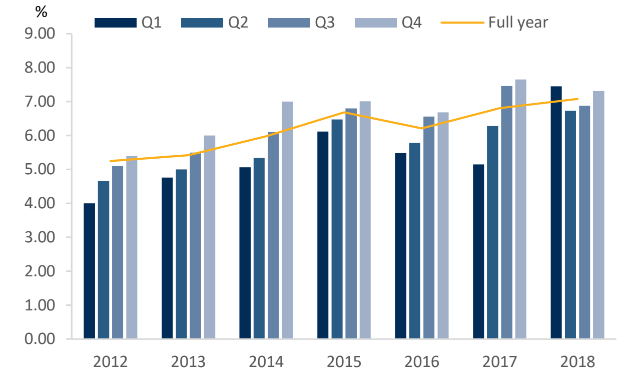
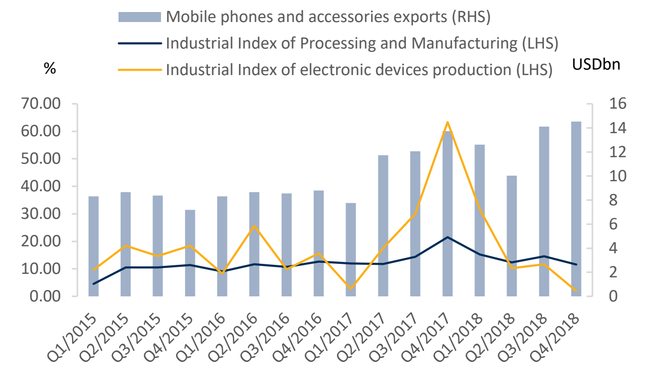


Figure 2: IIP and mobile and components exports



Source: GSO, KBSV

Source: GSO, Vietnam Customs, KBSV

PMI stayed above 50 – positive signal for exportation

Vietnam PMI experienced positive moves in 2018, reaching the highest level in the past 7 years in November. PMI stayed above 50 points in the last 37 months (Figure 3), contrary to the downtrend of PMI in countries in the region (the average PMI of Asian emerging countries in November tumbled to the lowest in 24 months).

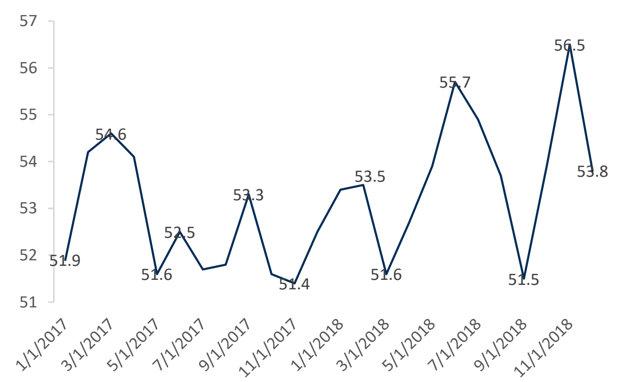
The growth of all sectors in service industry maintained stable

Service sector in 2018 saw a fairly good growth as consumption increased, grew by 7.03%, lower than 7.44% in 2017, but higher than that in 2012-2016. Within sectors, wholesale and retail growth rate increased by 8.51% YoY, which was the highest growth in this region.

Agriculture – Forestry – Fishing was in rebounding phase due to the stimulation of export

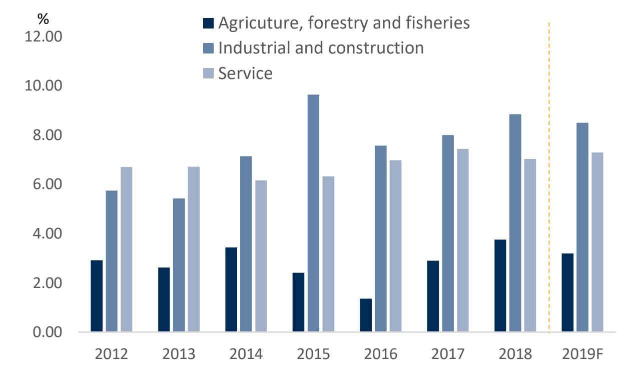
Agriculture – Forestry – Fishing growth has its best performance since 2012, reaching 3.76% YoY thanks to expanding export markets and favorable weather conditions in 2018. Particularly, the agriculture sector rebounded and increased by 2.89%, fishing signigicantly rose by 6.46%, forestry climbed by 6.01%.

Figure 3: PMI of Vietnam



Source: HSBC, Nikkei, KBSV

Figure 4: GDP growth by sector



Source: STOCK MARKET, KBSV

❖ **GDP in 2019 is forecast to have a small dip compared to that in 2018**

GDP outlook of Vietnam may follow the uptrend in 2018 despite a slowdown, maintain at **6.6 – 6.8%** in 2019. The economic cycle has been in a recovery since 2013, GDP growth is believed to experience the same moves in 2018 with a boost in 1Q. GDP growth by sectors is demonstrated in Figure 4.

❖ **Factors may boost GDP growth**

Despite having a slowdown, manufacturing and processing sector is still the main supportive factor to the economic growth

In 2019, industry sector continue to be the key supportive factor for the economy. However, after a surge in 2017-2018, the growth of processing and manufacturing industries will likely slow down in 2019. FDI region, including Samsung, Formosa, Nghi Son Petrochemical Refinery still strongly supports processing and manufacturing.

To be more specific, in 2019, we forecast Samsung Vietnam's revenue will have a growth rate of 5 – 10%. At the end of 1Q/2019, Samsung expects to launch 5 key mobile phone products with outstanding features (foldable screen, available 5G,...), which will strongly support GDP as in 1Q/2018. In addition, Samsung Displays factory has fully operated in Vietnam and expect to have a more dramatic growth as Samsung is the biggest distributor of OLED displays in the world, and the main provider of other mobile brands such as Apple and Pixel of Google... Besides, Samsung smartphone factory in Tiajin, China was closed last 2018, so Samsung will probably expand other factories in Vietnam.

Meanwhile, Nghi Son Petrochemical Refinery has been officially commercially operated in November 2018, with the production up to 200,000 crude oil barrels/day, equal to 10 billion tons/year, which will make a large contribution to the refined oil processing industry.

FTAs help to expand export market and attract foreign investment capital flow

The attractiveness of FTAs recently signed by Vietnam, especially CT-TPP and soon to be signed EVFTA will help Vietnam to expand the export market and attract a huge FDI flow. Trade and investment are expected to benefit from these FTAs. However, trade agreements have adverse impacts on fiscal policies and state budget collection and expenditure.

Key public investment projects are stimulated

2019 is an important year in the 2016-2020 public investment plans from the government, when many key projects will be stimulated by the Government such as Hanoi Urban Railway, Metro Ho Chi Minh... to support GDP growth, but also put some pressures on the State budget. According to the latest data from the Government, due to the slow progress of allocating and assigning capitals in 2016-2018, the pressure for balancing capital resources in the next 2 years is very high. This capital source, according to our assessment, will partly be supplemented by equalization and divestment of large SOEs (Agribank, VNPT, Petrolimex, Viglacera...).

Monetary policy is still loosening in 2019

With the forecast of under control inflation and exchange rate in 2019 (See more in Interest rate and exchange rate parts), SBV will have more room to loosen its policy 2019 compared to that in 2018, inferred from credit growth (expected to be 13%-15%), M2 money supply growth (about 11%-13%).

Nevertheless, we have noted that SBV monetary policy in recent years have been more flexible, and aimed at inflation curb and macro stabilization. Therefore, in case of unusual factors appearing to affect inflation, SBV may quickly return to tightening monetary policy. At the present, we believe this risk is not great.

❖ **Risks which may affect GDP**

A slowdown in global trade growth in 2019

Global trade growth will be corrected down to 3.7% in 2019 (estimated at 3.9% in 2018), according to calculations from the WTO, which may affect the production output, and lead to a slowdown in processing and manufacturing growth rate.

In the long term, the trade war will adversely affect the economy

The U.S-Sino trade war has currently not imposed negative impacts on Vietnam exports. Even some products (textiles, wood products, furniture,...) have shown positive results by taking advantage of export opportunities. However, in the long term, trade tensions between large economies might reduce the aggregrate global demand and increase competition in the third countries for Vietnam export goods, as Chinese goods have to divert to alternative export markets.

Risks from the scale of economic openness

In terms of internal factors, in the period of 2019-2020, Vietnam is exposed to risks when economic growth is increasingly dependent on the FDI sector with high economic openness. Although the public debt/GDP ratio has decreased slightly in recent years, it still remains high (over 60%), the country's foreign debt is increasing every year to the ceiling of 50% of GDP (49.7% in 2018). Especially in 2019-2020, there are many due debts affecting macroeconomic management and fiscal policy.

Agriculture – Forestry – Fishing will witness positive growth, but the weather is an unfavorable factor

According to the World Meteorological Organization (WMO), the possibility of El Nino in the first 3 months is up to 75-80%. This weather condition may lead to drought and saline intrusion in agricultural areas of Vietnam, thus rice and fisheries production may be affected. However, the forecast strength of this phenomenon is average, agricultural sector might slow down but still maintain the momentum of 2018. The growth of the agricultural sector is estimated at 3.0 - 3.2%.

INFLATION

❖ **Inflation in 2018 was kept under the target of the National Assembly**

Accoding to data collected from GSO, average CPI in 2018 went up by 3.54% compared to that in 2017 (Figure 5). CPI by the end of December 2018 rose by 2.98% YoY. Average core CPI maintained at 1.48% YoY. CPI was lower than the target set by the National Assembly, which prove the effectiveness of SBG monetary policy management.

Transport, education services and food & foodstuff contributed the most to CPI's hike in 2018

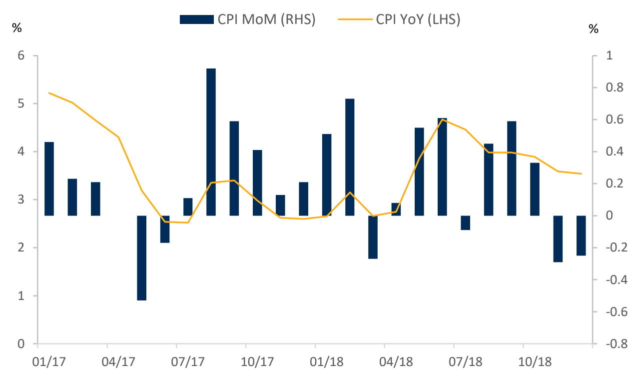
In 2018, factors enhancing CPI include:

(1) In the whole year of 2018, gasoline and oil prices were up by 15.25%, pushing up the transportation price and contributing 0.63% in CPI's hike.
(2) The adjustment of the prices of healthcare services in accordance with the Circular No.02/2017/TT-BYT and Circular No.39/2018/TT-BYT increased the healthcare services CPI by 13.86%, and CPI up by 0.54%.
(3) The implementation of the schedule to increase tuition fees in accordance with the Decree No.86/2015/ND-CP increased education services CPI by 7.12% YoY, raising the overall CPI by 0.37%.
(4) Food prices rose by 3.71% (overall CPI up by 0.17%); pork price increased by 10.37% (raised the CPI by 0.44%).

Government actions to prevent shocks to inflation by adjusting the prices of commodities under its management

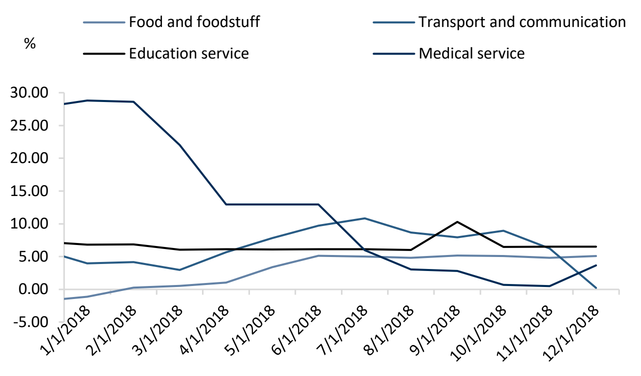
Government has decided to suspend the price adjustment of commodities to prevent rising prices, especially the Ministry of Industry and Trade insisted to keep electricity prices unchanged in Q4/2018 and proposed to postpone imposing environmental protection tax for petroleum until to January 1, 2019 (instead of October as expected). In addition, the Ministry of Health issued Circular No.15/2018/TT-BYT on May 30, 2018, reducing the medical services prices, thereby decreasing the medical price in July 2018 by 7.58% (made the overall CPI down by 0.29%).

Figure 5: CPI



Source: GSO, KBSV

Figure 6: Key CPI commodity movements



Source: GSO, KBSV

❖ **The average CPI in 2019 is forecast to be kept at the target of 3.8% - 4% by the Government**

We have noted headline inflation will likely to accelerate in 2019 when the prices of government administrated goods and services are expected to be adjusted. It might be controlled due to the Government's priority of macroeconomic stability. However, after being delayed in 2018, the Government will not have much room left to further delay the adjustment of those groups. On the other hands, limited pressure from the rising trend of global commodity prices, expected-to-be-stable exchange rate and the government's prudent monetary policy direction will help stabilize 2019 inflation. Overall, we estimate the average inflation in 2019 will climb by approximately **3.8 - 4.0%,** which is still under the target set by the Government.

Table 2: Fluctuations in commoditiy groups affecting CPI in 2019

	Groups	Weights (%)	Movement	+/- (%)	Contribution to overall CPI (%)
1	Food and foodstuff		↑		
	Grains	4.46	↑	1	0.04
	Foodstuff	22.60	↑	1	0.23
	Outdoor eatings	9.06	↑	2	0.18
2	Beverages and tobacco	3.59	↑	1	0.04
3	Clothing and footwear	6.37	↑	1.5	0.10
4	Housing, water, electricity, gas and other fuels	15.73	↑	12	1.89
5	Furniture, household equipment and maintenance	7.31	↑	1	0.07
6	Health	5.04	↑	10	0.50
7	Transport	9.37	↑	3	0.28
8	Communication	2.89	↓	-0.6	-0.02
9	Education	5.99	↑	6.31	0.38
10	Entertainment	4.29	↑	1.5	0.06
11	Miscellanous goods and services	3.30	↑	2	0.07
				Total	3.82

Source: GSO, KBSV

Prices of government administrated goods and services will be the most contributors in 2019 CPI's hike

(1) Environmental protection tax levied on gasoline and oil is adjusted to hike by about VND1,000/liter from January 1, 2019. It will push the gasoline and oil prices by 5% on average.

(2) Electricity retail prices may be adjusted in 2019, according to the Decision No.34/2017/QD-Ttg. According to our calculation, the current average retail price of electricity is VND1,720.65/kWh, the maximum price that EVN can reach is VND1,906.42/kWh, up by 10.8%.

(3) Healthcare service prices will increase by about 5-8% according to Circular No.39/2018/TT-BYT which came into effective from January 15, 2012.

(4) Education fees will likely to be raised by 6.31% under the Decree 86/2015/ND-CP.

(5) El Nino phenomenon is expected to take place at the beginning of the year, which may affect the supply and increase the price of some agricultural products (banana, coffee and rubber...).

2019 food prices is forecast to have a small increase

Domestic food prices will follow the global prices and according to the World Bank forecast (October 2018), the food price index in 2019 will only increase by about 1% (compared to 10% in in 2018). Global rice prices, according to FAO forecast (November 2018), will fall by 1.3% because the supply will rise by up to 1.3% while the demand is projected to increase by only 1.1%. Retail pork prices, a strong impact on CPI in 2018, is expected to remain stable in 2019, due to stable domestic supply and demand. In addition, the current price of live pork (about VND48,000/kg), according to our calculation, is sufficient enough to profit business households. Therefore, the increasing pressure on pork prices is not great.

Energy prices, according to World Bank forecasts, will only increase slightly by 1%. Similarly, by the end of 2016, OPEC's decision to cut oil production by 1.2 million barrels per day in cooperation with non-OPEC oil exporters in early December from January 1, 2019, will have an impact on the world crude oil supply. However, the supply from the U.S. is expected to grow steadily, which will help balance and push crude oil prices to not fluctuate strongly in 2019.

Flexible monetary policy from SBV, in which prioritizing the target of curbing inflation, which helps stabilize CPI

In order to maintain the Government target of macro stability and inflation control, SBV monetary policy is quite flexible in recent years. Although the policy is considered to be loosening, SBV can quickly turn to tighten its management to curb CPI if there is any sudden move in 2019 (as in Q2 and Q3/2018).

INTEREST RATES/MONETARY POLICY

❖ SBV monetary policy management – became more prudent in 2018

2018 monetary policy was managed more prudently by SBV via broad money and credit growth limit to ensure liquidity for the economy, support exchange rates, and control inflation.

M2 and credit growth were slower in 2018

By the end of December 20, M2 increased by 11.34%, outstanding credit increased by 13.30% compared to the end of 2017. This figure in 2017 was 14.19% and 18.24% respectively. Thus, credit growth in 2018 was 5% lower than that in 2017 and lower than the 2018 SBV's target set at 17%. Credit inflows focus primarily on manufacturing sectors and are controlled more strictly in high-risk sectors such as real estate. Specifically, credit is directly controlled through regulations on increasing the risk ratio of real estate loans from 150% to 250% and lower the rate of short-term capital used for medium and long-term loans from 60% to 45%. Credit growth annual target is established at 17% at the beginning of the year but credit growth limit granted to commercial banks is about 14% and Directive 04 issued on 02/08 confirmed SBV will not consider raising credit limit for most credit institutions, except for some commercial banks involved in the restructuring of banking system process. This movement made a difference compared to the previous years when in fact, in 4Q, the State Bank only allowed Techcombank, MB and HD Bank to extend room for credit this year, showing the cautions in SBV monetary policy management.

Table 3: M2 and credit growth

(VNDbn)	30/09/2017	31/12/2017	31/03/2018	30/06/2018	30/09/2018	20/12/2018
M2	7,877,753	8,192,548	8,521,098	8,844,675	8,933,154	9,121,583
Growth rate YTD (%)	10.55	14.97	4.01	8.39	9.04	11.34
Growth rate QoQ (%)	3.43	4.00	4.01	3.80	1.00	2.11
Increase in M2 amount by quarters	260,897	314,795	328,550	323,577	63,902	188,429
Credit outstanding balance	6,177,691	6,509,858	6,741,609	7,021,533	7,129,596	7,375,669
Growth rate YTD (%)	12.21	18.24	3.56	7.86	9.52	13.30
Growth rate QoQ (%)	2.94	5.38	2.23	4.03	1.54	3.45
Increase in lending amount by quarters	176,308	332,167	145,170	268,206	108,064	246,073
Difference between M2 and lending growth annually	79,667	62,295	96,799	175,680	-108,064	63,224
Difference between M2 and lending growth by quarters	84,589	-17,372	183,380	55,371	-44,162	-57,644

Source: GSO, SBV, KBSV

Exchage rate pressure during June – August was the reason that SBV sold USD and drained VND, which made M2 growth slower than credit growth in the second half of the year

In the first 5 months of the year with favorable market conditions, SBV had purchased USD to accumulate FX reserves. Particularly, it is estimated that SBV had injected a large amount of Vietnamese Dong (around VND250tn) to net buy USD11bn while only extracting VND130tn via OMO. From June onwards, when USD/VND exchange rate began to rebound, SBV intervened by selling foreign currencies and extracting a large amount of the Dong. According to an unofficial figure, within 3 months (end of June-end of November), SBV sold about USD 6bn (equivalent to draining about VND 140tn). In addition, at the end of November, SBV actively implemented foreign currency forward, with a total contract value of more than USD1 billion.

Liquidity in the banking system has been stable despite being lower than that in the last six months of 2018

Liquidity in the banking system is reflected from the fluctuation of interbank interest rates and net injection of the SBV through open market operations. The movement of interbank interest rates in the first 6 months was quite stable, maintaining around **1 - 2%** but continuously moved upward during 3Q and being around 4.5% for all terms in the 4Q (Figure 7). Relatively high interbank interest rate in July and August is an active action of SBV to reduce the pressure on exchange rates at that time. SBV raised VND interest rates to above 4% to create a VND-USD interest rate spread of 2%, in order to prevent USD accumulation in commercial banks, and lower the pressure on foreign currency supply.

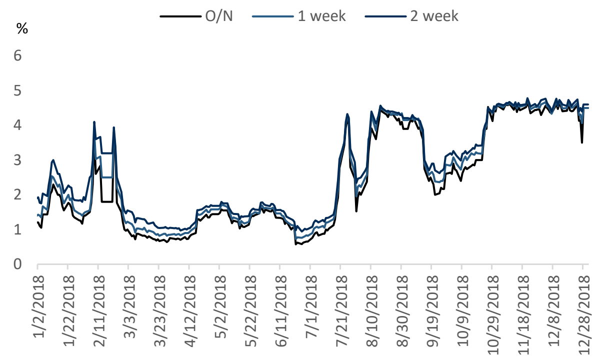
Deposit rates, especially in long terms, started to rise again from last July, while the lending interest rates were in a sideways drift in 2018

Deposit rates at some commercial banks rose again in the last 6 months, especially for maturities without interest rate ceiling of SBV (from 6 months or more), after a continuous fall during the first 6 months of 2018. The average deposit interest rate for over 12 month terms was about **6.8% - 8.0%,** with an increase of about 0.3% to 0.5%. Reasons for deposit interest rate hikes are both seasonal factors and the change in SBV policy. In other words, banks also need to strengthen medium-term and long-term capital sources when the maximum ratio of short-term funds used for medium and long-term loans was adjusted down to 40% instead of the current 45% in

2019.

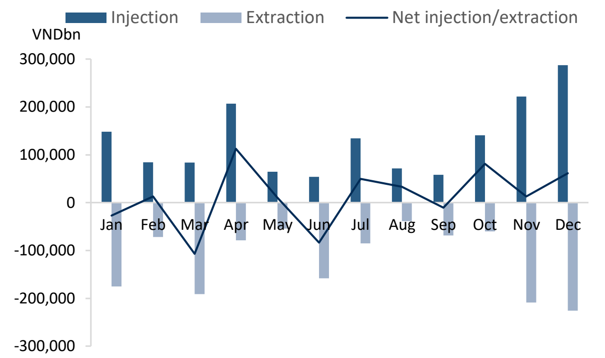
Meanwhile, VND lending rates remained stable in 2018. According to the report from the National Financial Supervisory Commission of Vietnam, the average lending rate in 2018 was about 8.91% (8.86% in 2017). At the moment, the rise in deposit rates has not put much pressure on lending interest rates.

Figure 7: Interbank interest rates



Source: Bloomberg, KBSV

Figure 8: Net injection/withdrawal in the open market



Source: SBV, KBSV

❖ **The management of monetary policy – is forecast to maintain prudent in 2019**

M2 and credit growth are expected to be higher than that in 2018, staying at 11-13% and 13 - 15% respectively.

In 2019, we expect that the exchange rate pressure will be lower than in 2018 (see the Exchange rate section) and inflation may increase compared to 2018 but still under control and under the Government target (less than 4%). Therefore, M2 growth and credit growth will increase slightly by **11% - 13%** and **13% - 15%** respectively compared to 2018. This is a high level compared to other countries with similar economic background in the region, but is a reasonable level considering specific characteristics of the Vietnamese economy. In addition, this growth is much lower than that in 2013-2017. As Vietnam economy is entering a late upswing phase, if M2 and credit growth stay high, a booming economic growth will probably happen. With the current market openness, the economy may quickly turn to a recession in case of external shocks.

The pressure from external factors on SBV monetary policy in 2019 is not high

US monetary policy would move to more dovish side when Fed made a prediction that it would only raise interest rates twice instead of three times in 2019 as previously announced. Thus, for countries in Southeast Asia, monetary policy is also forecast to be loosened gradually as the pressure on exchange rates is not high and pressure of inflation is expected to cool down. Philippines and Malaysia are supposed to reduce policy rates, Indonesia will only raise interest rates if the pressure on the Rupiah is large, and Thailand is likely to keep interest rates unchanged after hiking in the last November. As the Vietnam economy has many mutual characteristics with others in Southeast Asia (high market openness, trade war,...), the monetary policy of Vietnam should be managed in relation to that in other countries in the region.

The average deposit and lending rates will be adjusted to go up slightly (by about 25 – 50 points)

The pressure on lending rates in 2019 is huge as the deposit and lending rates often share similar movement with 3 - month difference. Deposit rates have been adjusted up sharply in the last 6 months of 2018, which will put high pressure on lending rates in early 2019.

Furthermore, general deposit and lending interest rates are also under pressure of increasing when credit institutions need to raise Tier 2 capital to prepare for Basel 2 to be applied in early 2020.

CURRENT ACCOUNT BALANCE

❖ **The current account balance is forecast to be surplus in 2018 thanks to large remittance and record high export surplus**

According to the latest data from the SBV, Vietnam current account balance by the 2Q 2018 was USD1.2 billion surplus with a large contribution from the trade balance surplus. We estimate that the current balance in 2018 remains surplus (+2.7% of GDP, about USD6.5 billion). As a result, the current account balance has remained positive since 2011 (Figure 9) as the impacts of economic reform such as trade liberalization to attract foreign investment have been effective, and helped Vietnam move to become an export-oriented country.

Remittances have grown sustainably in 2018

Data from the World Bank's Development and Immigration Division estimated the total amount of remittances sent to Vietnam in 2018 will be up to USD 15.9 billion, up by 6.23% compared to that 2017, accounting for 6.6% of GDP in 2018. World Bank statistics show that the amount of remittances transferred to Vietnam has an average annual growth of 7.70%; overseas remittances have grown sustainably over the past 10 years. The recent fundamental change is that remittances have been transferred for investment instead of being converted to VND for savings purpose.

The trade balance reached a record high surplus thanks to FDI enterprises successful trade performance

By December, Vietnam trade balance reached a record high surplus of USD7.2 billion, much higher than the equivalent figure of USD 2.1 billion in 2017. In particular, the achievement of trade surplus brought by FDI sector not only helped offset the trade deficit caused by the domestic economic sector, but also contributed a large amount to the overall trade balance surplus.

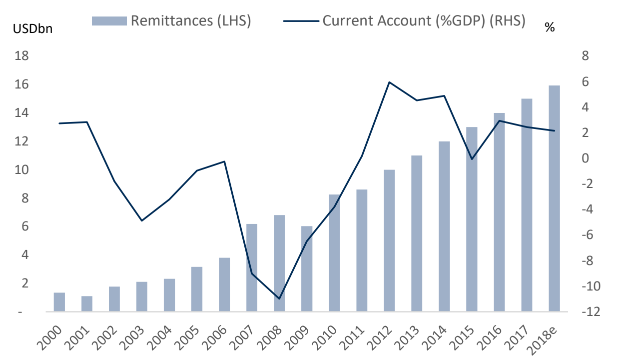
Domestic economic area witnessed positive export growth

Data collected from GSO show that the export turnover in 2018 is estimated at USD 244.72 billion, up by 13.8% over the same period. Domestic economic sector reached USD 69.20 billion, up 15.9%, accounting for 28.3% of total export turnover; FDI sector (including crude oil) posted USD 175.52 billion, increasing by 12.9%, accounting for 71.7% (72.6% in 2017). Thus, the domestic economic sector has made positive changes when reaching the growth rate of export turnover higher than the FDI sector, as well as the proportion of the total export turnover increased compared to 2017. The reasons are: (1) An increase in the number of outsourcing contracts on processing products such as textiles and footwear (from China, under the impact of trade war and); (2) A surge in export activities of agricultural crops (rice) and fisheries due to favorable weather conditions and expanded exporting market.

Import turnover also surged due to increasing import demand for raw materials for export processing, expanding FDI disbursement scale as well as growing demand for imported consumer goods

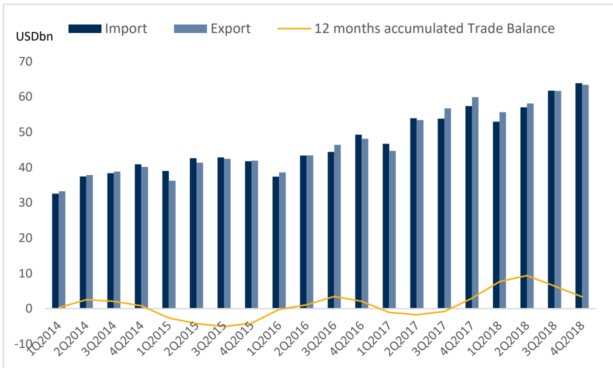
Import turnover this year is estimated at USD237.51 billion, climbing 11.5% compared to 2017. Imports are mainly raw materials for processing export commodities such as machinery, phones, electronics and components, fabrics, etc. According to our assessment, key reasons for increasing in imports are (1) Demand in importing raw materials and semi-manufactures hiked for the productions of key export products such as mobile phones, electronics, textiles, footwear; (2) The scale of FDI disbursement improved (USD19.1bn, +9.1% YoY); (3) An increase in domestic consumption in line with favourable economic conditions.

Figure 9: Remittances and current account balance



Source: Bloomberg, WB, KBSV

Figure 10: In-export turnover and accumulated trade balance



Source: GSO, KBSV

❖ **The current account balance will stay surplus in 2019**

In 2019, we forecast the current account balance will follow the downtrend in the region, but still reach a surplus (of **1.5 – 2% GDP**).

Remittances still maintain stable growth

Remittances still maintain stable growth as the number of Vietnamese working abroad is high (148,000 people in 2018). In particular, in 2018, given the fact that Fed's continuous interest rate hikes and pressure from rising exchange rates, remittances still increase by 6%, contrary to previous concerns. Therefore, in 2019, when the U.S. economy growth is expected to slow down, the remittance flow from the U.S (accounting for 60% of the total cash flow to Vietnam) may continue to be poured into Vietnam.

The trade balance will be in a surplus thanks to expanded FDI sector and increasing scale of export processing contracts

The trade balance remained positive thanks to the contribution of both FDI and domestic sectors. In other words, the trade war and free trade agreements will help Vietnam to benefit from the expanded FDI sector and increasing scale of outsourcing contracts. Traditional export products will continue to take advantage of available advantages to expand the market.

Exports in 2019 may grow at 11-12%, imports will grow at 10-12%. The trade balance in 2019 is expected to be in a surplus of about USD4-5 billion.

However, in Figure 10, Vietnam's 12-month cumulative trade balance tends to decrease, which is likely to maintain in 2019 due to the deacreasing export growth of electronics, phones and components sectors.

EXCHANGE RATES

❖ **VND depreciated by 2.4% in 2018, which is much lower than that in countries of the same region**

Strong exchange rate movement in 2Q and 3Q 2018

After a period of stable movement in the first 6 months, the exchange rate was under strong pressure from the end of June. USD/VND exchange rate in the interbank market tended to increase sharply, approaching the upper range. The gap between the interbank and unofficial market is widening given the central and unofficial exchange rate spread are sometimes up to 350 dong (1.5%). In 4Q, the exchange rates were somewhat stabilized thanks to the SBV's flexible policies, and temporarily decreasing pressure from external factors (Figure 11).

Despite the tendency of depreciation, VND remained relatively stable compared to other currencies in the region

By December 28, 2018, the central exchange rate increased by 1.69% and the interbank exchange rate increased by 2.39%, significantly lower than the average of Asian currencies of 3.61%. Thus, At this stage, the Dong is still seen as a stable currency in the region, one of the least depreciated currencies while as since January, Rupee (India) down by 10.15%, Peso (Philippines) losing 5.51%, Yuan (China) down by 5.53% and Won (South Korea) decreasing by 4.63%.

External factors are the main reasons leading to the strong fluctuation of the exchange rate in 2018

The volatility of the Dong was triggered by the USD appreciation (we use the Dollar Index DXY as a benchmark) and the Renminbi (CNY) depreciation.

The US dollar appreciated, with DXY increasing by up to 4.73% YTD, supported by the strong growth of the U.S economy and Fed's interest rate hikes. Fed raised interest rates 4 times this year instead of 3 times as previously expected, strongly supporting the Dollar. In addition, the biggest contributor on the strong movement during 3Q was the escalating global trade tension.

Reasons for USD/CNY up by 5.53% YTD, besides the external factor of trade war, is also an internal factor such as China's economic growth signs of slowing down and continuously capital outflows.

❖ **SBV intervened to stabilize foreign exchange market**

NEER and/or REER approached and surpassed 105, which may serve as a signal for SBV

If choosing 2014 as the starting point, we have calculated and observed that whenever the NEER value (nominal effective exchange rate) and/or REER (real effective exchange rate) approach 105 (Figure 12), the SBV will actively devalued VND to stabilize the market and prevent adverse impacts on exports. From June to September, when both indices tended to increase rapidly, REER approached 105, reflecting the appreciation of VND compared to the reference currency basket, the SBV had some specific actions to stabilize the exchange rate.

The gaps between the interbank , unofficial market rates and relative to the upper band can be seen as another signal predicting the actions of SBV

Historically, the gaps between the unofficial market rate and the interbank rate and relative to the upper band are considered as the practical measures of the Dong devaluation expectation. Whenever the interbank – unofficial gap has been widening (more than 1%) and interbank rate reaching the upper band in a relatively long period, SBV will usually impose some acts to devalue the Dong to avert speculation in the market. In August, the gap between the two markets sometimes reached 1.5% and the interbank exchange rate was continuously close to the upper band (Figure 11).

SBV actions was considered to be quite successful and reasonable

Unlike the previous period, when the exchange rate pressure increased, SBV often devalued the Dong at a large rate. In 2018, the measures that SBV used to stabilize the foreign exchange market were quite flexible and successful. In particular, these measures include:

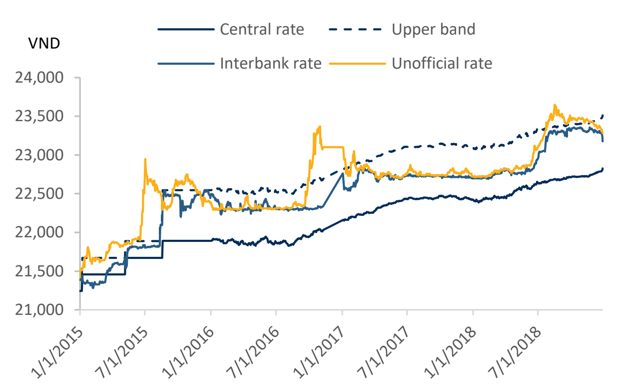
(1) SBV sold a large amount of USD in foreign exchange reserves in a short time. Specifically, from July to the end of November, SBV sold over USD6 billion, and withdrewabout VND140 trillion to narrow the gap between supply and demand in the short term.

(2) Sold USD1bn worths of USD forward contracts which are allowed to be free cancelled before due date of on January 30, 2019 on November 23 and 26. SBV setting a forward selling price of +0.3% compared to the spot price showed that they set a limit of + 0.3% for the depreciation of the VND until the end of January 2019 to stabilize sentiment and enhance investor morale.

(3) SBV issued a large amount of 140-day term bills (about VND29 trillion) with high interest rates in late July - August periods to actively push interbank interest rates to a high level, thereby creating a safe gap between VND and USD interest rates to exclude speculation in the market.

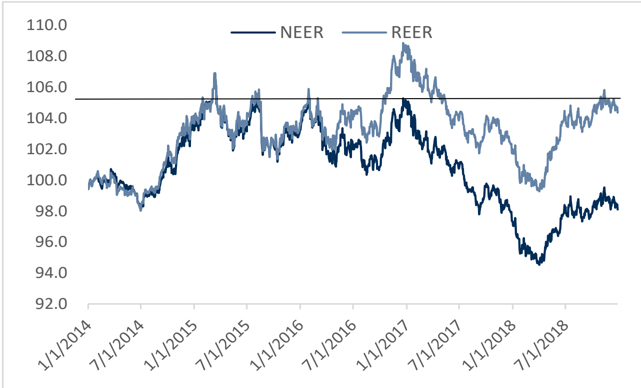
(4) In the last 2 months of the year, exchange rate pressure on the interbank and unofficial market became less tightening, SBV has continuously raised the central exchange rate at a small rate to prepare for year-end fluctuations without rocking the market.

Figure 11: The movement of USD/VND exchange rate in 2018



Source: Bloomberg, FinnPro, KBSV

Figure 12: NEER & REER



Source: Bloomberg, KBSV

❖ VND is forecast to lose about 2.3-2.5% of its value in 2019

In 2019, it is noted that external factors adversely affecting the exchange rate movements in 2018 will remain, but the impacts are less powerful. In particular, our view on USD/VND rate will be highly dependent on the fluctuation of USD (Dollar Index) and CNY. Furthermore, internal factors like remittances, FDI inflows and trade surplus will significantly support the foreign currency supply.

Table 4: Forecast DXY and USD/CNY in 2019

	1Q2019	2Q2019	3Q2019	4Q2019
DXY				
Average	95.8	94.4	92.9	91.9
Highest	99.2	99.4	99.9	99
Lowest	92.4	89.9	87.8	85.3
USDCNY				
Average	6.93	6.92	6.91	6.88
Highest	7.1	7.42	7.78	7.9
Lowest	6.75	6.6	6.5	6.6

Source: Morgan Stanley, Standard Chartered, CitiGroup..., KBSV

DXY is supposed to cool down in 2019

We expect the greenback will experience an downtrend in 2019. To be more specific, the USD will maintain its upward momentum in the first period of 2019, then weakening fundamentals will cause the USD growth to slow down at the end of the year. Estimated average DXY index in 2019 is **91.9 points**, falling by about **5%** compared to the current figure.. In contrast to 2018, risks will return to out pressure on the greenback in 2019.

Fed is now approaching the neutral interest rate (about 3%), so its monetary policy in the future will be less tightening (Fed has lowered the frequency of raising interest rates from 3 hikes in 2019 to 2 ones), while several other central banks are preparing to tighten their policy rates. Therefore, the divergence of monetary policies will narrow the interest rate gap between the US and other countries (currently in a downward trend, Figure 13).

In addition, the U.S economy has shown signs of slowing growth since 3Q 2018. The housing market is facing difficulties due to rising interest rates and unstable inflation compared to the the target level. According to the forecast from Goldman Sach, the U.S economic growth will slow significantly next year, estimated at 1.75% at the end of 2019 mainly because tighter financial conditions and fading fiscal stimulus.

Furthermore, investors may be concerned about the twin budget and current account deficit in 2019. The separated power in Washington - Democracy and Republic Parties take turn to run the House of Representatives and Senate, creating political instability within the United States, so investors will no longer regard the US as a safe haven currency.

The CNY may turn to rebound in 2019, but the increase is insignificant

We believe that the CNY will increase slightly in 2019. The average estimated USD/CNY exchange rate in 2019 is 6.88, 0.3% less than the current rate. CNY is still under the control of the PBoC, and PBoC will want limit the devaluation of CNY (not exceeding the sentiment threshold of 7.0) due to the lesson from the volatile market in 2015-2016, when CNY devaluation caused a large capital outflow from the market and a sharp decline in foreign exchange reserves (Figure 14). In addition, we found that internal and external uncertainties had a significant impact on CNY movements in 2018. In 2019, if there are no obvious signs of the next shock, the CNY will slightly rebound. However, the sharp fall in Chinese bond yield in recent years and loosening monetary and fiscal policies to support the economy will put pressure on the value of the Yuan.

The trade war is the biggest risk to the CNY in 2019

The most significant risk for CNY devaluation is that US and China cannot reach a trade negotiation after 90 days of "cease fire." In the negative scenario, in addition to the U.S raising tax rates for Chinese goods valued USD200 billion from 10% to 25% and China retaliating with USD60 billion American imports, the US will impose taxes on all Chinese remaining exports valued USD270 billion. If the trade war escalates, PBoC will definitely need to devalue the CNY, thereby putting pressure on the VND value.

Figure 13: DXY and 2 year bond yield between the U.S and G10 spread

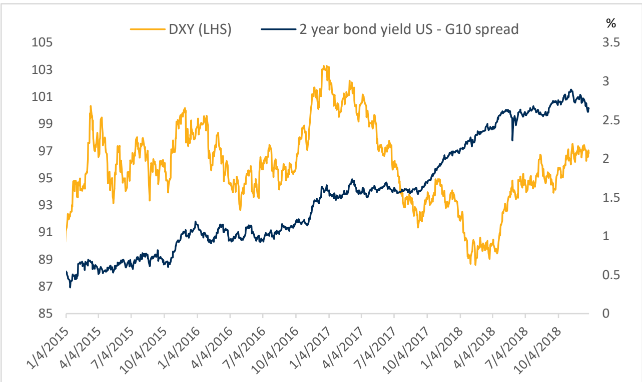
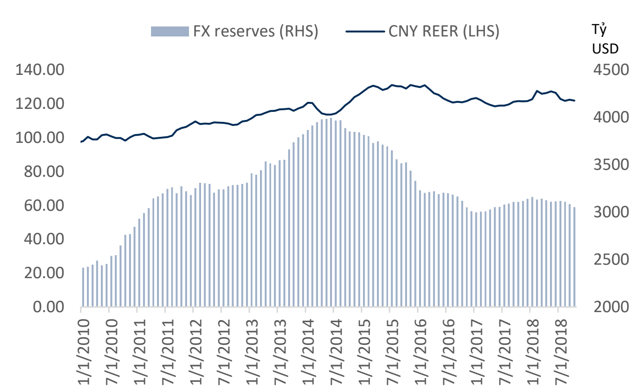


Figure 14: CNY REER and China foreign exchange reserves



Source: Bloomberg, KBSV

Source: IMF, WB, KBSV

Foreign currency supply is expected to stay positive

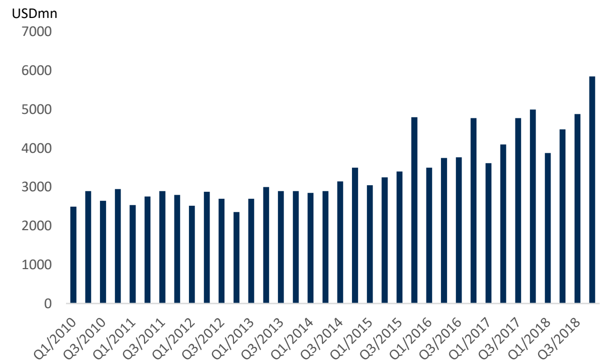
The supply side in the foreign exchange market of Vietnam is quite sufficient, positively supported by the surplus current account and the financial account.

The current account balance stays positive thanks to dramatic growth of exports and remittances each year. In 2019, current account is forecast to stay surplus of 2% GDP because Vietnam key commodity exports still have stable growth.

The financial balance is supported by FDI and FII disbursement which still tend to flow into Vietnam (Figure 15). Particularly in 2019, the potential foreign exchange supply can benefit from divestment deals between SOEs and foreign strategic partners.

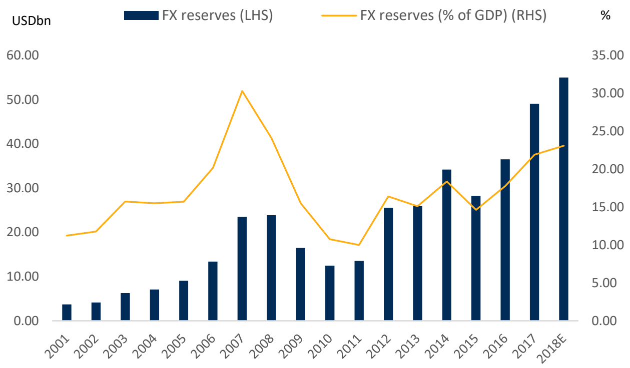
Vietnam's foreign currency reserves though is not high in terms of months of imports (recording a minimum 3 months of imports) but is considered as adequate in terms of GDP's size and economic conditions (Figure 16).

Figure 15: FDI disbursement



Source: FIA, KBSV

Figure 16: Vietnam foreign exchange reserves



Source: IMF, Stock market, KBSV

Three scenarios for USD/VND exchange rate in 2019

	Positive	Baseline	Negative
DXY	<90	92-95	>97
USD/CNY	<6.5	6.6 – 7.0	>7.0
USD/VND*	1.8% – 2.0%	2.3% - 2.5%	2.8% - 3.0%

* VND depreciation in 2019 compared to then end of 2018

DISCLAIMER

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