

Asia Policy Watch

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Vietnam's central bank devalued the official VND exchange rate for the 2nd time in the past 3 months

What happened:

The State Bank of Vietnam (SBV) announced a devaluation of the Vietnamese Dong (VND) by lowering its mid-point exchange rate to 18,544 from 17,941 previously on February 10, to be effective February 11. This 3.4% adjustment in the value of the VND is the second time in the last 3 months, which is smaller than the previous 5.4% depreciation on November 25, 2009.

The direction of this move is in line with our long maintained view that the VND will depreciate against the USD, but we did not expect depreciation to take place through another official exchange rate adjustment so soon after the previous one.

What we think:

In our view, the devaluation is another attempt made by the SBV to narrow the gap between the quoted exchange rate and the prevailing rate in the black market and relieve the pressure on balance of payment imbalances. Vietnam's trade deficit has remained relatively stable at just above US\$1 billion per month in December 2009 and January 2010. Compared to the FX reserve level we heard of (well above US\$15 billion, and some street talk of even above US\$30 billion), the VND devaluation does not seem to be an involuntary move, unless massive capital outflows have occurred under the capital account recently. Given the gap between the official exchange rate and the black market rate is only 4% or so before the announcement on February 10, the government probably considered the devaluation as a preemptive move before the Tet holidays to help clear the foreign exchange demand in the black market.

However, our concern is that the exchange rate gap could widen again in the near future on the back of the expectations of a weaker VND trend. Notably, frequent downward adjustments in the VND exchange rate may deter investors and Vietnamese citizens (who hold a large proportion of assets in FX and gold) from holding the local currency even for the short term. Before the central bank demonstrates a strong willingness and capability of defending and stabilizing the exchange rate, we believe the public will find it more difficult to regain their confidence in the VND.

In addition, we believe the devaluation will likely put further upside pressure on inflation. The double-digit sequential mom growth rates in both industrial production and headline CPI inflation in January suggest the emergence of overheating and inflation risks. Neither the inflation pass through from imports nor the depreciation expectations going forward will likely help the SBV rein in inflationary pressures. A gesture from the central bank to increase the VND interest rate would be helpful in reinstating the credibility of the monetary authority on inflation control and anchor the expectation of the VND exchange rate.

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