Vietnam Outlook: Tiptoeing Toward the Winner's Circle

BY STEVEN COCHRANE, STEVEN SHIELDS — SEPTEMBER 30, 2019
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By Steven Cochrane and Steven Shields

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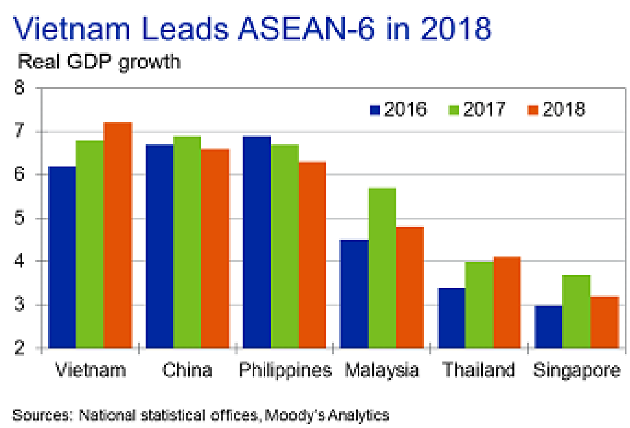
- Vietnam's robust economic expansion has been powered by its transformation into a global manufacturing hub.
- Fallout of the trade war between the U.S. and China has proven advantageous for Vietnam.
- However, fading external demand and a weaker global outlook serve as the primary concerns for Vietnam’s export-reliant economy.

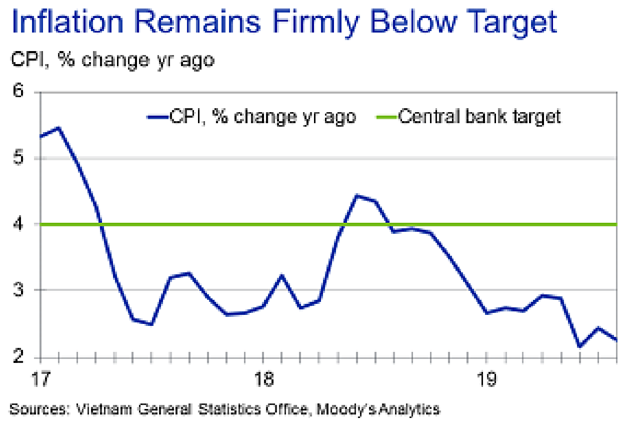
A small but dominant player in Southeast Asia, Vietnam’s economy continues to race ahead. The nation’s record expansion has exhibited few signs of slowing, with real GDP growth exceeding 6% for the past decade, a feat only a small number of emerging markets have achieved. What’s more, Vietnam outstripped Chinese GDP growth for the first time in nearly three decades in 2018. The country’s service sector continues to perform particularly well thanks to sustained domestic demand and increased private consumption.

Small pockets of weakness are beginning to emerge. Agricultural outputs have dampened following the African swine fever outbreak across Asia. Nearly 5 million hogs have been culled in the process to date. Additionally, weaker external demand has moderated growth within Vietnam’s export-oriented manufacturing sector. The near-term outlook reflects optimism that this recent weakness will diminish as renewed export growth and steady inflows of foreign direct investment underpin continued expansion. But risks are firmly tilted to the downside.

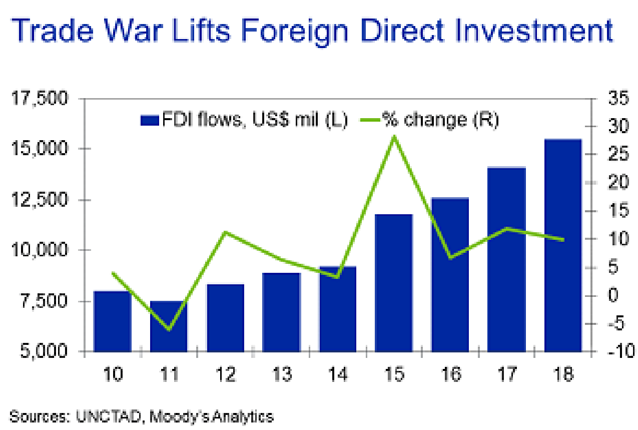


The country’s robust economic expansion has been powered by its transformation into a global manufacturing hub. Vietnam has been a rising star economically following broad-based reform measures introduced under the country’s Doi Moi policy in 1986. Under Doi Moi, Vietnam began its transition from a centrally planned economy into the socialist-oriented market economy of today. The policy promotes privately owned and foreign-owned enterprises and enhanced national competitiveness by removing price controls, focusing on infrastructure improvements, and disbanding government monopolies. The shift to a market-based economy has been a slow process but has borne fruit in the form of strong inflows of foreign investment, trade pacts, and the debut of the Ho Chi Minh City Stock Exchange at the turn of the century.

High inflation and the global financial crisis led a sharp drop in foreign capital entering the country in 2009, but Vietnam’s government and central bank have managed inflation well through the past decade despite a rapidly expanding economy. More recently, pricing pressures have eased following a brief period of above-target inflation in 2018. Year-to-date CPI increased just 2.6% in July, its lowest growth rate in three years. Record-high consumer confidence, rising incomes, and reduced price pressures will provide a lift to private domestic consumption. The exchange rate has also been stable relative to other currencies that have weakened against the U.S. dollar in 2019.



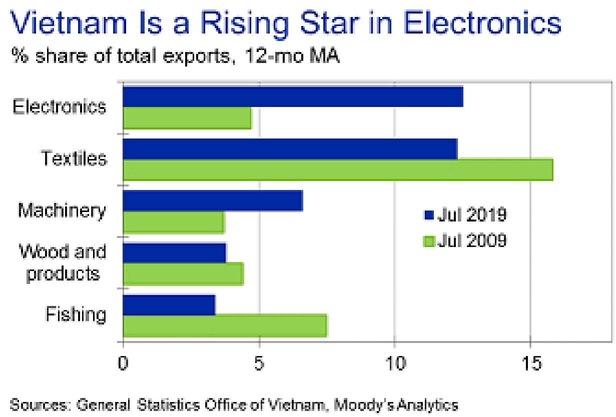
Foreign direct investment reached a record high for the sixth consecutive year in 2018, according to the United Nations Conference on Trade and Development, but recent trends portend a slowdown in 2019. According to the Ministry of Planning and Investment, Vietnam attracted $22.6 billion in foreign direct investment through July, down 7.1% compared with last year. The manufacturing and processing industry is the largest single recipient of investment, making factories responsible for more than two-thirds of pledges. Hanoi has received the largest share of foreign investment, with Ho Chi Minh City and Binh Duong serving as the second and third largest recipients of foreign investment.



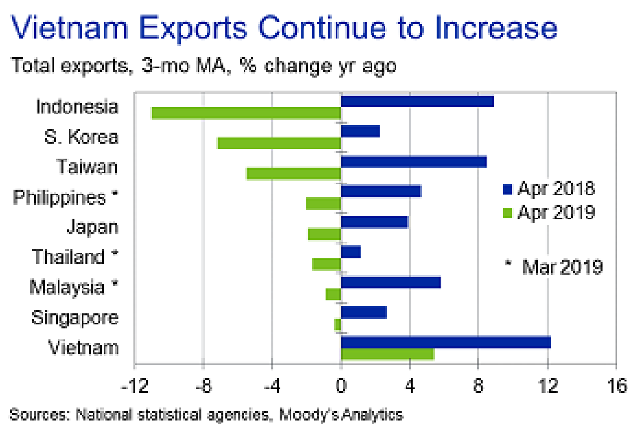
On September 13th, the State Bank of Vietnam surprised with a 25-basis point interest rate cut, lowering its discount rates to 6% and 4%. With inflation anchored below the target ceiling of 4%, Moody's Analytics anticipates that the State Bank of Vietnam will return to its neutral stance in the near term. The SBV is largely content with how economic conditions are playing out this year, but the insurance cut will provide additoinal support economic growth while also increasing liquidity within the banking system.

The SBV continues to pare back credit growth, having mandated banks to incorporate Basel II standards by 2020. These risk management protocols coupled with tighter lending standards will ensure that financial institutions are adequately capitalized, which the central bank hopes will alleviate concerns over the nation's banking system after the proliferation of bad debt forced the central bank to intervene in 2012.

As an emerging market, Vietnam relies heavily on the exports of natural resources, textiles and, to an increasing degree, the manufacturing of electronics and broadcasting equipment.



The fallout of the trade war between the U.S. and China has proven advantageous for Vietnam as Chinese manufacturers shift production into the country to evade U.S. tariffs. Therefore, Vietnam is one of the few countries in the region to experience a pickup in exports in 2019. As Vietnam has become a relatively more attractive destination for manufacturers in the region, its overall export volume has increased. Exports were up 11.2% on the year in April, though growth has slowed compared with last year.



Not only are Chinese producers moving operations to Vietnam, but U.S. consumers are also purchasing more Vietnamese -produced goods, evidenced by a 27% increase in U.S. imports from Vietnam during the first six months of 2019. These trends are also providing stability for the country's equity markets. The Ho Chi Minh Stock Index rose approximately 10% year to date through August, far outperforming the MSCI emerging markets ETF, which lost value over the same period.

Despite these positive developments, the rapidly expanding economy is not without its growing pains. Supply chains are not nearly as fleshed out as in China due to inadequate infrastructure. Development will be key as officials plan to invest in new expressways, ports, airports and railways. Hanoi and Ho Chi Minh City are also building mass transit systems, with Hanoi's expected to be fully operational by 2020. According to Vietnamese officials, foreign direct investment will be needed to fund many of these infrastructure enhancements. The government lacks the fiscal capacity to tackle these projects on its own. Even with funding secured, infrastructure upgrades will take time.

A relative shortage of workers

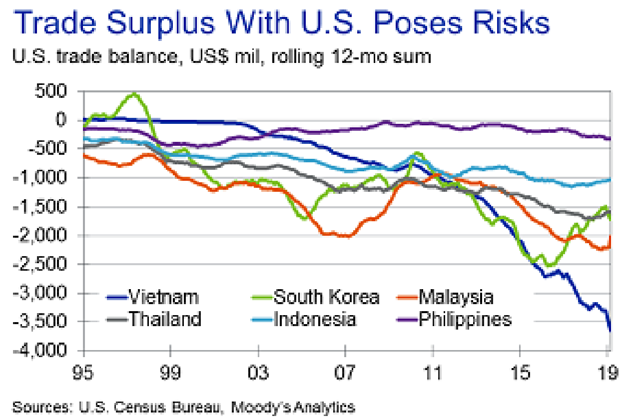
Adding insult to injury, a relative shortage of workers makes production less efficient than in China. While the share of residents with higher education is similar to that of China, the size of Vietnam's working-age population pales in comparison. Moreover, while wages are far less than in China and Malaysia, Vietnamese labor is more expensive than that of some other emerging markets such as India and Bangladesh. A dwindling supply of available labor coupled with a surge in demand for workers will create additional upward pressure on wages in the near term. While this is a net positive for income growth and consumer spending within Vietnam, it could dampen Vietnam's overall attractiveness of foreign capital in the long term.

Vietnam has endorsed China's Belt and Road Initiative and the China-led Asian Infrastructure Investment Bank but is cautious about the economic, political and strategic implications of this initiative. There remains lingering distrust between the two countries and rising anti-China sentiments in Vietnam due to recent tensions over the South China Sea disputes, especially following the 2014 oil rig crisis. On the one hand, Vietnam has expressed formal support for the BRI, as it is Chinese President Xi Jinping's signature foreign policy initiative. On the other hand, Hanoi seemed more concerned with how this initiative is implemented.

Other aspects of Vietnam's demographic profile also raise concern. Similar to China, Vietnam faces an aging population, with the labor force as a share of total population declining since 2015. The increase in the elderly population and declining birthrate imply slower economic growth in the medium term. However, advancement in high-skilled manufacturing and broader economic development will promote stronger immigration flows, injecting upside risk to the current population forecast. Additionally, improved infrastructure will provide a boost to productivity, lessening the impact of unfavorable demographics in the medium term. For these reasons, Vietnam will benefit, but it will struggle to compete with Chinese production in the near term. Given the relatively high educational attainment, but slowing labor force growth, Vietnam must move into higher-valued-added industries.

Risk of undoing

Benefiting from the U.S.-China trade war does not come without repercussions. The trade balance between the U.S. and Vietnam is heavily tilted in Vietnam's favor, making the nation increasingly vulnerable to accusations of a one-sided relationship. U.S. President Donald Trump has already taken notice of this dynamic, stating, "Vietnam is the single-worst abuser of everybody," when questioned if he planned to impose tariffs on Vietnam. Weeks later, the U.S. Department of Commerce enacted duties of more than 400% on Vietnam steel imports. The economic impact of these tariffs will be limited, since metal accounts for less than 1% of total exports, but further punitive measures by the U.S. risk undoing the many benefits that have taken hold since the onset of the U.S.-China trade tensions. Additionally, Vietnam was one of nine countries placed on a currency manipulation watch list by the Trump administration in May, citing the rising trade and current account surplus with the U.S.



Properly navigating the country's relationship with the U.S. will be crucial for Vietnam to be viewed as one of the rare winners associated with the U.S.-China trade war. Vietnam's relationship with the U.S. has been friendly since the two nations formalized diplomatic relations in 1995, while its close proximity, government stability, and increasingly business-friendly environment have attracted increased Chinese capital. Aware of this dependence on both Chinese and American consumers, Vietnam's government leaders have been effective in diversifying the nation's trade relationships. On June 30, for example, the country signed a deal with the EU that will eliminate nearly all duties on goods.

Outlook

Moody's Analytics forecasts Vietnam's real GDP growth to be 6.7% in 2019, slightly below last year's pace. Fading external demand and a weaker global outlook serve as the primary concerns for Vietnam's export-reliant economy. Despite risks firmly leaning to the downside, Vietnam will remain one of the fastest-growing global emerging markets as continued foreign direct investment, greater industry diversification, and strong domestic demand support continued economic expansion.

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Moody's Analytics added the economic forecasting firm Economy.com to its portfolio in 2005. This unit is based in West Chester PA, a suburb of Philadelphia, with offices in London, Prague and Sydney. More information is available at www.economy.com.

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