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IN-DEPTH REPORT:

FORECAST EXCHANGE RATES UNDER THE PRESSURE OF CNY DEPRECIATION

INTERNATIONAL CONTEXT

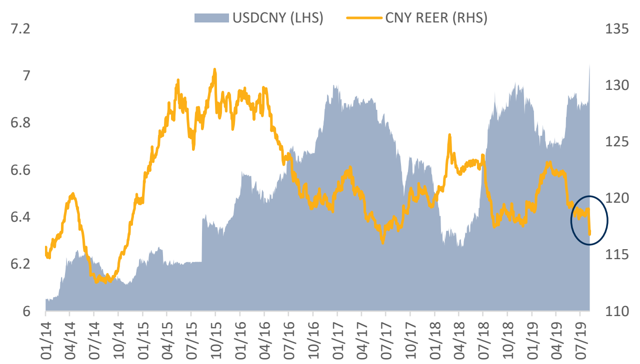
PBoC deliberately depreciated the CNY on August 5, which has been carefully considered by China

USD/CNY exchange rates on August 5 exceeded the 7.00 psychology threshold after two testing periods in December 2016 and November 2018. This is a deliberate move from the People's Bank of China (PBoC) through fixing the RMB reference rate at 6.9225, which was the highest level since June 2008, and continued to to 6.9683 in the next day. Theoretically, the CNY in mainland China is allowed to be traded in a range of +/- 2% compared to the reference rate, so PBoC has allowed the CNY to slide to 7.1. Actually, it can be seen that the CNY has weakened significantly compared to the USD and a basket of currencies (Figure 1). The move is to retaliate for the US imposition of an additional 10% tax on USD300 billion of Chinese goods from September 1. We think this is an action that has been carefully considered by China - as it is possible to warn the US about "retaliatory" measures that China can use, and also take the opportunity to release pressure on CNY after PBoC's long-term cash injection into the system to boost the economy.

In the short term, after this CNY depreciation, PBoC will temporarily stabilize market sentiment although the case of further depreciation is existing, because it still depends on the trade war movements

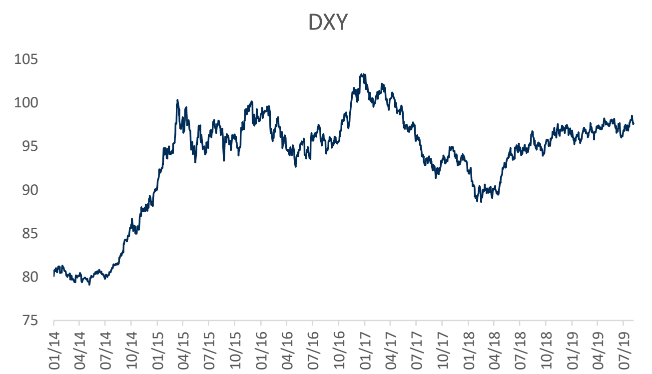
After this retaliation, it is likely that PBoC will stabilize market sentiment to prevent a withdrawal in investment capital. Al so, the weakening currency oriented policy will undermine recent efforts from China in enhancing the payment position of the CNY globally. In terms of exportation, China's advantages are less dependent on exchange rates, but rely on economics of scale and the supply chain. In fact, there are still many measures that PBoC can apply to stabilize exchange rates, such as foreign exchange reserves and the sale of international bonds… Therefore, we believe that the CNY will soon regain its stability in the short term, although the case of further depreciation is existing, because it still depends on the trade war movements.

Figure 1: USD/CNY exchange rate fluctuation



Source: Bloomberg, KBSV

Figure 2: DXY



Source: Bloomberg, KBSV

VIETNAM SITUATION

NEER and REER are surging, but they have not exerted a large pressure on the market

According to our calculation model, NEER (nominal effective exchange rate), which measures the value of the VND against a basket of 8 other currencies with reference to the central rate, and REER (real effective exchange rate), an inflation-adjusted index compared to NEER, are increasing sharply (Figure 3). This showed that VND is appreciating considerably against the currency basket. When we look closer, we see that the VND has appreciated against CNY, KRW, SGD, and TWD this week, while it depreciated against the rest 4 currencies - EUR, USD, JPY, and THB.

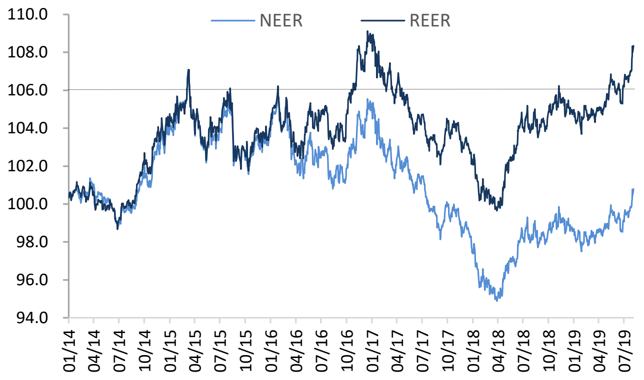
In general, the appreciation of VND against the basket of currencies may create obstacles to the exportation of Vietnam, and make the market expect a future depreciation. It can be seen from the market movements in the past that whenever NEER & REER approach the sensitive threshold of 106, there will be a depreciation pressure of VND to protect exportation activities and stabilize the investor sentiment. However, at the moment, we think that the reference feature of the 106 threshold is no longer clear as in the past because:

1) Although REER surpassed 106, NEER was just slightly over 100. Theoretically, the gap between the two lines were created by the inflation rate. Meanwhile, the increase in inflation in Vietnam in recent years depends heavily on the adjustment of prices of state-managed products, particularly healthcare and education services. These costs will have a lag in reflecting the operational costs of enterprises. As a result, the pressure of lowering competitive advantages in export activities is not very high, although REER has exceeded 106.
2) From the expectation of a depreciation on the market, we have not spotted any extraordinary signs. In the past, if REER reached 106, there would be a high expectation on a depreciation, which was reflected in the interbank exchange rate closely following the upper boundary of the reference range (+/- 3% compared to the central exchange rate) and the unofficial exchange rate increasing beyond the upper boundary. At the present time, it can be seen that the interbank and unofficial exchange rates are still moving in the safe zone (Figure 4).

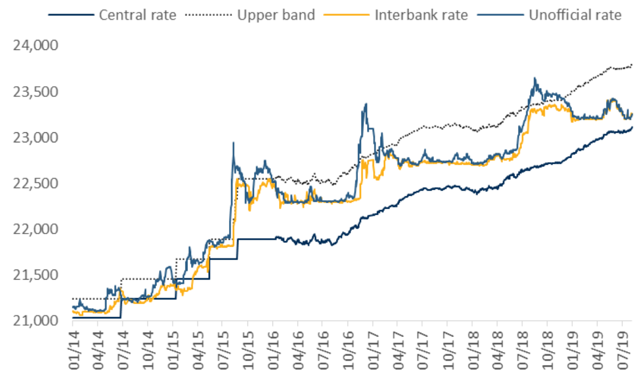
Therefore, technically, we have not seen any signs of a great pressure of depreciating the VND, although the SBV has slightly decreased a value of VND (increased the central rate) after the depreciation of CNY.

Figure 3: NEER and REER

Figure 4: USD/VND exchange rate fluctuation



Source: KBSV



Source: Bloomberg, FinnPro, KBSV

FACTORS AFFECTING THE SBV'S MOVES

RISKS FROM TRADE DEFICIT WITH CHINA

Trade deficit with China is surging, while there are some worrisome signs of Chinese goods labeled fake "Made in Vietnam"

In most of the reports about the impact of the US-China trade war, Vietnam is one of few countries that benefit from trade war as an alternative market for investment. However, in the latest report in the Wall Street Journal, Vietnam was warned and accused of transshipment with some evidences. In particular, some companies in Vietnam illegally labeled there products "Made in Vietnam" to replace "Made in China" labels to avoid export taxes to the US.

The picture of market structure and im-exports in the first 6 months of 2019 shows a surge in the number of exports to the US market (27% YoY), while imports from China also increase correspondingly (18.15% YoY).

According to our assessment, there are 3 reasons leading to the increase in trade deficit value with China. First, the depreciation of CNY against VND makes Chinese goods much cheaper. Second, as mentioned above, some companies in Vietnam make transshipment to relabel commodities. Third, FDI companies which turn to invest in Vietnam instead of China increase the number of imports of machineries and materials for manufacturing.

Figure 5: Movements of some exported sectors to the US

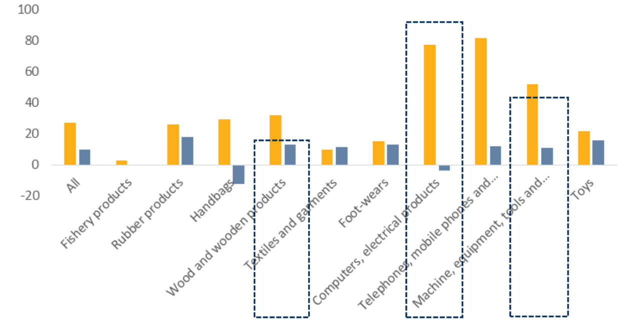
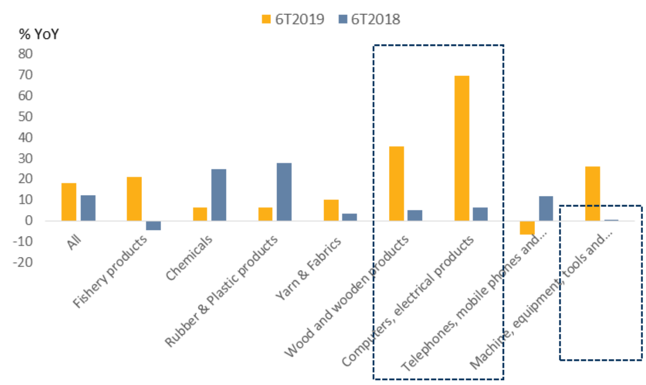


Figure 6: Movements of some imported sectors from the China



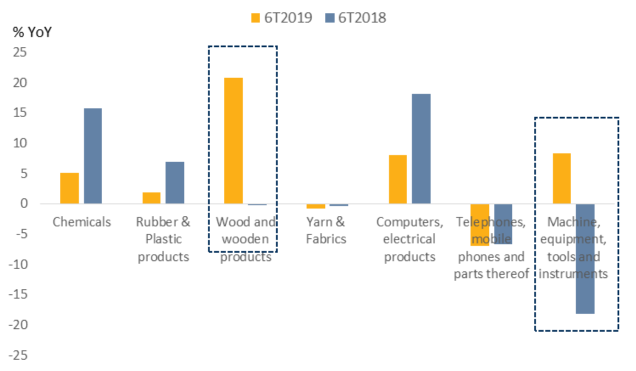
Source: VN CUSTOMS, KBSV

Source: VN CUSTOMS, KBSV

For the first factor, with a devaluation of about 2% from the beginning of the year, this pressure is still existing but not large. For the third factor coming from the import of manufacturing materials of FDI enterprises, Figure 7 shows the growth in the wood and other spare part sectors. However, this increase is not the same as the original comparison model and does not correspond to the strong increase in imports of this sector from China (Figure 6). For the second factor, the worrisome point is that except for phones and components, a lot of commodity groups with strong growth rates to the US coincide with the rising commodity groups imported from China like computers, electronics, spare parts, wood and wood products (Figure 5).

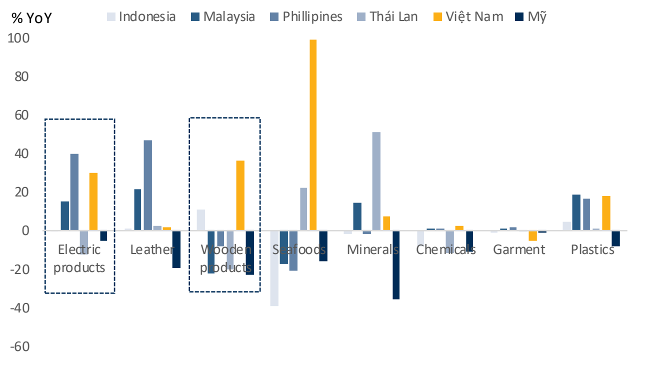
Thus, it can be concluded that the second factor is one of the main reasons for the increase in trade deficit with China in recent years. In addition, when comparing the export movements from China to ASEAN countries (Figure 8), we also observed a sharp increase in sectors taxed by the US in ASEAN countries, especially are Malaysia and the Philippines.

Figure 7: Export movements of FDI enterprises



Source: VN CUSTOMS, KBSV

Figure 8: Export movements from China to ASEAN countries



Source: Bloomberg, IMF, KBSV

THE RISK OF BEING LISTED AS A CURRENCY MANIPULATOR

Vietnam has not been accused of currency manipulation by the US yet, but the Government of Vietnam will have to be more cautious, especially with the moves to intervene in the foreign exchange market, to avoid this risk in the future.

In the latest report of the US Department of the Treasury in April, Vietnam was listed for the first time in the Currency watchlist. One of the evaluation criteria of the United States is that the volume of 12-month net foreign currency purchases (January - December 2018) must not exceed 2% of GDP. In 2018, Vietnam did not violate this criterion as the foreign exchange market intervention level of the SBV, based on the amount of USD net buying, was only 1.7% of GDP, below the 2% allowed by the US. In addition, Vietnam also has a reasonable basis to buy USD to increase foreign exchange reserves as Vietnam's foreign exchange reserves in 2018 were only enough for 2.9 months of imports, below the minimum recommendation of IMF. The US accepted this reason, but urged Vietnam to continue reforming monetary policy – and recommended Vietnam to gradually increase REER to reduce trade deficit with the US.

For the review in October 2019, we believe that Vietnam will not violate the US criteria as the net buying volume (July 2018 - June 2019) is less than 1% of GDP because the SBV sold USD in the 2H of 2018 to prevent a strong depreciation of VND.

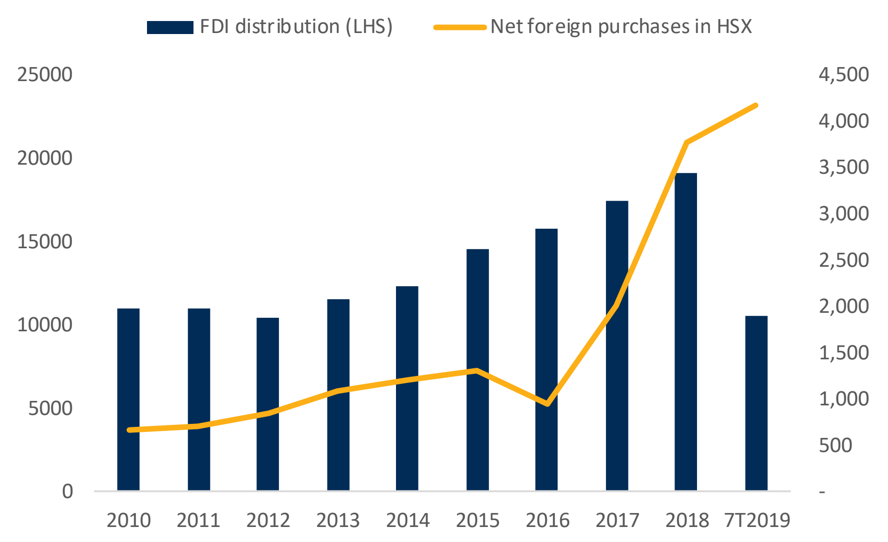
For the review in April 2020 (data collected from January - December 2019), if Vietnam's estimated 2019 GDP is about USD 270 billion, the limit of SBV allowed to buy foreign currencies will be around USD 5.4 billion so as not to surpass 2% of GDP. Based on the official figures of IMF (as of April 30, 2919) and our collected data, SBV has now bought about USD8.5 billion since the beginning of the year, surpassing the "maximum allowed to buy" level. Thus, from now until the end of the year, in order not to violate the 2% GDP criterion, the SBV will have to net sell about USD 3.1 billion. This action is considered reasonable and creates room for the SBV to stabilize the exchange rate in case the Yuan continues to decline sharply.

THE TARGET TO KEEP EXCHANGE RATE UNDER 3%

The SBV will make efforts to ensure its commitment not to devalue VND by more than 3% in order to keep the trust of foreign investors

Foreign investment, both direct and indirect, is one of the important drivers of Vietnam's economic growth. The contribution of the foreign investment sector in the country's GDP increased from 9.3% in 1995 to 19.6% in 2017 and is a key additional source of capital for development investment capital of Vietnam with a proportion of about 23.7% of the total social investment capital (data from the Ministry of Planning and Investment).

Figure 9: FDI disbursed and accumulated with net-buying of HSX foreign investors



Source: FIA, HSX, KBSV.

Before investing in each country, all multinational enterprises do assess the stability of exchange rates as one of the most vital indicators, in addition to some other macro balances. This is also the motivation for the Government to annually set target for VND devaluation right from the beginning of the year, as a commitment to the multinational enterprises that have planned or are planning to invest in Vietnam.

In early 2019, the Government has set a target to maintain a stable exchange rate with an adjustment of less than 3%. From the beginning of the year, the SBV remains consistent with the above target. This target is reasonable to balance other economic goals related to GDP growth maintenance, inflation curb, interest rate control, export stimulation and the trade balance support.

CONCLUSION

China is currently the largest trading partner of Vietnam, the devaluation of CNY has created a great pressure on VND movements; and a pressure to the monetary policy of SBV to protect competitive advantages of exports, as well as the production capacity of domestic enterprises against imports from China.

However, we realize that the pressure of VND devaluation in the coming time is not high due to the following main reasons:

(1) Based on the observation of the above technical changes of NEER & REER, the 106 threshold, which was surpassed by the REER, is no longer too sensitive due to the gap caused by the price adjustment of healthcare and education services.

(2) Based on the observation of the fluctuation of the interbank exchange rate and the unofficial exchange rate, it can be seen that the market's expectation of a devaluation is not very high.

(3) The strong increase in trade deficit with China was partly caused by the CNY depreciation against the VND. The main reason was the increase in Chinese commodities illegally labeled "Made in Vietnam" to avoid import taxes.

(4) The risk of being tagged as a currency manipulator by the US makes the SBV more prudent in increasing FX reserves. In contrast, in the 2H of the year, SBV will likely net sell foreign currencies, which will reduce the pressure of VND devaluation.

(5) The 3% level is an important level that the SBV will try not to let the exchange rate fall below this in order to keep the trust from the market, ensure the commitments made by the Government from the beginning of the year, and not trigger any significant impacts on inflation.

All things considered, we believe that the target of the SBV is to maintain a moderate trend of VND devaluation compared to the USD (although the VND still goes up against the basket of currencies) at about 2%. This level is enough to partly neutralize the adverse impacts on the strong depreciation of the RMB, but still creates a safety buffer to make sure the 3% target, set at the beginning of the year, will not be violated. We provide forecasting cases for the year-end exchange rate as follows:

USD/VND cases in 2019

	Negative		Base		Positive	
	USD/CNY	USD/VND*	USD/CNY	USD/VND*	USD/CNY	USD/VND*
Q4/2019	>7.2	3%	7.05-7.15	2%	<7	1%

Source: KBSV * VND depreciation compared to the depreciation rate at the end of 2018

DISCLAIMER

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