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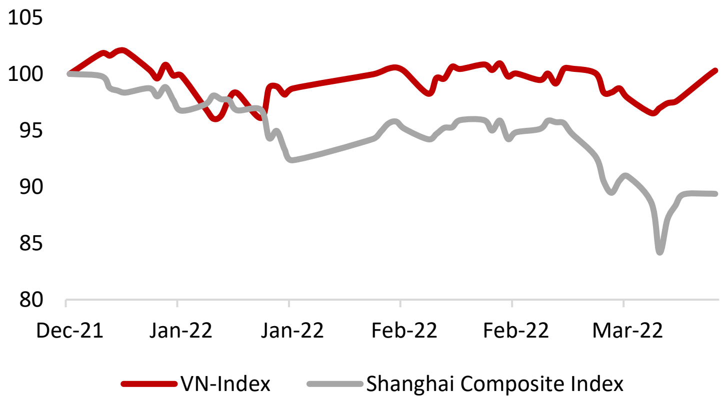
Vietnam Investors Need Not Worry About China's Economy

One of the most frequent questions we have been asked by investors in recent weeks (aside from questions relating to the potential impact of the Russia-Ukraine situation on Vietnam) is how some significant developments in China could affect Vietnam. The short answer to that question is that while Vietnam is a major trading partner of China's, it is surprisingly decoupled from the country. As a result, recent economic developments in China – both positive and negative – are only having a modest impact on Vietnam.

Consequently, wild swings in the Chinese stock market this year have had virtually no impact on Vietnam's VN-Index (VNI). China-specific factors have put downward pressure on China's stock market, including renewed COVID lockdowns and the risk of Russia-related sanctions on China. However, equally powerful country-specific factors have also prompted a bounce in China's stock market, such as the Chinese government's relaxation of its crackdown on tech companies and its vows for new policies to support the stock market (including informal guidance that major monetary easing is imminent).

VN-Index vs. Shanghai Composite Index



That said, many investors remain concerned about the potential impact on Vietnam from the deflation of China's real estate bubble (Chinese house prices have fallen six months in-a-row), its "Zero COVID" policy, and other developments. However, in our view, the much bigger story is the dramatic surge in factories relocating from China to Vietnam driven by COVID and by the US-China trade war, something that is likely to intensify in light of the Ukraine situation as well as China's continued strict approach to COVID. Importantly, FDI from mainland China (ex-HK) to Vietnam doubled over the last five years, making China Vietnam's fastest growing source of FDI.

<u>Follow the (~~Money~~) Trade Flows</u>

The headline of this report asserts that investors in Vietnam do not need to be overly concerned about developments in China's domestic economy, even though the trade flows between the two countries are enormous. When two countries have deep trade links, each typically has a high degree of economic exposure to the other. However, while China accounts for over 30% of Vietnam's imports and nearly 20% of its exports, Vietnam's trade deficit with China is massive, at around 15%/GDP. That outsized trade deficit is an intuitive indicator that investors should not be overly preoccupied with a slowdown in China's economy or its property market; Vietnam buys much more from China than China buys from Vietnam.

Vietnam's Trade Balances (as a % of Vietnam GDP)

	2018	2021
US	+11%/GDP	+22%/GDP
China	-8%/GDP	-15%/GDP

Vietnam's Trade Flows with China (% of VN Export & Import with CN)

Electronics-Related	53%
Textile/Garments	11%
Commodities	6%
Steel	6%

76%

Next, the majority of Vietnam's two-way trade with China are of electronics- and garment-related products, which reflects the fact that the supply chains of both industries now overlap across geographic boundaries into both Vietnam and China[1]. The components used to make smart phones, televisions and other home electronics products repeatedly criss-cross between various companies in the supply chain. Some of those factories are in China and some are in Vietnam.

This means Vietnam and China are both more exposed to the economic conditions of the end-buyer of the products manufactured by these firms than they are to conditions in each other's economies. The dominant end-buyers of these products are US consumers, which is reflected by the fact that Vietnam ran a 22%/GDP *trade surplus* with the US in 2021. Note also that Vietnam's trade surplus with the US grew by a comparable magnitude as its *trade deficit* with China since the start of the US-China trade war (which can be seen in the table above) because companies have been moving factories that produce products for US consumers from China to Vietnam.

Finally, about 8% of Vietnam's exports to China are of food commodities and 7% are of non-food commodities, implying that there are specific industries with significant exposure to China' economy, and/or that have suffered from COVID-prompted border closures, including rubber production, seafood, and farms that produce fruits and vegetables favored by Chinese consumers. However, these trade flows are not sufficiently significant to impact Vietnam's overall economy.

A Summary of China's Other Impacts on Vietnam

Investors are concerned about the potential impact on Vietnam from the following three China-specific developments:

- China's "Zero COVID" policy
- China's property market
- African Swine Fever (ASF) / food price inflation

Last week's news that China would impose strict COVID lockdowns on Shenzhen was of particular concern, given the discussion about electronics-related and garment supply chains, but the actual closure of factories that produce high tech products was very brief (i.e., a few days). Furthermore, China's government is now reportedly shifting to a strategy that aims to reduce the economic impact of COVID while simultaneously mitigating public health risks, plus some manufacturers are now adopting a COVID mitigation strategy that entails their workers living at the factory – both of which were part of Vietnam's relatively successful response to COVID last year.

In addition, FDI companies in Vietnam are generally sitting on large inventories of production inputs, which would limit the impact of COVID-prompted supply chain disruptions (in early 2021 FDI companies' imports of components used to make high tech products surged by over 50% yoy). That said, China's current "Zero-COVID" policy makes it unlikely that Chinese tourists – which previously accounted for one-third of Vietnam's total tourist arrivals - will return to Vietnam in 2022.

Next, the deflation of China's property bubble has had virtually no impact on Vietnam. Most Vietnamese companies have minimal exposure to China's domestic economy, which is reflected in the table above of trade flows between the two countries. However, the Chinese government has signalled that aggressive steps are imminent to stabilize China's real estate market and to boost infrastructure development (fixed asset investment surged from 4% CAGR over 2019-21 to 12% yoy in 2M22). These imminent support measures, along with the surge in global commodities prices, helped push up steel prices in Vietnam by nearly 20% YTD.

Finally, given China's enormity and its proximity to Vietnam, food price inflation in China has a heavy influence of Vietnam's level of food price inflation - and that influence was exacerbated by the African Swine Fever (ASF) epidemic that was the dominant influence on both countries' headline CPI inflation rate in recent years. China's pig population has now recovered to pre-ASF levels, so pork prices in China and Vietnam are down about -50% and -20% year-on-year respectively. Consequently, food price inflation in China and Vietnam are currently -3.9% yoy and -0.2% yoy respectively, although those figures will certainly go higher in the months ahead because of the Ukraine situation.

Conclusions

Recent economic developments in China are unlikely to have a major impact on Vietnam's economy because most of the trade between the two countries entails the production of goods that are ultimately sold to consumers in the US, the EU and other countries around the world. These trade flows *do* expose Vietnam to any supply chain disruptions, so we are relieved that the Chinese government appears to be taking steps to minimize such disruptions, as well as note that FDI factories in Vietnam are currently sitting on sufficient inventories of production materials that can enable them to withstand any short-term disruptions.

[1] Nearly 60% of Vietnam's exports to China are of electronics-related products

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