Michael Kokalari, CFA
Chief Economist

Chinese Yuan Appreciation is Good for Vietnam

Summary

- China's currency appreciated by 8% against the US Dollar over the last 5 months
- The appreciation of the Chinese Yuan is set to continue for at least another year, driven by several factors discussed below
- The appreciation of China's currency makes Vietnam's exports more competitive, and will encourage more factories to move from China to Vietnam

The Chinese Yuan Has Been Appreciating

- The Chinese Yuan has been appreciating against the USD since mid-2020, as can be seen in the chart above, driven by: 1) the prompt recovery of China's economy from COVID, 2) China's surging exports of both medical and "stay at home" goods, 3) FII inflows, prompted by an increase in China's stock & bond market in global indices, and ***especially*** by 4) the informal guidance of Chinese policy makers that China's government now prefers a stronger Yuan - in order to support domestic consumption.
- In recent weeks, there have been developments on every one of these factors suggesting the Yuan will appreciate further over the next year[1]:
    - Three weeks ago, a communiqué by the Central Committee of China's Communist Party (CCP) guided to expect a doubling of Chinese GDP over the next 15 years[2], with domestic consumption

[1] This report focuses on China-specific factors, although there is a separate consensus forming that the value of the US Dollar is likely to be weak over the next year for a variety of reasons, including the US election results

increasingly driving China's economic growth in what Chinese policy makers are calling the "Duel Circulation Economic Model".

- Last week, a speech by China's Central Bank Governor gave a speech titled, "Construct New Economic Development and Open Up Financial Industry". Many analysts are interpreting this speech as the clearest sign yet that the China's government is switching from trying to suppress, to trying to support the value of the Yuan.[3] [4]
- The prospects for further Foreign Indirect Investment (FII) inflows into China's stock and bond markets was bolstered by the recent announcement that Chinese Government Bonds will be added to the FTSE Russell World Government Bond index, following a similar announcement from JP Morgan earlier this year. FII inflows to China's stock and bond markets surged nearly 50% yoy in 9M20, to over $130b.
- China's export October growth came in above the consensus expectation, so the on-going rebound in the country's exports is also supporting the Yuan.

- In addition to the factors discussed above, China has the highest real interest rates of any large country in the world, and the country's CPI inflation rate plunged from 1.7% in September, to 0.5% in October, further focusing traders' attention on China's high interest rates (recall that real rates increase when inflation drop, ceteris paribus).
- Finally, notwithstanding all of the above, the main factor that is likely to drive the appreciation of China's currency over the next 1-2 years is the country's mix of loose fiscal policy, and tight monetary policy. This policy mix, which is often called "Reagan's Imperial Circle" usually causes a country's currency to appreciate, and is discussed at length below.

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[2] The Chinese government's guidance implies circa 5% annual GDP growth over the next 15 years, but the government is no longer targeting specific growth rates.

[3] When developing countries transition from pursuing an export-oriented manufacturing / commodity exporting economic model to a domestic consumption economic model (as the US did in the late 1800's !), policy makers ***always*** shift from trying to depress the value of their country's currency to supporting the value of their currency – in order to bolster the purchasing power of their citizens.

[4] The Chinese government's recent policy pronouncements also implicitly acknowledge that a strong Yuan policy will disadvantage the country's poor, rural citizens in order to benefit its urban consumers

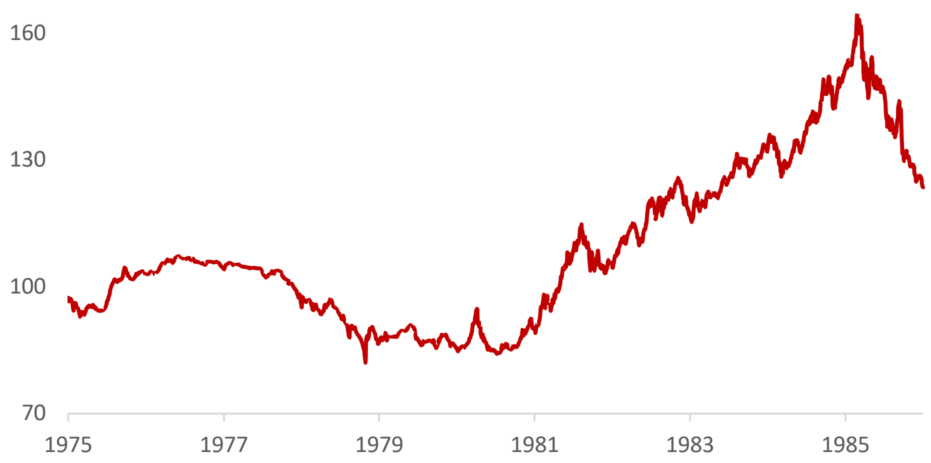
Chinese Yuan Appreciation Is Good For Vietnam

- An appreciation of the Chinese currency is unambiguously positive for Vietnam because:
    1) It would make Vietnam's exports more competitive than China's (China & Vietnam essentially compete against each other when exporting to the US and other countries around the world), and
    2) It would prompt factories to relocate out of China
- Further to that last point, an appreciation of the Yuan would actually benefit all of South East Asia, but would be especially good for Vietnam because Vietnam is currently considered the most attractive country in the region for manufacturers to relocate their factories to, for a variety of reasons (low wages, high work ethic, cultural homogeneity, etc.)
- The appreciation of the Chinese Yuan would drive an increase in Vietnam's exports to China, partly because a stronger Yuan would make products that are made in Vietnam cheaper to buy for Chinese consumers. However, an appreciation of China's currency is also "part and parcel" the country's a shift towards a more consumer-driven economy in China.

Further to that last point, the Chinese government's widely publicized "Duel Circulation" economic model represents a rebalancing the country' economy towards domestic consumption – and will present ample opportunities for Vietnamese firms to manufacture and sell products to Chinese consumers.

Understanding Reagan's Imperial Circle

- In the early 1980s, the US government budget deficit soared when President Reagan cut taxes and expanded military spending - prompting widespread concerns that the value of the US Dollar would collapse as the US government's finances deteriorated. However, instead of collapsing, the value of the US Dollar soared by ~50%, in a phenomenon that George Soros called Reagan's Imperial Circle.
- The Regan Imperial Circle policy mix is characterized by loose fiscal policy and tight monetary policy. The previous bullet point highlighted the extraordinarily loose fiscal policy in the US during the 1980's, monetary policy was very tight at that time because the legendary Federal Reserve Chairman Paul Volcker radially increased US interest rates in order to crush the high inflation that was endemic during the 1970s.
- Soaring budget deficits did <u>not</u> cause a collapse in the value of US Dollar, because: 1) high budget deficits stimulated US economic activity – which prompted investment inflows, 2) the US government's borrowing caused long-term bond yields to rise (which economists call the "crowding out" effect), and 3) the issuance of large volumes of US Treasury securities prompted Japanese and other foreign investors to pour money into this highly liquid market - and those foreign investors had to first convert their money into US Dollars, to buy Treasury bonds.



- In addition to the dynamics described in the previous bullet point, the very high level of real (ie. inflation-adjusted) US Dollar interest rates also made it attractive for investors to pour money into the US. Note that: 1) China currently has the highest level of real interest rates in the world right now, and 2) the current US policy mix of high budget deficits and loose monetary policy has the exact <u>oppose</u> effect of everything discussed here.

- Further to that last point, loose fiscal <u>and</u> loose monetary policy (which the US currently has), causes a country's currency to plunge – because it essentially means that the country's central bank is essentially printing money in order to finance government expenditures – which is exactly what led to hyper-inflation in Germany before WWII, in Venezuela recently, etc.

- Finally, the two most famous examples of the "loose fiscal, tight monetary" policy phenomenon were the US in early 1980's, and Germany in the 1990's (Soros made huge trading profits on both). Most economists had expected the value of the Deutschmark to plunge after the re-unification of East & West Germany. However, the German government essentially did a massive fiscal stimulus in order to absorb East Germany, while the Bundesbank aggressively raised interest rates to prevent inflation – which caused the Deutschmark to soar. [5]

<u>Reagan's Imperial Circle Comes to China</u>

- China's government has been fighting the economic impact of the COVID pandemic with fiscal stimulus - including a modest increase in infrastructure spending – so it's likely to run a fairly hefty ~10%/GDP budget deficit this year.

- In contrast that last point, the People's Bank of China (PBOC) has <u>not</u> been aggressively printing money to support the country's economy (ie. monetary policy is fairly tight), because:

    1) The central bank is fearful of inflating another stock market bubble, after having spent $1T of its reserves to stabilize the country's economy in the aftermath of the 2015 stock market bubble.

[5] In addition to the anecdotal explanations of the Regan's Imperial circle phenomenon in this report, a more technical understanding of why the combination of loose fiscal, and tight monetary policy cause the value of a country's currency to appreciate can be garnered by investigating the Mundell-Fleming model (also known as the IS-LM-BP model): https://en.wikipedia.org/wiki/Mundell%E2%80%93Fleming_model

Chinese authorities are ***very*** cognizant of the social unrest that would certainly accompany the inflation and subsequent collapse of another major real estate bubble !

2) China wants to establish the Chinese Yuan as an alternative reserve currency - especially for use in Asia.

- Further to #2 above, Chinese policy makers understand that the US Dollar's role as the world's reserve currency gives the US what some economists call an "exorbitant privilege", which enables the US government to borrow enormous amounts of money,[6] and enables US citizens to enjoy a much higher material quality of life then they would be able to were the US Dollar not the world's reserve currency. [7]
- Finally, China currently has a loose fiscal policy and a ***fairly*** tight monetary policy, so money market interest rates in China increased by about 150bp since May, to back above pre-COVID levels (China is the only large economy in the world, in which government bond yields have increased YTD).

  However, the country's monetary policy is nowhere near as tight as the US in the 1980's and Germany in the 1990's – so the Yuan's appreciation over the next 1-2 years will be much less pronounced than that of the US Dollar and the Deutschemark in the two cases described above.

Disclaimer

[6] Countries around the world always need to hold US Dollars in order to trade with each other, and the easiest place for the central banks around the world to keep those USD is in US Treasury Bonds (this is the reason that the USD's reserve currency status enables the US government to borrow enormous amounts of money at low interest rates).

[7] A cynical view is that the US sends pieces of paper (that it prints by itself !) to countries around the world – and it receives real commodities & manufactured products in exchange for those pieces of paper…