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IN-DEPTH REPORT:

2019 EXCHANGE RATE PICTURE

Highlights: The VND's depreciation level was 1.04% YTD by May 31, but the movements of exchange rates on the interbank and unofficial markets were quite different compared to those in the previous period. The main reasons leading to the depreciation of the VND include external factors such as escalating trade tensions between the US and China and the temporary supply constraints of foreign currencies.

Outlook: It is forecast that the VND will depreciate 2.0 – 2.5% in the fundamental scenario.

EXTERNAL CONTEXT: ADVERSE MOVEMENTS

Sino-US trade war suddenly escalated

The US President Donald Trump announced to raise the tariffs from 10% to 25% on USD200 billion imported goods from Chinese, which was effective from May 10, 2019. Three days later, China decided to raise the tariffs on thousands of commodities, valued at USD 60 billion in retaliation for Trump's move, which was effective from June 1, 2019. The US Trade Representative's Office soon also announced a list of USD300 billion worth of Chinese goods that could be taxed at 25%. While the previous trade negotiations saw relatively positive progresses in the previous five months, Trump's actions imposed a negative impact on the world currency market.

Table 1: US – China trade tensions

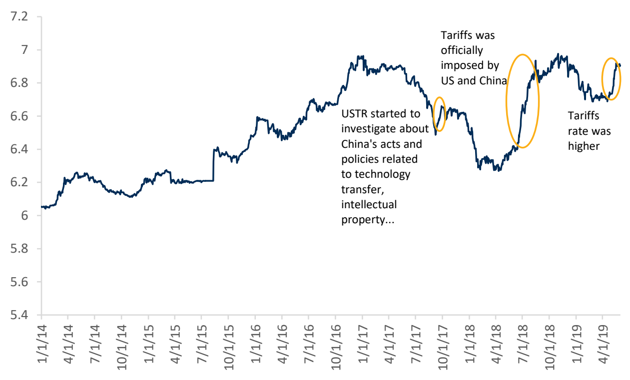
	Tariffs from US	Tariffs from China
06/07/18	USD 34 billion	USD 34 billion
23/08/18	USD 16 billion	USD 16 billion
17/09/18	USD 200 billion at 10%	USD 60 billion at 10%
Dec 2018 - May 2019	Trade Negotiations	
10/05/19	Tariffs up from 10% to 25%	
01/06/19		Tariffs up from 10% to 10 - 25%

Source: KBSV

The CNY strongly depreciated in May

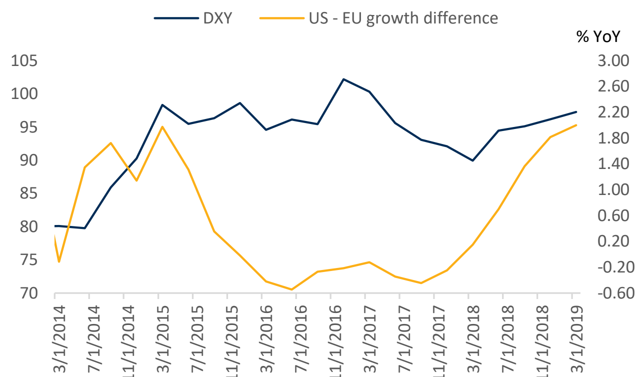
The CNY came through the first four months of the years with no sudden changes in its value, inching up 2% against last year. However, in this May, CNY reversed and became one of the currencies that saw strongest depreciation level in Asia. Specifically, the average decrease of CNY value in May was 2.06% compared to the level recorded in April (Figure 1.) In particular, in only four days from May 6 to May 9, 2019, the CNY lost 1.37% of its value, roughly the depreciation level in the middle of June 2018. At the moment, the CNY has been fluctuating around 6.9 CNY/USD – very close to the psychological threshold of 7.0 – which was only reached in the financial recession in 2008.

Figure 1: USD/CNY exchange rates movement



Source: Bloomberg, KBSV

Figure 2: The DXY and EU – US growth gap



Source: Bloomberg, Fred Louis, KBSV

DXY index has remained at a high level since the beginning of the year. However, DXY tended to decrease slightly after the Fed signaled to reduce interest rates

The DXY had always stayed around 97 in the first four months and surged to 98.2 on April 25, 2019 – the highest in the last two years. The reason is the US economic data were much better than those in other big economies such as EU, Japan… To be more specific, GDP growth in the 1Q/2019 of the US was much higher than previously forecast, reaching 3.2% YoY – the highest compared to the figures in the same period of the past four months, and doubling the growth rate in the EU. Figure 2 shows the growth gap between US – EU is extending, the DXY tends to increase.

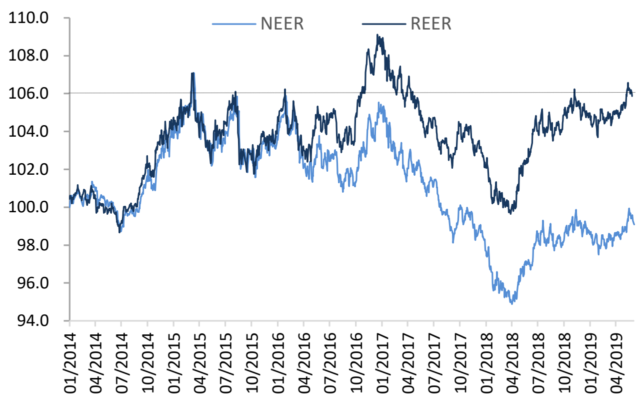
However, right after the FED signaled to cut interest rates to deal with the risks of declining growth due to trade war, DXY hit the 7-week lows. As for June 20, DXY declined more than 1% compared to the figure in late May.

INTERNAL CONTEXT: DIFFERENT COMPARED TO THE PREVIOUS PERIOD

Exchange rates surged in May after the stabilization period in the first four months

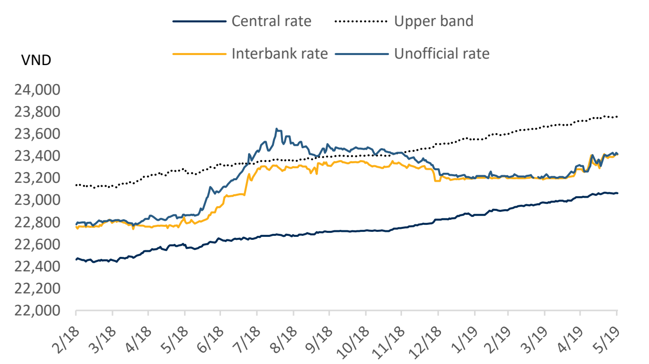
From the beginning of the year to the end of April, VND transactions were quite stable with the increase of the center rate higher than the increase of the average rates on the interbank and unofficial markets. However, within only a short time (the first half of May), interbank and unofficial exchange rates skyrocketed (Figure 4). Specifically, by 31/5, interbank exchange rates gained 0.58% compared to the figure late April, and 1.04% YTD. Unofficial exchange rates also saw a similar move, with an increase of 0.4% against late April and 0.52% YTD.

Figure 3: NEER and REER



Source: Bloomberg, KBSV

Figure 4: USD/VND exchange rate movements



Source: Bloomberg, FinnPro, KBSV

NEER and REER approached and surpassed the 106 threshold – which previously considered a sign for the SBV to devaluate the VND

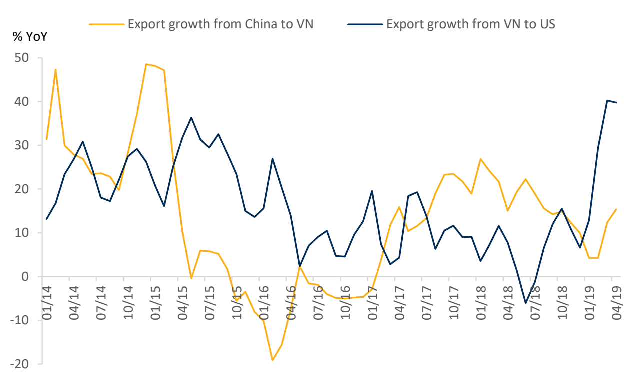
According to our calculation model, NEER (Nominal Effective Exchange Rate), measures the value of the VND against the basket of 8 other relevant currencies with reference to the central rate and REER (Real Effective Exchange Rate), is an important indicator to adjust the inflation rates by NEER). It can also be used as a key signal for the SBV to decide when to devaluate the VND. In particular, from 2015 to 2016, when the REER approached the 106 threshold, the SBV had to decrease the value of VND to stabilize the market outlooks and prevent adverse impacts on exports. However, at the moment, although REER surpassed 106 threshold (Figure 3), the market's moves are quite steady and the SBV is not necessary to interfere in the market.

The gap between the interbank exchange rate/free exchange rate and the ceiling exchange rate is quite safe

In the past, when there are external factors that put pressure on the exchange rate, the gap between the interbank exchange rate, the free exchange rate and the ceiling exchange rate is often widened and is considered another signal for the SBV to decide whether to devalue VND. In the last few years, despite unfavorable external factors, the interbank and unofficial rates still fluctuate in line with each other and have not created a big gap as in the previous periods, indicating that market sentiment is relatively stable. In addition, the gap between the interbank exchange rate and the ceiling rate is still quite safe (about 1.5% lower than the ceiling rate) (Figure 4).

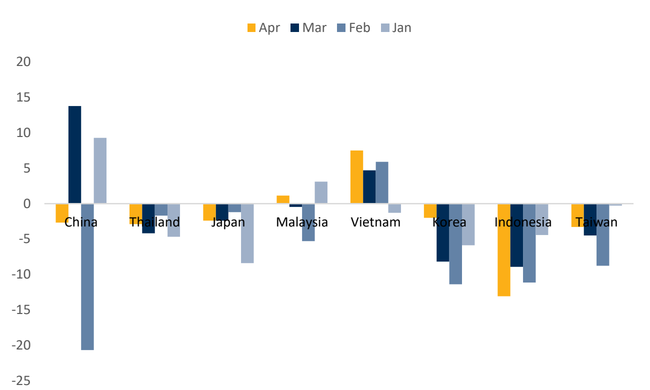
We believe that there are some reasons that helped the domestic foreign exchange market remain stable despite unfavorable movements of the world currency market, even when REER has surpassed the threshold of 106: (1) The SBV has actively adjusted the central exchange rate since the beginning of the year to narrow the gap with the market rates; (2) The foreign currency supply is quite abundant in recent years, especially from disbursed FDI inflows; (3) The SBV has proven its ability to stabilize exchange rates in recent years, building trust in the market, helping to reduce speculation and hoarding USD.

Figure 5: The growth of Chinese exports to Vietnam and US



Source: US Census, NBS, KBSV *Financial data calculated in March

Figure 6: Import growth of some regional countries



Source: Bloomberg, KBSV

Export growth remains stable amid trade war

The Sino-US trade war made some of Vietnamese commodities become substitutes to be imported by the US. According to the data by the US Consensus Bureau (Figure 5), the US imports from Vietnam climbed 38% YoY in the first four months of 2019, showing that the United States tried to buy more goods from Vietnam, while Chinese commodities have been pressured by high tariffs due to the trade war. If this gaining momentum lasts until the end of this year, Vietnam will rise to the 7th among the largest importers to the US, from the 12th last year.

In general, the overall export growth in Vietnam has shown contrasting moves with the movements in countries of the same region, which are negatively affected by US-China trade war. Although Vietnam export growth partly slowed down compared to 2018, Vietnam is still a highlight compared to other countries in the region. The export turnovers of Japan, Korea and large exporters in ASEAN all went down, while Vietnam exports went up to 7.5% YoY (Figure 6). With the recent stable increase in Vietnam export growth and sharp increase in imports (mainly due to seasonal factors and imports for manufacturing materials), we still believe in a trade surplus in the fiscal year of 2019. This is a strong supportive factor for the supply of foreign currencies in Vietnam.

The trend of trade deficit, especially from China, also increased strongly, threatening the stability of the foreign exchange market

However, at the same time, Vietnam's trend of trade deficit from China increased sharply (Figure 5). Data from China Statistics Bureau recently showed that imports from China increased again since the beginning of 2019. Data from the General Department of Customs stated that as of May 31, 2019, trade deficit from This market has reached USD16.3 billion, equaling 68.2% of the 2018 trade deficit (USD23.9 billion). This suggests that RMB (CNY) devaluation is a factor that increases the amount of goods flowing from this country to Vietnam as Chinese goods become cheaper.

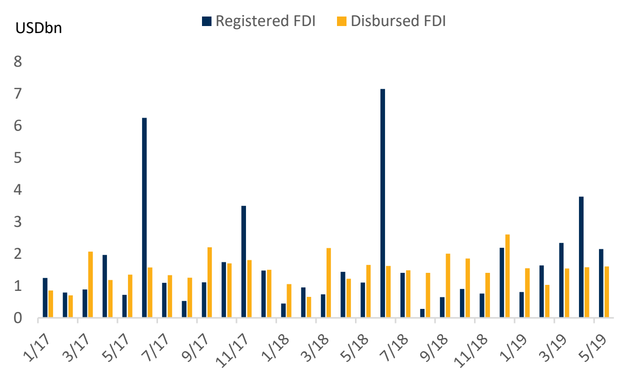
Newly increased FDI inflows and disbursed FDI maintained a positive growth. While foreign investors have been net buyers on the stock market since the beginning of the year.

Disbursed FDI in the first five months reached USD 7.3 billion, up 7.8% YoY. Meanwhile, newly registered FDI, increased sharply by 69.1% via M&A over the same period last year to USD 16.74 billion (Figure 7). In addition, in May, the SK Group deal of USD1 billion to buy Vingroup shares also helped to supplement the supply of foreign currencies. From early year, foreign investors disbursed on Vietnam stock market with a net value of over USD1.5 billion. These are important foreign currency sources to help balance the supply/demand of foreign currency on the market, and are forecast to maintain in the coming time.

Foreign exchange reserves reached the highest level ever

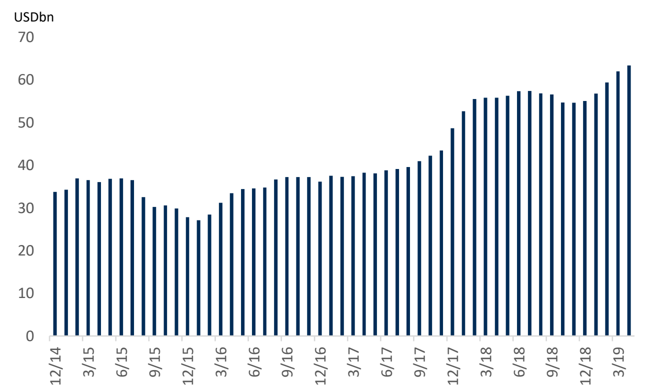
After the SBV buying USD8.35 billion of foreign exchange reserves in the first four months of the year, this amount by the end of May was estimated at about USD63.5 billion, the highest level ever based on data from IMF and our unofficial statistics (Figure 8). The relatively large foreign exchange reserves will increase the ability of the SBV to intervene in the foreign exchange market when necessary.

Figure 7: Disbursed and newly registered FDI



Source: FIA, KBSV

Figure 8: FX reverses



Source: Bloomberg, IMF, KBSV

USD/VND EXCHANGE RATE OUTLOOK

EXTERNAL FACTORS

Trade war is the biggest risk in the short term

We are considering the scenario that the US-China trade war will not reach a significant progress, at least in this year. However, it is expected that the two sides will reach an agreement at a weak level so that tariffs will not increase for the remaining goods valued at USD300 billion. Large financial organizations, such as Goldman Sachs, Nomura, and J.P Morgan, all had certain changes in the forecast for this war. A report by Nomura said the probability of US tariff imposition on all Chinese goods before the year-end will rose to 65%. Meanwhile, Goldman Sachs supposed if there are no progresses between the two sides' relations in the upcoming period, Goldman's basic scenario will switch to the next tariffs that will be applied.

In our basic scenario, in the short term, the imposition of tariffs will not happen and tensions will not escalate until the end of June - when Xi Jinping and Donald Trump meet at the G20 summit. We think that the two sides will have a cease-fire to find a weak-level trade agreement to reconcile the interests of both parties.

Table 2: Scenarios about the trade war

Trade war scenarios				
Scenarios	Tariffs for USD 200bn	Thuế với 300 tỷ hàng hóa TQ còn lại	Note	Probability
Positive	10%	Not applicable	US and China will reach trade agreement this year	10%
Baseline	25%	Not applicable	US and China continue to negotiate after G20	50%
Negative	25%	25%	Trade agreement can be reached and full-blown trade war	40%

Source: KBSV

The USD is expected to remain high in the short term before weakening due to FED's dovish monetary policy

The USD will continue to stay high in the short term because the impact of trade war and the gap of economic growth between the US and other developed countries can still be maintained. However, in the mid and long term, DXY will be in a downtrend, mainly due to the change in the Fed's monetary police viewpoint. According to our baseline scenario, the Fed will have at least a rate cut in 2019 because of some main reasons such as the risks from trade war, inflation in 2019 being estimated to decline to 1.5% - much lower than the expected level of 2%. On the Derivative market, traders are betting with an almost 100% probability that Fed will lower interest rates in July.

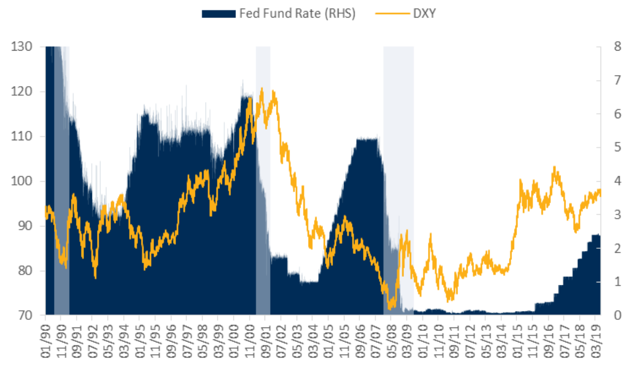
According to our observation (Figure 9), DXY will tend to "go ahead" when Fed Fund rate drops/rises by an average of 5-12 months, but due to specific risks at the present time, especially ones related to trade war, the lag is expected to narrow and specific impacts from Fed's actions on DXY will be more apparent in Q3.

Table 3: DXY scenario in 2019

	Close price @ 20/05/2019 Actual	Q1/2019 Actual	Q2/2019 Forecast	Q3/2019 Forecast	Q4/2019 Forecast
EUR/USD	1.117	1.122	1.120	1.130	1.150
DXY	97.933	97.284	97 - 98	96.5 - 97	95 - 96

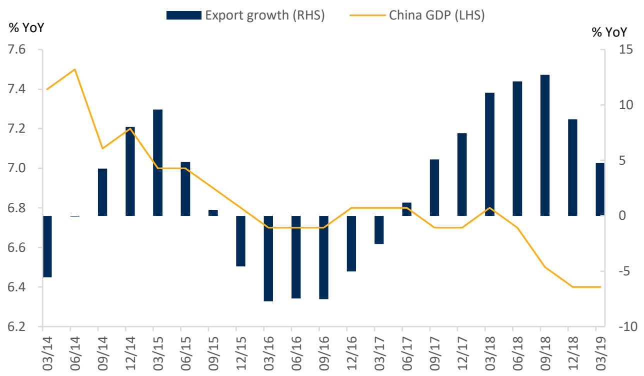
Source: KBSV

Figure 9: DXY and Fed Fund Rate



Source: Bloomberg, KBSV *Vùng màu ghi thể hiện suy thoái kinh tế ở Mỹ

Figure 10: China GDP growth and Chinese export growth



Source: Bloomberg, IMF, KBSV

USD/CNY exchange rate is forecast to surpass 7.0 if the negotiation process does not bring many changes

We assess that the CNY in the short-term (by the end of the 2Q/2019) will fluctuate around 6.90 – 6.95 because (1) The trade tensions are forecast not to escalate until the end of June; (2) PBoC will interfere in the FX market to keep the CNY value stable in the allowed level with an aim to keep the market sentiment calm, and prevent the capital flow out of China. Measures that may be taken by PBoC are to sell USD in FX reserves, to drain yuan liquidity, and to make announcements to support exchange rates.

However, in the medium term, we suppose the CNY will be able to surpass 7.0 because CNY devaluation pressure is huge. We evaluate the devaluation rate of CNY can be controlled by PBoC. However, macroeconomic data, especially trade data, signaled that China's economy is growing slowly (Figure 10), which is putting pressure on CNY.

On the other hand, among the measures that China can take in retaliation to US tariffs, adjusting the CNY exchange rate is the first and easiest option. We observed that there is a 1-1 correlation between the imposed tariffs and the devaluation of CNY. Specifically, in case the average tax rate applied on all Chinese goods is 10%, the devaluation rate of CNY will be equal to 10%. In other words, when the US officially imposed 25% tariffs on USD200 billion commodities imported from China, the average tax on all goods is about 10%, USD/CNY increased to 6.96. The ratio of 6.96 represents a 10% devaluation of the currency since the first time the tariff was applied by the US on March 23, 2018 (USDCNY = 6.32). In case all Chinese goods are subject to a 25% tax, USD/CNY = 7.90 will be considered to offset this tax rate. Although it is very unlikely that PBOC will allow CNY to depreciate too deeply as calculated above due to unpredictable consequences on the financial system of this country, however, it is possible to see a risk of breaking the threshold of 7.00 in the escalating trade war scenario.

Table 4: USD/CNY scenario in 2019

	Close price @ 20/05/2019	Q1/2019	Q2/2019	Q3/2019	Q4/2019
	Actual	Actual	Forecast	Forecast	Forecast
USD/CNY	6.9179	6.7121	6.90 - 6.95	6.9 - 7.0	6.9 - 7.0

Source: KBSV

Baseline scenario: the VND will depreciate 2.0 – 2.5% during 2019

As a result, for the rest of the year, exchange rate fluctuations will be influenced by three main factors. First, the downward trend of USD, according to our baseline scenario, will have a favorable effect on VND as even if the USD/VND exchange rate does not change much, VND will still have a downtrend compared to most currencies in the basket of currencies (except for CNY). Second, the trend of CNY depreciation, according to our basic scenario, will have an adverse effect on VND because the trade deficit from China will tend to increase. Third, the stability of foreign currency supply, which we forecast remains positive, will support the exchange rates.

When comparing the impacts of the first factor (USD depreciation) and the second factor (CNY depreciation), technically, we observe that the USD depreciation in general will have a stronger impact because it indirectly affects the strong trend of other currencies in the basket. This is quite evident in recent weeks when the USD has decreased and CNY has also decreased, the NEER line still reversed to go down.

According to our quantitative model with the dependent variable of the NEER and the independent variable of DXY and USD/CNY, for the basic scenario, if the DXY fluctuates around 95-96, and USD/CNY exchange rate is traded at around 6.9 - 7.0 at the end of 4 Q, the NEER will increase by 0.51%, and the USD/VND exchange rate will decrease about 2%. However, in fact, as the trade deficit with China is increasing very fast, the SBV may still have to consider lowering the VND price to a reasonable level to protect exports and limit trade deficit. We provide scenarios for the year-end exchange rates as follows:

Table 5: USD/VND scenarios in 2019

	Negative			Baseline			Positive		
	DXY	USD/CNY	USD/VND*	DXY	USD/CNY	USD/VND*	DXY	USD/CNY	USD/VND*
Q4/2019	> 100	> 7.0	3 - 4%	95 - 96	6.90 – 7.0	2 – 2.5%	< 94	< 6.7	1 - 2%

Source: KBSV

* VND depreciation rate compared to that by the end of 2018

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