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Vietnam Dong Stable Despite EM Currency Sell-Off

The value of the Vietnam Dong (VND) has remained remarkably stable this year, despite depreciations in several Emerging Market (EM) currencies that prompted significant capital outflows from those countries.

Country	YTD Currency Depreciation / Appreciation
Argentina	-29.2%
Turkey	-17.3%
India	-6.6%
Philippines	-5.2%
Indonesia	-3.6%
Vietnam	**-0.3%**
Thailand	1.5%
China	2.0%
Malaysia	2.1%

Furthermore, this week Fitch upgraded Vietnam's credit rating by one notch (to BB), the first time since early 2014, citing the country's improved ability to absorb external shocks.

Vietnam's improved resilience and stable USD/VND exchange rate is attributable to:

- **The Government's Prudent Macroeconomic Management**

  FX reserves recently reached 3.5 months' worth of imports[1] (up from 2.3 months at the end of 2016), and Vietnam's inflation rate is below 3%

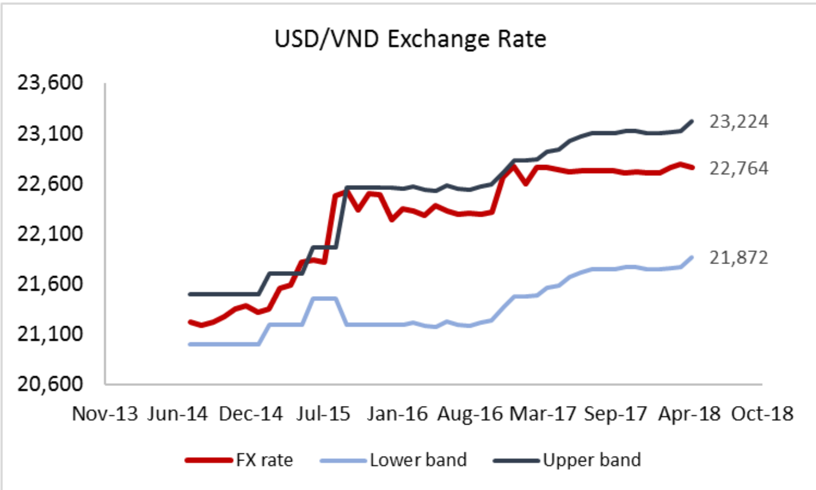
- **The Continued Growth of Capital *Inflows* to Vietnam**

  FII rose by an estimated 67% yoy in 4M18 to USD2.3 billion; FDI inflows are on-track to exceed 7% of GDP in 2018, and have averaged 7.5%/GDP over the last five years

- **Vietnam's c. 3% of GDP Trade Surplus**

  The country has run current account (C/A) surpluses for over five years in a row, which averaged more than 3%/GDP annually; electronics and mobile phones now account for over one-third of Vietnam's exports

Furthermore, the State Bank of Vietnam (SBV) implemented a "crawling peg" on the official USD/VND exchange rate in the beginning of 2016 that effectively alleviated the speculative pressures on the Dong which triggered steep depreciations of the country's currency in the past.

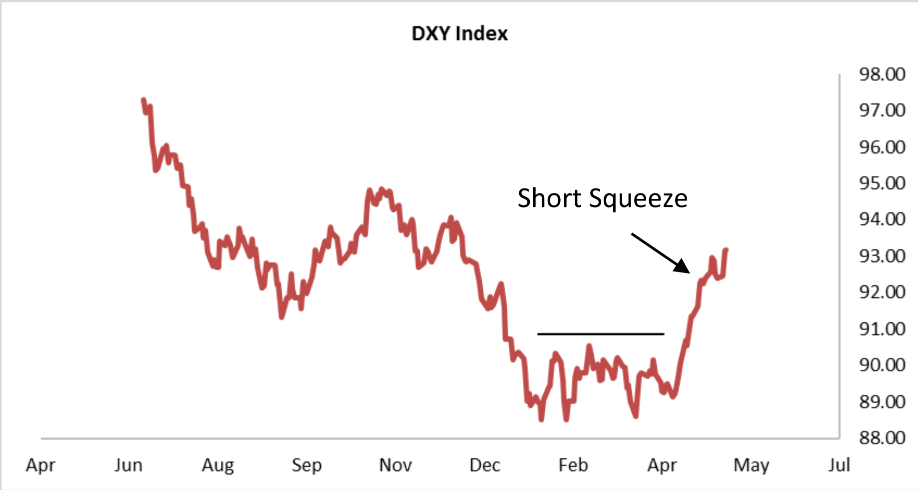


The SBV's adept, daily incremental adjustments to the official USD/VND rate kept the "unofficial" exchange rate within the +/-3% official band (in prior periods of macroeconomic stress, the grey market value of the VND traded more than 10% below the official value of Vietnam's currency).

[1] The State Bank of Vietnam bought USD13 billion of FX reserves in 2017, and an additional USD11 billion 2018 YTD, and Vietnam's imports are growing at about a 10% annual rate.

What's driving the current emerging market FX sell-off?

The DXY, US Dollar Index has risen 4% since mid-April, driven by the widening gap between (increasing) interest rates in the US, and those in Europe, Japan, and other parts of the world.



The jump in the DXY stems from the fact that speculators had accumulated the biggest short position *against* the dollar in seven years, according to Goldman Sachs.

Traders had been betting that the dollar would continue falling in value this year, after having plunged by about 11% in 2017, driven by the continued deterioration of America's current account and government budget deficits this year. However, a "short squeeze" on the dollar forced those leveraged investors to rapidly close out their leveraged short positions (about half have been closed out since mid-April, according to Goldman).

The resulting sharp upward move in the DXY index is unnerving EM investors because:

1) USD denominated debt is more expensive to pay back when the value of the Dollar increases – and foreign currency denominated debt in EM's soared over the last decade…to nearly USD4 trillion, according to the BIS
2) Countries that have current account and trade deficits (which EMs usually have) can suffer much higher inflation when their currencies depreciate
3) Foreign investors withdraw capital from emerging markets when the risk of EM exchange rate losses increases

Further to that last point, "hot money" outflows from emerging markets are primarily caused by the unwinding of "carry trades", in which foreign investors pour money into relatively stable EM countries like India and Indonesia, because of the higher interest rates investors can earn in those EMs compared to the interest rates achievable in developed markets.

However, the additional investment income that those "carry trade" investors earn gets wiped out when the currency of the investee country depreciates - so those foreign investors are quick to repatriate their "carry trade" investments when EM FX rates wobble.

Finally, Fed Chairman Powell made a speech in Switzerland last week which guided that the Fed's interest rate policy would not be influenced by EM volatility, which also hurt sentiment.

Why Vietnam is resilient to the emerging market FX sell-off

Vietnam's resilience to the current EM FX sell-off is partly attributable to the facts that:

1) Foreign investors aim for long-term capital gains in Vietnam, rather than "carry trade" investment income – which makes Vietnam less susceptible to "hot money" outflows

Unlike Indonesia, where foreign investors owned nearly half of the country's outstanding government bonds until recently, foreign investors are insignificant participants in Vietnam's Government Bond (VGB) market[2]

2) Vietnamese companies rarely borrow with foreign currency debt

Vietnam's external debt is fairly high, at nearly 50%/GDP, but most of that foreign currency denominated debt is owed by Vietnam's government to the World Bank, ADB, and other similar institutions.

Vietnam vs. the rest of EM

The factors currently depressing EM currencies are not major risks for Vietnam, but there is a risk that an EM contagion could prompt foreign investors to sell Vietnamese stocks and bonds.

That said, risk that EM stock and bond markets could suffer a bout of panic selling is tempered by the improved macroeconomic stability of most EM's following the 2013 "Taper Tantrum" because most EMs increased FX reserves, reduced C/A deficits, and tamed inflation.

The severe FX depreciations of Argentina and Turkey reflect macroeconomic mismanagement that is now unheard of in EM Asia.

FX Depreciation Drivers in Emerging Markets

Argentina & Turkey	Gross economic mis-management
Philippines & India	Deteriorating C/A's and Imported inflation
Indonesia	"Hot Money" outflows by *Carry Trade* investors
Thailand, Malaysia, and China	FX **appreciation** supported by C/A surpluses

Argentina squandered its FX reserves, so nearly half of its central bank's assets now consist of worthless IOU's from the government, and inflation is around 25%. Nearly two-thirds of the country's aggregate debt (private and public) is USD denominated, making an IMF bailout inevitable.

Turkey's central bank needs to raise interest rates in order to stem the decline of the Turkish Lira, but the country's president believes [high] interest rates are the "mother and father of all evil", and also believes that high interest rates cause (rather than cure) inflation.

Modest FX depreciations in the Philippines and India are being driven by deteriorating current account balances, which are exacerbated by rising oil prices (both countries import nearly all of the oil they consume). In addition, the Philippines runs a circa 10%/GDP trade deficit, so FX depreciations are inflating consumer prices.

In contrast, Vietnam is essentially energy self-sufficient, and about three-quarters of the country's imports are of production materials and equipment by FDI companies, so Vietnam is not susceptible to imported inflation.

India is also suffering from "Hot Money" outflows, but this a greater issue in Indonesia, because foreigners owned nearly half of the country's outstanding government bonds until recently.

The interest rates paid by Indonesia's 10-year government bonds are nearly 4%pts above the yield of 10-year US Treasury bonds, but investors already lost most of that additional investment income this year because Indonesia's currency depreciated nearly 4% YTD.

Finally, current account surpluses are supporting Thailand, Malaysia, and China's currencies. Malaysia's current account surplus is bolstered by high oil prices, and Thailand's 10%/GDP current account surplus stems from its successful tourism and export manufacturing industries.

China's currency also benefits from the country's neutral monetary and loose fiscal policies (the central bank recently cut China's Reserve Ratio Requirement but is simultaneously tightening macro-prudential regulations).

[2] We estimate that foreign financial investors own less than 7% of outstanding VGBs.

In addition to those macroeconomic factors, China's government appears to be targeting a strong currency as part of its aim to reduce the role of the US Dollar in Asian intra-regional trade by ensuring that the Renminbi is a reliable store of value.

In 1997, Chinese policy makers adeptly navigated the Asian financial crisis by refusing to depreciate the Renminbi which facilitated soaring FDI inflows in the 2000s. We believe Vietnamese policy makers are now pursuing the same FX strategy.