US-China Trade Tensions and Vietnam

The escalation of US-China trade tensions is weighing on Vietnam’s stock market, despite Vietnam’s solid macroeconomic fundamentals (GDP grew 7.1% in H1, the current account surplus was over 5% of GDP, and inflation is under control), and despite the fact that a protracted US-China trade war would benefit the country by accelerating the on-going displacement of manufacturing production from China to Vietnam.

Trade wars are emotive because of the widespread (and erroneous) belief that the 1930 Smoot Hawley tariff caused the Great Depression1. The degree of sway trade tensions has on investor sentiment is corroborated by comparing the consequences of US tariffs for China’s economy, with the much larger impact on its stock market.

Specifically, the current bout of US-China trade tensions reduced the value of China’s stock market by an estimated 5% of GDP, even though the US’s USD50 billion of new tariffs on Chinese imports (from July), plus an additional USD200 billion of mooted tariffs would only reduce China’s GDP by an estimated 0.5%, according to most economists specializing on China.

SHORT TERM STOCK MARKET VOLATILITY

The trade war between China and the US is disproportionately perturbing Vietnam’s stock market and currency because the escalating trade tensions between China and the US are putting downward pressure on China’s currency, and Vietnamese investors are very concerned about the impact of Yuan depreciation on Vietnam’s economy.

1) The Fordney-McCumber tariffs in 1922 were far larger than the 1930 Smoot Hawley tariffs; 2) the great depression was essentially caused by a 60% expansion of the money supply in the 1920s, followed by a 30% contraction in 1930-34; 3) the 1920s money supply expansion inflated asset prices, but consumer price inflation was constrained at that time by new technology, globalization, etc., just as it is today.
In mid-June, the value of the Yuan was nearly unchanged YTD, despite the imminent imposition of USD50 billion worth of new tariffs on US imports from China, and despite 4-7% YTD depreciations in the Indonesian, Indian, and Philippine currencies at that time. But the mid-June US threat to impose an additional USD200 billion of tariffs on Chinese imports triggered a rapid 6% sell off of the Yuan\(^2\).

The depreciation of China’s currency is unnerving local stock market investors and has prompted a 2.5% YTD depreciation of the VN Dong. In 2015, a 5% depreciation of the CNY against the USD prompted a similar magnitude depreciation of the VND, even though Vietnam was running a current account surplus at that time, inflation was under 1%, and GDP growth was very robust.

Furthermore, the sudden depreciation of the CNY in August 2015 triggered an almost immediate 15% sell-off in Vietnam’s stock market, driven partly by concerns that Vietnamese policy makers would continue depreciating the VN Dong in order to maintain the country’s export competitiveness vis-à-vis China.

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2 The CNY also came under pressure during the week of July 16 because of an unpreceded public argument between China’s Central Bank and the country’s Finance Ministry, in the wake of the default by Wintime Energy, which has USD11 billion of outstanding debts.

3 China aims to displace the USD for use in intra-regional trade, but that necessitates maintaining a stable value of the Yuan. Also, a steep depreciation of the CNY would trigger a resumption of the capital outflows that ultimately led People’s Bank of China to deplete its FX reserves by USD1 trillion in 2014-15.
However, those concerns were unfounded three years ago, and continue to be unfounded now in our opinion because factory wages in Vietnam are still only one-third of those in China, and wages in both countries are growing at about 6-7% annually. For these reasons, a modest depreciation of the CNY is unlikely to significantly impact Vietnam’s export competitiveness.

Some local analysts are also worried that Vietnam’s 7% of GDP trade deficit with China would widen if the CNY depreciates, which would in turn degrade Vietnam’s overall trade balance. However, we also believe this concern is unfounded, partly because Vietnam primarily imports production materials and intermediate goods from China, rather than consumer goods.

All of that said, Yuan depreciation is likely to mar investor sentiment over the next few weeks, as will nascent concerns that Vietnam’s high export-to-GDP ratio exposes the country to a slowdown in global trade flows. We are not overly concerned about the latter apparent vulnerability because Vietnam’s exports still only generate modest economic value for the country, as evidenced by the country’s diminutive 1.3% of GDP trade surplus last year, and by the fact that manufacturing still only contributes 16% of Vietnam’s GDP.

To put those figures in context, China ran trade surpluses of nearly 10% of GDP in the 2000s, and manufacturing peaked at about 30% of GDP in all of the “Asian Tiger” economies. The value-add of Vietnam’s exports should improve over time, especially as the domestic industries to support FDI exporters are developed. At that point, Vietnam will be much more vulnerable to slowdown in global trade.

**THE TRADE WAR’S LONG-TERM BENEFITS TO VIETNAM**

The trade war between the US and China will speed up the on-going efforts of companies to relocate manufacturing facilities from China to Vietnam. Multinational firms such as Foxconn, Samsung, and Daikin are already opening new factories in Vietnam, rather than in China because Chinese factory wages doubled over the last seven years.

Furthermore, wages in Vietnam are two-thirds lower than Chinese wages, but the quality of Vietnamese workers is comparable to that of Chinese workers, according to a survey by the Japanese government. For those reasons, Chinese manufacturing companies already prefer to
relocate their factories to Vietnam more than to any other country, and with the US-China trade war brewing, companies now have another reason to relocate production to Vietnam, in order to avoid new US tariffs.

Further to that last point, the US is unlikely to target Vietnam in the trade war because it has exerted considerable effort in recent years to build a special relationship with Vietnam, motivated by concerns about declining US influence in Asia as China rises.

**Further Boost to Vietnam’s High-Tech Exports**

Most of the additional FDI that will flow to Vietnam as a result of the US-China trade war will probably be focused on the production of cell phones, electronics and other high-tech products because of Vietnam’s close geographic proximity to the supply chains that support the manufacture of those products. The manufacturing of less sophisticated products such as garments that do not entail complicated supply chains is already moving to countries like Bangladesh that have even lower wages than Vietnam.

<table>
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<tr>
<th>China vs. Vietnam’s High-tech Exports to the US</th>
<th>China</th>
<th>Vietnam</th>
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<tbody>
<tr>
<td>High-tech Exports to the US (USD)</td>
<td>USD250 billion</td>
<td>USD8 billion</td>
</tr>
<tr>
<td>Fraction of China/Vietnam’s total exports to US</td>
<td>~50%</td>
<td>~18%</td>
</tr>
<tr>
<td>Fraction of US’s total technology imports that are made in China/Vietnam</td>
<td>~60%</td>
<td>~2%</td>
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</tbody>
</table>

Finally, China exported about USD250 billion of high-tech products to the US last year, compared to Vietnam’s circa USD8 billion (about half of Vietnam’s exports to the US are still garments and footwear). This enormous gap gives us confidence that Vietnam’s high-tech exports will continue surging for years to come, as does the fact that less than 10% of the country’s workforce is employed by FDI firms, so the country has ample workers to support the ongoing relocation of production from China to Vietnam.

Also, about two-thirds of the high-tech products the US imports are made in China, so it needs to reduce its dependence on China by diversifying to other suppliers, making Vietnam and Malaysia the biggest winners from the US-China trade war, according to Standard Chartered.

According to the University of Groningen’s sophisticated “World Input-Output Database (WIOD)” Leontief matrix analysis, Vietnam’s economy will get a circa 2% boost from the trade war, but we believe the ultimate lift to Vietnam’s economy could be even larger.

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5 Mobile phones, electronics, TVs, semi-conductors, etc. (Sources: GSO, Vietnam Customs, US Census Bureau, Standard Chartered, Alliance Bernstein).
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