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Good News for Vietnam from the US Government

The threat of tariffs on Vietnam's exports to the US *finally* ended with last week's meeting between US Treasury (UST) Secretary Janet Yellen and State Bank of Vietnam (SBV) Governor Nguyen Thi Hong. The tariff risk had been hanging over Vietnam's stock market and business community for months, so the joint communique from the UST and SBV (discussed below) relieved investors and paved the way for a sustained appreciation in the value of the VN Dong.

In late 2020, the US Treasury Department labelled Vietnam a "currency manipulator", accusing Vietnam of artificially depressing the value of the VN Dong to ~10% below its fair value, and the US Commerce Department opened a "Section 301" investigation into Vietnam's trade practices. These actions spawned widespread concerns in Vietnam because the US government used Section 301 as one justification to impose tariffs of up to 25% on nearly half of China's exports to the US.

We were not overly concerned about the Section 301 investigation, and published a report titled, "*There's No Risk the US Will Impose Draconian Tariffs*" in October 2020, as well as several articles in the local business press on this topic, one of which can be found [here](#). However, many investors continued to believe that tariffs were a major risk right up until last week, because of the surge in Vietnam's trade surplus with the US.

Vietnam's exports to the US increased 26% in 2020, and then surged by a further 45% yoy in 1H21, which swelled Vietnam's trade surplus with the US to USD38 billion in the first half of 2021. To put those figures in context: 1) Vietnam's trade surplus with the US equates to 20% of its GDP versus China's 2%/GDP trade surplus with the US, and 2) one of the US Treasury Department's criteria¹ to be considered a "currency manipulator" is a USD20 billion trade surplus with the US for a full year.

"No" To Tariffs...But "Yes" To VND Appreciation

The US Treasury and State Bank of Vietnam published a carefully worded, diplomatic joint statement on the UST's website which can be found [here](#), and which essentially says: 1) the US will not impose stiff tariffs on Vietnam, and 2) the SBV will allow the value of the VN Dong to appreciate in-line with Vietnam's strong economic fundamentals. We have highlighted the two most important passages in the joint communique below:

"The SBV Will Let the VN Dong Appreciate"

"The SBV will continue to improve exchange rate flexibility over time, allowing the Vietnamese dong to move in line with the stage of development of the financial and foreign exchange markets and with economic fundamentals, while maintaining macroeconomic and financial market stability."

"The US Won't Impose Stiff Tariffs on Vietnam"

"Treasury will inform other U.S. government agencies that it has reached agreement with the SBV to address Treasury's concerns about Vietnam's currency practices."

The joint US-Vietnam statement clearly implies that Vietnam's policy makers are under considerable pressure to allow the value of the VN Dong appreciate, which was reinforced by US Trade Representative (USTR) Katherine Tai's statement that the "USTR, in coordination with Treasury, will monitor Vietnam's implementation of its commitments...related to the valuation of its currency". In our view, sustained 2-3% annual appreciation in the value of the VN Dong is now a near certainty, because of the huge amount of capital that continues to flow into the country and because Vietnam's central bank will no longer engage in the "unsterilized FX interventions" that dampened the value of the VN Dong in recent years.

We estimate that 10% of GDP worth of foreign capital flowed into the country last year, including FDI inflows of 7%/GDP. Capital inflows, coupled with a 4.5%/GDP Current Account surplus, swelled Vietnam's Balance of Payments (BoP) surplus to 7%/GDP in 2020, and we expect a 5% BoP surplus in 2021. This explains why the value of the VN Dong remained very firm this year, and has even appreciated slightly in recent weeks, despite Vietnam's worsening COVID situation.

¹ The UST's three criteria for a country to be considered a currency manipulator are: 1) a USD20 billion annual trade surplus with the US, 2) a 2%/GDP Current Account surplus, and 3) the purchase of FX reserves equivalent to 2%/GDP by the country's central bank over one year.

A Major Win for Vietnam – In Several Ways

The US Government terminated its threat to impose tariffs on Vietnam despite Vietnam’s surging trade surplus or the fact that Vietnam continues to exceed the US Treasury Department’s criteria to be considered a currency manipulator. This development demonstrates the strong desire of US policy makers to maintain friendly relations with Vietnam for geopolitical reasons and illustrates how much the US is willing to overlook to foster strong relations between both countries.

The fact that tariffs are off the table will encourage FDI inflows, but this agreement will also benefit Vietnam tremendously over the long term by: 1) encouraging inflows from foreign financial investors (i.e., FII inflows) because those investors prioritize countries with stable, or appreciating currencies, 2) compelling local companies to improve their competitiveness, and 3) lifting living standards for local consumers by fostering the further development of Vietnam’s domestic economy. Regarding #2 and #3, the “Asian Tigers” prospered by manufacturing exports, but most of those countries relied on export-oriented manufacturing for far too long, which entailed artificially undervaluing their currencies for years.

When a country artificially depresses its currency to support its exports, the quality of life of its citizens suffers (for example, consumption averaged 53%/GDP in China over the last 10 years versus nearly 70% in the US), and the crutch of an undervalued currency spawns inefficiencies and warped incentives that ultimately disadvantage most local companies. In contrast, Vietnam’s appreciating currency will help the country escape the “middle income trap” by encouraging innovation because local companies will not be able to rely on a cheap FX exchange rate to compete. That said, Vietnam’s factory wages are two-thirds below those in China, so Vietnam will still retain its competitive advantage for years to come.

Geopolitics and the US Government’s Decision

The current laissez faire attitude of US policy makers towards Vietnam’s trade surpluses stems from the on-going escalation of US-China tensions, which policy makers are responding to by increasing US engagement in Southeast Asia (SEA).



This engagement strategy was promoted in “The Longer Telegram: Towards a New American China Strategy”, report published by the influential Atlantic Council think-tank in early 2021. The Biden Administration’s Chief Asia Strategist Kurt Campbell reiterated the strategy a few weeks ago when he said the US needs to “step up its game in Southeast Asia”. Ironically, the US is finding Vietnam the most receptive country in SEA with which to engage, since most countries in the region “pivoted” toward China to varying degrees in recent years (the Philippines is the most notable example). We believe this opens a huge opportunity for Vietnam to benefit from US economic assistance that takes the form of a receptive market for Vietnam’s exports (this was the same strategy that the US used to support Japan and Korea during the cold war).

Finally, this week’s meeting between senior Chinese and US diplomats in Tianjin was characterized as a “stalemate” between the two countries, following demands by the Chinese that the US “correct its errors” in its treatment of China. Trump’s “Phase 1” trade deal will expire at the end of the year, and there are no signs that Biden will remove tariffs on China’s exports to the US, so US-China tensions will almost certainly continue escalating – which should ultimately benefit Vietnam.

Conclusion

The US Government’s decision to terminate the threat of tariffs on Vietnam eliminates one major risk for investors in Vietnam’s stock market. In addition, investors will benefit from Vietnam’s commitment to allow the country’s currency to appreciate. The decision by the US was motivated by the need to win friends in the region as tensions with China escalate, and we believe many more benefits will accrue to Vietnam as a result of that dynamic.

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