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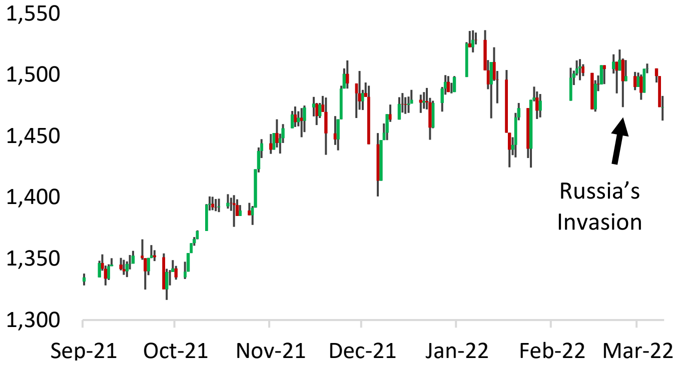
Russia's Invasion of Ukraine: Modest Impact on Vietnam

Russia's invasion of Ukraine has created shockwaves in international financial markets and has had a major impact on commodity prices. But the direct impact of these geopolitical developments on Vietnam's economy is modest, which helps explain why the VN-Index (VNI) only sold off by about 2% since February 23rd despite these unprecedented events.

The biggest immediate Russia risk is that surging commodity and oil prices could increase Vietnam's headline CPI inflation by 1-2%pts. We are also concerned about the possibility that a sharp, sudden spike in the value of the US Dollar could cause the value of the VN Dong to depreciate by 1-2% against the USD, which we discuss below. That said, VN Dong depreciation is not our base case scenario; the USD-VND exchange rate is essentially unchanged since the invasion took place because the value of the VN Dong is well supported by fundamental factors discussed below.

The VN-Index (VNI)



Vietnam's Trade with Russia

Exports		Imports	
Total	**$3.2b**	**Total**	**$2.3b**
Mobile phones	$1.1b	Coal	$0.5b
Electronics	$0.4b	Steel	$0.5b
Garments	$0.3b	Fertilizer	$0.1b

The direct economic linkages between Vietnam and Russia are fairly minimal, despite the strong legacy relations between the two countries. Less than 1% of Vietnam's exports (circa USD3.2 billion) are sold to Russia, less than 1% of Vietnam's imports come from Russia, and less than 4% of Vietnam's tourist arrivals (pre-COVID) were from Russia.

Vietnam imported about USD145 million of fertilizer from Russia in 2021, which we estimate is less than 10% of the fertilizer used in Vietnam (note that Vietnam has a substantial local fertilizer industry, including two fairly large, listed firms, DPM and DCM, the combined revenue of which was nearly USD1 billion last year). About 10% of Vietnam's coal imports are from Russia, which is the third largest source of coal after Australia and Indonesia, despite the fact that Vietnam has abundant coal deposits in the north of the country, especially of high-value anthracite coal.

Finally, although Vietnam produces a considerable amount of oil, natural gas, and coal, the country is not quite energy independent, and we estimate that Vietnam has a circa 1% of GDP energy deficit (i.e., the country is a small, net importer of energy). This energy deficit – in the face of soaring energy prices - coupled with the fact that higher oil prices will divert some of local consumers' incomes from spending on consumer goods to spending on petrol will weigh on GDP growth somewhat this year. Specifically, that drag on Vietnam's economy from surging energy prices, coupled with a likely delay in the full resumption of foreign tourism, has prompted us to lower our GDP growth forecast by 1%pts to 6.5% for 2022.

Modest Inflation Boost

Global oil prices surged by nearly 40% after the invasion, and were up nearly 70% YTD at one point, before pulling back somewhat. Vietnam's retail petrol prices were up nearly 20% YTD at the time of the invasion, and petrol prices in Vietnam generally move in-line with global prices - albeit with a lag - so petrol prices in Vietnam could be hiked by another 30% in the months ahead. If that were to happen, we estimate that Vietnam's headline inflation rate would increase by about 1.5%pts due to the surge in global oil prices since the time of the invasion.

Further to that last point, note the petrol prices account for 3.6% of Vietnam's CPI basket, and we have assumed that a large petrol price hike would also have indirect impacts that would also contribute to higher inflation, which is how we arrived at our forecast that inflation in Vietnam could get boosted by 1.5%pts by higher global oil prices. The Government recently reported that Vietnam's CPI inflation fell from 1.9% yoy in January to 1.4% in February, so the escalation to inflation from higher oil prices that we are envisioning would leave inflation in Vietnam at around 3%, which is still below the Government's stated maximum 4% inflation target for 2022.

Finally, there have been several recent articles in Vietnamese newspapers highlighting the fact that about 15% of the price that Vietnamese consumers pay at the pump for petrol is an environmental tax, so the Government has the option of temporarily dropping that tax to control the headline inflation rate if needed (we estimate that dropping the environmental tax would reduce Vietnam's headline CPI rate by about 0.5%pts).

Food & Other Inflation

The circa 50% surge in wheat prices since Russia invaded Ukraine has been widely reported in the international business press, but wheat and other grains make a very small contribution to Vietnam's CPI basket, and the price of rice, which accounts for over 3% of Vietnam's CPI has barely moved in recent weeks. In our understanding, about 20% of the cost of producing rice is fertilizer, but fertilizer prices in Vietnam have also not moved much since the time of the invasion – although that could change in the months ahead. Finally, the prices of industrial metals have risen around the world, but as of the time this report is being written, the price of steel – which is by far the most important industrial metal in Vietnam – is up only about 6% since the invasion.

A Risk For the VN Dong

The fundamental factors supporting the value of the VN Dong remain strong in 2022, so we had previously expected the value of the VN Dong to appreciate by 2-3% this year, prior to Russia's invasion of Ukraine. In short, FDI inflows are up about 8% yoy in 2M22 to USD2.7 billion, and Vietnam's trade surplus is likely to rebound from 1% of GDP in 2021 to the 4-5%/GDP surpluses that were typical in recent years, going forward. Further to that last point, Vietnam's trade surplus was depressed by COVID in 2021 because FDI companies were unable to operate their factories at full capacity during the year, but companies' export orders surged in recent months, according to Vietnam's Purchasing Manager Index (PMI) survey.

Given that supportive backdrop, our concern about VN Dong depreciation may be surprising, but that depreciation risk stems from exogenous factors that are not related to Vietnam. When Russia first invaded Ukraine, the US Dollar/DXY index initially surged by over 1.5%, driven by "safe haven" buying of the USD, but then rapidly receded. However, over the last few days, concerns have been growing that cutting Russia out of the SWIFT system is having the unintended consequence of severely impeding US Dollar liquidity in the off-shore markets. Those concerns quickly pushed up the value of the US Dollar/DXY index by an additional 1.5%, and are the cause of considerable consternation among knowledgeable insiders.

Consequently, we believe there is a risk that a further, sudden spike in the value of the US Dollar could cause major disruptions in FX markets, which could in-turn prompt a 1-2% depreciation in the value of the VN Dong. To be clear, this is not our base case scenario and we do not believe there is a risk of much more than a 2% depreciation in Vietnam's currency because of the fundamental strengths in the VND discussed above, and because the US Federal Reserve would likely intervene to calm the currency markets if the situation deteriorates by more than anticipated.

Conclusions

Russia's invasion of Ukraine has a muted direct effect on Vietnam, which helps explain why the stock market has not sold off significantly since February 23rd. The two biggest immediate risks are that surging global oil prices will boost inflation in Vietnam by 1-2%pts (which we expect), and that developments in the off-shore US Dollar market could prompt a 1-2% depreciation in the value of the VN Dong (which we believe is less likely).

Finally, current developments in the market reinforce the opportunities for active managers to outperform the VN-Index. For example, we observe that although the overall market has sold off slightly, the share prices of leading oil services stocks (PVD & PVS) are up about 15% since the invasion while the prices of leading fertilizer stocks (DPM & DCM) are up about 30% since that time.

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