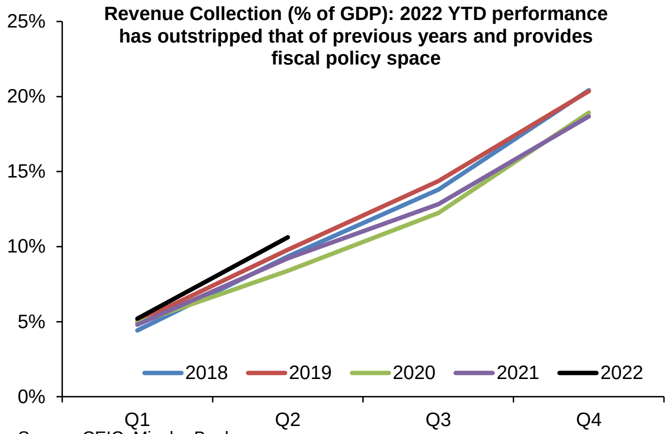
Aug 16, 2022 | Tan Boon Heng | Market Economist

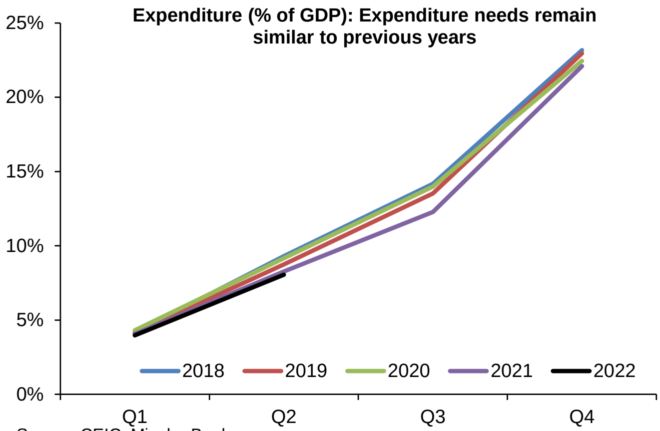
Vietnam: Stronghold or Hold Out?

In a nutshell: VND's outperformance in 2022 can be attributed to several reasons: i) strong fiscal outturns allow enviable position to **curb inflation via tax and fee reductions** while priming for productivity improving infrastructure investments, ii) consequent **inflation containment** prevents diminished real asset returns seen in regional peers, and iii) **stellar economic recovery and healthy FDI disbursements** amid supply chain shifts which strengthens growth outlook. As such, while the State Bank of Vietnam being one of the holdouts which has yet to normalise monetary policy, the economic circumstances **enhance their status as a reasonable stronghold** in consideration of SBV's continued targeted support for growth and their **relatively high real interest rate differentials**. On balance, **policy normalisation for the SBV is of less urgency** especially if productivity improvements from investments and growth nudges down the neutral rate. **We therefore push back projections of SBV's policy rate normalisation to Q4 2022** with the view that **peak rates may not necessarily be fully restored to pre-Covid levels even in 2023.**

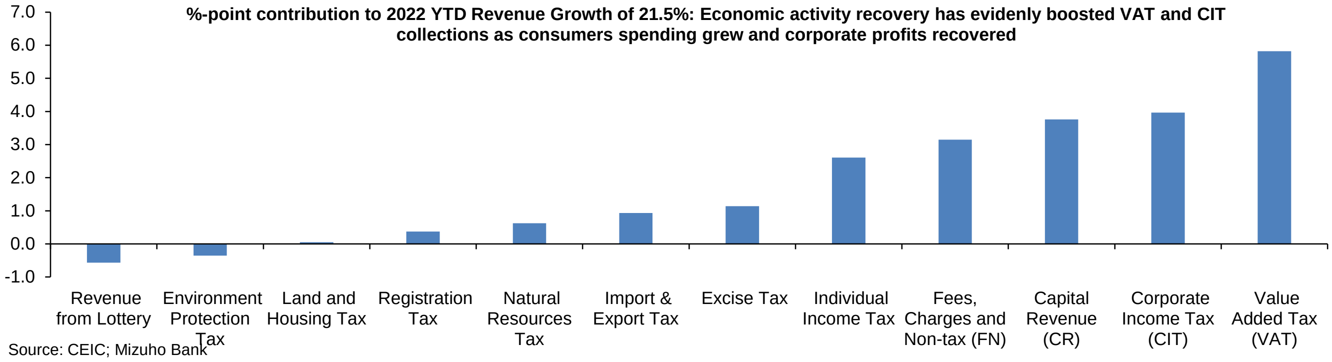
Ample Fiscal Policy Space



Source: CEIC; Mizuho Bank



Source: CEIC; Mizuho Bank



Source: CEIC; Mizuho Bank

With strong economic growth in the first half of 2022, revenue collections at 21.5% YoY have outperformed that in previous years, averaging 1-2%pt of GDP higher. This can be largely attributed to:

i) higher value added tax collections which is notable as household consumption rebound strongly from their Q3 2021 lockdown, **supported by strong wage growth and this stellar performance was despite the VAT rate cut** in February 2022;

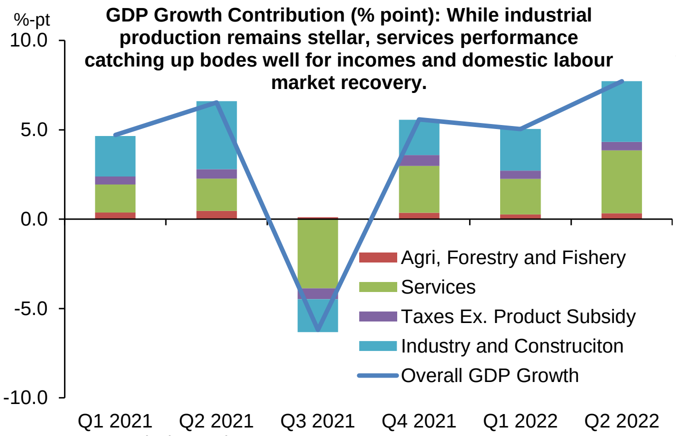
ii) higher corporate income tax collection which highlights the **industrial sector's recovery despite rising input costs**

iii) higher capital revenue from **land use rights assignments** that likely point to steady business expansions and strong FDI inflows.

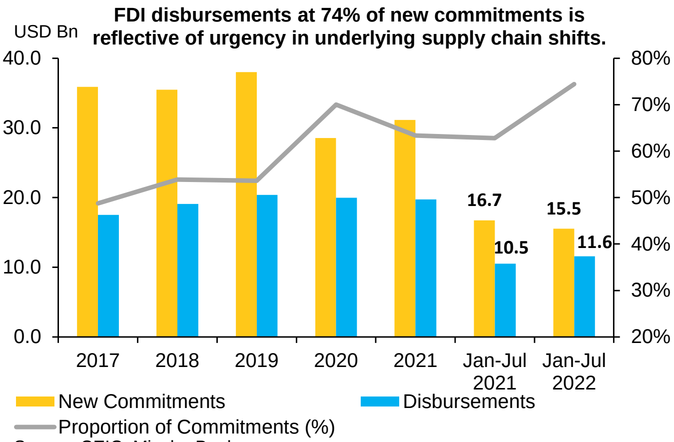
Drags on revenue collections include lower revenue from lottery and environment protection tax. The latter's decline has been well publicised as environmental protection taxes on petroleum products such as diesel and petrol was cut in order to restrain rising petrol prices and keep a lid on inflation.

With fiscal expenditure kept at similar levels (as a % of GDP) compared to previous years, overall fiscal balance stands at a surplus of approximately 2.5% of GDP. This provides ample fiscal policy space to cushion against macroeconomic risks with **creeping inflation being the priority** while buffering for plausible slowdown in global economic growth.

Strong Recovery, Solid Prospects



Source: CEIC; Mizuho Bank

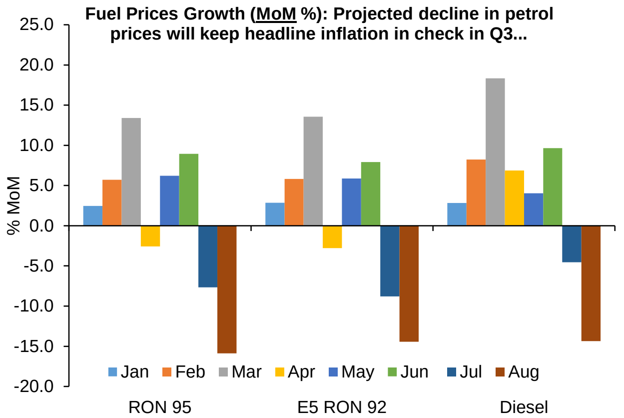


Source: CEIC; Mizuho Bank

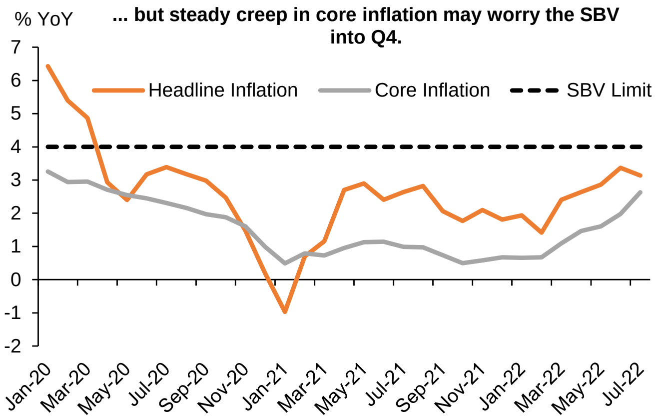
With Q2 GDP growth coming in at 7.7% YoY, **economic activity has recovered well beyond pre-pandemic levels.** Underlying services sector recovery augurs well for **domestic multipliers to improve incomes and employment.** Looking ahead, **substantial uptick in FDI disbursements** pointing to Vietnam being a likely beneficiary of urgent ongoing global supply chain shifts. This will engender broadening of their domestic industrial base and green shots of local suppliers and encourage technology transfer while assisting in labor skill upgrading to fulfil these new opportunities. Concomitantly, the government continues to embark on **complementary infrastructure** projects which attracts and facilitates FDI growth by improving logistical flows. The government has set aside VND734 trillion (**8.7% of GDP**) for major traffic infrastructure projects such as roads, expressways, high-speed railways connecting North and South Vietnam, urban railways in Hanoi and Ho Chi Minh and airports.

These developments represent **multi-year endeavours to achieve sustainable high level of growth**, rather than short term boost. Nonetheless, investment spending has been shown in numerous studies to **have the highest economic growth multiplier** relative to other forms of fiscal spending such as transfers, taxes and current spending. Such projects also **boost longer term productivity** growth to mitigate structural issues such as declining labour force and **restraint cyclical run up in inflation** from demand led growth.

The SBV- Underlying Core Risks

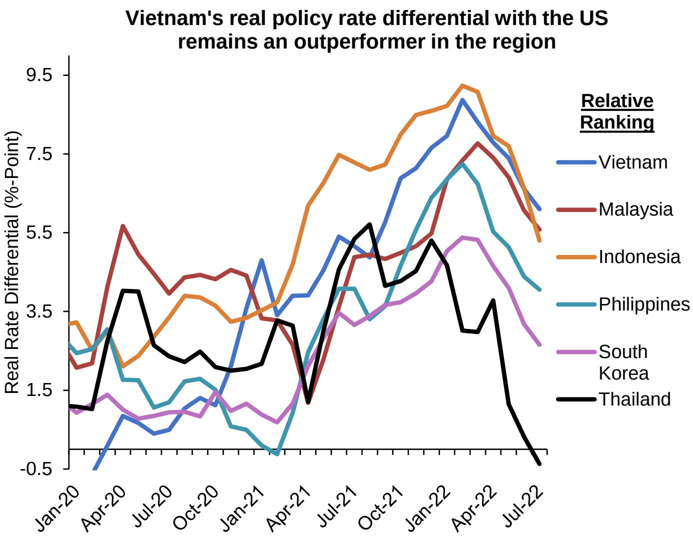


Source: Complied from various sources, Mizuho Bank

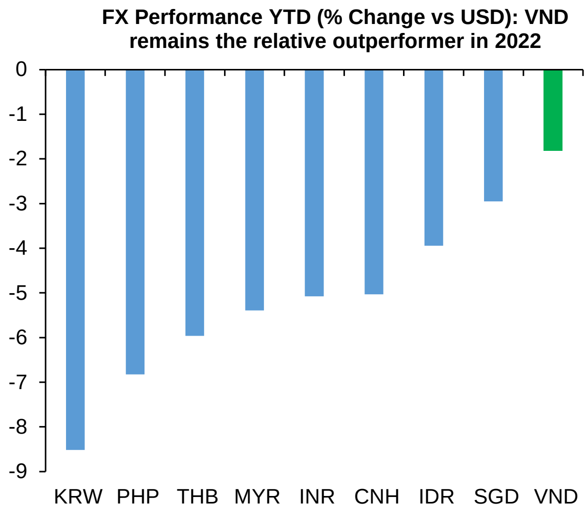


Source: CEIC, Mizuho Bank

In Q3, headline inflation is expected to stay below the SBV's 4% target with the authorities employing multiple administrative levers to curb transportation cost with the latest being halving the Most Favour Nation (MFN) tariff on petroleum products from 20% to 10%. Aside from base effects which may result in headline inflation challenging 4% in Q4, the **underlying core inflation which has been accelerating in recent months may become more troubling.** The strong economic recovery has been accompanied by labour market recovery with a **2.3% unemployment rate in June being close to pre-Covid trends.** Ongoing tourism recovery will provide further impetuous for employment and push conditions tighter **and wage pressures higher** and threaten to underpin wage-spirals.



Source: CEIC; Mizuho Bank Estimates



Source: Bloomberg, Mizuho Bank

Meanwhile, Vietnam's relatively high real policy rate differential with the US mitigates capital outflow risks and form one of the pillars supporting the VND's relative outperformance in addition to strengthening macroeconomic fundamentals. On vulnerabilities, with debt rescheduling and loan forbearance policies expired at the end of June 2022, NPLs may experience an uptick though the extent is unlikely to threaten financial stability. Nonetheless, the SBV continues to implement low interest rate support packages at low rate of 2% to support business activities of Covid-hit sectors such as aviation, transport, tourism and social housing construction.

All in, the **SBV has sufficient room to delay policy normalisation to end-2022/early-2023** if core inflation can be kept in check. The extent of policy hikes into the medium term will be dependent on various productivity enhancing investments which raises wage growth and increases the supply of savings, in turn pushes down neutral rates and reduces need to recover the 2%-point cut during the pandemic.