South China Morning Post
February 14, 2011 Monday

The trouble with a heated Vietnam

Tom Holland

It was back in 1994 that The Wall Street Journal first described Vietnam as "the next hot thing".

Judging by the way the country has been pitched to investors over the intervening years, it seems like Vietnam has been the next hot thing ever since, without ever quite graduating into the hot market of the current moment.

In fact, for the past year or so, the Vietnamese economy has not been hot so much as overheating, with impressive growth rates masking a deteriorating foreign trade position and accelerating inflation.

Something had to give, and last Friday the government took a long-expected step and devalued the country's currency, the dong, by 9 per cent against the US dollar.

The devaluation - the third in the past 12 months - was unavoidable. Vietnam is running a trade deficit of more than US$1 billion a month, and according to Standard Chartered foreign reserves are now down to a meagre US$12 billion.

But whether Friday's devaluation will do anything to solve Vietnam's problems is doubtful.

The government is hoping a cheaper dong will make the country's exports more competitive, closing Vietnam's gaping trade deficit.

But unfortunately for Hanoi, the trade imbalance is just a symptom of a deeper problem resulting from the government's own economic mismanagement.

For the past few years, the Vietnamese government has pursued a growth-at-all-costs economic strategy. Not only has it successfully encouraged foreign investment, attracting around US$9 billion in direct investment last year, it has also encouraged state-owned companies to borrow from the international markets, while pushing the largely state-controlled banking system to lend generously to fund investments by domestic borrowers.

On one level, the policy has worked. Growth last year is estimated at just short of 7 per cent, up from 5.3 per cent in 2009.

But that growth is looking increasingly expensive. Bank lending expanded by nearly 28 per cent last year, pushing outstanding domestic credit up to around 140 per cent of gross domestic product. That's higher even than the 130 per cent level that precipitated Thailand's economic crisis in 1997.

Worse, there are fears that much of that lending has vanished into a black hole. Between 30 and 40 per cent of the assets of Vietnam's state banks are believed to consist of loans to the country's state-owned companies, which as a group are notorious for their lousy governance.

Investors are now worried that December's default by foreign currency debt-laden state ship-builder Vinashin may just be the tip of a dangerous iceberg. Attention has now switched to the ability of state mining company Vinacomin to service its debts.

Whether or not state borrowers can repay, their borrowing binge has had a major impact on the domestic economy. Unlike China, where private consumption has been suppressed for years, Vietnam has a thriving private consumer market, which makes up around two-thirds of total GDP.

As a result, the injection of liquidity from the banking sector's credit expansion has helped push inflation up to a punishing 12 per cent rate.

What's worse, with Vietnam's burgeoning consumer demand directed largely towards imported goods, the country's trade deficit has worsened sharply, hitting an estimated 10 per cent of GDP last year.

The government hopes that Friday's devaluation will help solve the trade imbalance. But in the near term, it is likely to make the economic situation worse.

Imports will become even more expensive in local currency terms, adding to inflation, which is expected to climb further to 15 per cent over the next few months.

Meanwhile, servicing Vietnam's foreign debt - worth around 30 per cent of GDP - will become even more difficult, raising the possibility of more defaults and prompting a rush into US dollars which will only put the dong under more pressure.

Capital flight is already a problem. With residents desperately seeking safety in gold as well as foreign currencies, last week's devaluation only brought the official exchange rate more closely into line with the rates already being quoted on the black market. With more devaluations expected, Friday's move is only likely to speed up the outflow.

For the time being, the authorities are still insisting that Vietnam's fundamentals are strong and that its long-term growth prospects are healthy.

They are right. But in the short term, they are faced with a stark choice. On the one hand, they can jack up interest rates and crack down on borrowing to discourage consumption, quell inflation and stabilise the trade situation, all of which will mean accepting a painful slowdown in growth.

On the other hand, they can continue with their current high-growth strategy, and risk a descent into a full-blown inflation, debt and currency crisis.

Either way, Vietnam's status with investors as the next hot thing looks as if it will be postponed - yet again.