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How will Vietnam Cope with the Impact of the US-China Trade War?

*Tuan Ho, Trang Thi Ngoc Nguyen, and Tho Ngoc Tran**

EXECUTIVE SUMMARY

- In the short term, Vietnam may benefit from the US-China trade war through replacing Vietnam's Chinese exports of goods to the US market and the relocation of China-based manufacturers to Vietnam.
- The Vietnamese government's strategy to address these external trade tensions is to enhance macro-economic stability, mitigate exchange rate volatility, and participate in trade agreements to maintain export growth.
- However, in the long term, the US-China trade war presents challenges to Vietnam's export-led and foreign investment-led growth model.
- Vietnam needs to adopt economic policies to achieve a truly market-based economy and improve public investment to maintain and enhance the growth momentum.

** Guest writers, Tuan Ho is Lecturer in Finance and Accounting at the University of Bristol in the United Kingdom, Trang Thi Ngoc Nguyen is Associate Professor of Finance, and Tho Ngoc Tran is Professor of Finance at the University of Economics - Ho Chi Minh City. The authors thank Le Hong Hiep and Tham Siew Yean for their insightful comments and suggestions.*

INTRODUCTION

The IMF's World Economic Outlook published in October 2018 names trade tensions as one of the greatest risks to global economic growth.¹ The US-China trade war is at the centre of global trade tensions, and although some analysts suggest that Vietnam is one of the 'winners' in the US-China trade war,² a report by FT Confidential Research argues that the country is in fact one of the most vulnerable countries due to its dependence on exports.³ Furthermore, achieving a sizeable trade surplus with the US would lead to Vietnam being put on the watch list of US trade policy makers.⁴

This article analyzes both the positive and negative effects of the US-China trade war on Vietnam. It will also discuss the Vietnamese government's strategies in dealing with the situation, and conclude with some important points that Vietnam needs to pay more attention to when coping with the war.

IMPACT OF US-CHINA TRADE WAR ON VIETNAM

We believe that US-China trade war brings both challenges and opportunities for Vietnam. In the short term, Vietnam may benefit from trade tensions between the US and China through the temporary boost in exports and foreign investment.

At the recent conference—"Impact of US-China Trade War on Ho Chi Minh City's Economy"—, Dr. Vo Tri Thanh said that when imports from China to the US became more expensive due to higher tariffs, US companies would look for import alternatives from other countries, such as textiles, garments and electronics from Vietnam.

According to the General Statistics Office (GSO), Vietnam's exports to the US reached nearly \$35 billion in September 2018, up by 12.5 percent from last year. In particular, exports of mobile phones and accessories increased by 46% while exports of textiles, leather, and footwear increase by more than 12 percent.⁵

Vietnam can also benefit from a global supply chain transformation as businesses move a significant part of their production out of China. In recent years, multinational companies had already been shifting high-margin industrial operations to Vietnam due to rising costs and risks of doing business in China. The US-China trade war accelerates the trend. The advantages of the US-Vietnam Bilateral Trade Agreement (BTA), 12 established free trade agreements (FTAs) and important agreements awaiting for ratification such as the EU-Vietnam FTA and the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) make Vietnam attractive to multinational companies after the trade tensions escalate,⁶ and major global manufacturers such as Intel, Foxconn, LG and Samsung are already relocating their factories to Vietnam.

At the same time, Chinese companies are also transferring production orders of goods affected by higher tariffs to partners in Vietnam. Some Chinese producers may increase investment in Vietnam or cooperate with companies in Vietnam to fulfill orders for their partners in the US market. Anna Ho, the CEO of Silstar Machinery, a supplier of machinery for plastic packaging manufacturers, told The Saigon Times Online that in the past few

months she had been welcoming many plastic packaging manufacturers from China as well as buyers from the US who were interested Vietnamese enterprises producing this item.⁷

The trade war has, however, also created many challenges for Vietnam. The first is that Vietnam may soon be subjected to higher tariffs being imposed by the US government due to the practice of Chinese-owned factories rerouting their Chinese-made products to Vietnam and labelling them as “made in Vietnam” products.⁸

For example, Do Duy Thai, Chairman of Viet Steel Corporation, is worried that cheap Chinese steel is being disguised as Vietnam’s products and then re-exported to the US.⁹ The same holds for the Vietnam Leather, Footwear and Handbag Association, which has expressed concern about Chinese companies bringing in their finished goods to Vietnam through cooperation and joint-ventures with Vietnamese enterprises and then re-exporting them as “made in Vietnam” products to the US.¹⁰ Such practices may lead to Vietnam-made goods being hit by with higher US tariffs. Vietnam already had the sixth-highest trade surplus with the US in 2017, after China, Mexico, Germany, Canada and Japan; countries which are all under scrutiny by President Trump’s trade team.¹¹ The risk is therefore high that US policy makers will consider placing higher tariffs on imports from Vietnam.

The relocation of Chinese-based production facilities to Vietnam, though providing short-term boosts to exports and foreign investment, also adds to the risks for Vietnam becoming a “pollution haven”. At the press conference on 28th September 2018, Nguyen Bich Lam, Director General of the General Statistics Office (GSO), explicitly expressed his concern that the “waves” of Chinese enterprises relocating to Vietnam could make the country a destination for outdated, pollution-generating, and small-scale industrial technologies coming from its giant neighbor.¹²

Another risk to Vietnam is that US and Chinese consumer goods and agricultural products affected by the trade war will pour into Vietnam instead. One example is US pork. With China imposing an additional tariff of 25 percent, the tariff levied on US pork exported to China increases to 71 percent. At such a high rate, it is very difficult for US pork to gain market shares in China, and Vietnam becomes an attractive alternative for these products. As it is, the price of pork in Vietnam is at around 48,000 to 50,000 VND per kg, one of the highest in the world, while the cost of US pork imported to Vietnam is just over \$1.5 per kg, equivalent to only about 35,000 VND per kg. The latter would thus enjoy a great comparative advantage on the Vietnam domestic market. Nguyen Van Ngoc, Vice Chairman of the Animal Livestock Association in the Southeast region, has said that US meat imported into Vietnam increased by as much as nearly 50 percent in the first half of 2018.¹³

Similar scenarios can happen with other Chinese and US agricultural products. Currently China is the big market for agricultural products such as fruits, rice and seafood from Vietnam. Chinese vegetables and fruits, abundant in supply and relatively cheap, put a lot of pressure on Vietnam’s agricultural products being sold in both China and the domestic market of Vietnam. In addition, US fruit exporters may also focus more on Vietnam once their products are hit by higher Chinese tariffs.

In the longer term, the biggest negative consequence of the trade war, in our opinion, is the slowdown of the global economy. Slower economic growth can force businesses to cut

capital spending as monetary market conditions in the US and some developed countries tighten. Since Vietnam’s growth model relies heavily on exports and foreign investment, it is especially susceptible to a global economic slowdown and tighter financial conditions.

Table 1. Summary of negative and positive effects of US-China trade war on Vietnam

Positive effect	Negative effect
<ul style="list-style-type: none"> • Increase in exports to the US to replace Chinese goods. • Increase in export orders of goods transferred from China. • Companies relocate Chinese-based high-margin industrial operations to Vietnam. 	<ul style="list-style-type: none"> • Vietnam goods could suffer high US tariffs due to Chinese goods being rerouted through Vietnam before being exported to the US. • Chinese companies accelerate the process of transferring outdated and pollution-generating technologies to Vietnam. • Fierce competition from US and Chinese consumer goods and agricultural products on both Vietnam’s export and domestic market • Lower long-term economic growth

In short, we think that in the short term, the impact of the trade war on Vietnam will be more positive than negative, but in the long term, the potential damage caused by higher US tariffs, environmental problems and growth deceleration will outweigh short-term benefits.

HOW DO VIETNAM’S POLICY MAKERS PERCEIVE THE TRADE WAR?

Before the US-China trade war broke out, Prime Minister Nguyen Xuan Phuc had in early 2018 set as the principle for coping with as by being “firm in principles, flexible in strategy and tactics” (in Vietnamese “Đĩ bất biến ứng vạn biến”).¹⁴

After the trade war started, and the Chinese Yuan dropped in value, many Vietnamese economists urged the government to take appropriate actions quickly. One of the most controversial suggestions was for State Bank of Vietnam (SBV) to act proactively by devaluing the Vietnamese dong to increase the competitiveness of Vietnam’s exports. While experts and the public in general debated the proposal to devalue the Vietnamese dong (VND), the Prime Minister once again reaffirmed his principle of “firm in principles, flexible in strategy and tactics”. He insisted that there would be “no change in economic and financial policies in 2018, including the petrol tax”, adding that “We do not act based on guesses about the international financial market as many people have recommended before there is evidence of clear impacts”. He also emphasized the need to stabilize the fluctuations of the

USD/VND exchange rate within a range of 2 percent compared to the rate at the end of 2017.¹⁵

This approach is consistent with some suggestions that have been put forward in China on how China is to cope with the trade war. Shen Jianguang, an economist at Mizuho Securities Asia, stated that while the Chinese government should not panic, it should not underestimate the impact of the approaching trade tensions. China should also consider the US-China trade war as a driving force for accelerating economic reforms, thus converting external pressure into an internal force to push China towards a “second accession to the WTO”. This could be interpreted as a “firm in principles, flexible in strategy and tactics” approach.¹⁶ This remark coincides with the recent report in the South China Morning Post that Chinese leaders are considering joining the CPTPP as a part of the strategy to cope with the trade war.

Appearing recently on Bloomberg, Prime Minister Nguyen Xuan Phuc said that it was important for Vietnam to maintain macroeconomic stability and export growth and to stabilize the living standards of the 96 million people in the country. The Prime Minister has consistently remarked on Vietnam being “self-reliant” when facing global challenges and will seek more trade co-operations with countries outside of the 12 FTAs Vietnam has already signed. “We have to rely on internal strength to overcome all obstacles and maintain the momentum of growth,” Mr. Phuc emphasized.¹⁷

Through the Prime Minister's remarks on Bloomberg, it can be discerned that the Vietnamese government's core strategy to cope with the trade war is to promote macro stability, stabilize the value of the dong, and pursue more trade agreements to increase exports and maintain growth momentum.

Although economic reform was briefly mentioned, it was not central to the Prime Minister's messages. This is cause for worry that Vietnamese leaders may not be paying enough attention to domestic economic reforms in their strategy. In other words, the trade war may actually distract these leaders from moving further towards a market economy, and may see them focusing too much only on tactical solutions to maintain macro stability and increasing exports in the short term and neglecting radical economic reform as a means to revitalize long-term growth.

Some other recent developments suggest that this is a legitimate concern. The state-owned enterprises (SOEs) equitization process, one of the three major pillars of economic restructuring, has slowed down significantly. According to the government's plan for 2018, 85 SOEs should be equitized this year. However, as of July 2018, only 19 of them had been equitized. What is even more worrying is that despite the plan to equitize 39 SOEs in Ho Chi Minh City and 11 in Hanoi, leaders of these two major economic centres have so far equitized none.¹⁸

HOW CAN VIETNAM RESPOND TO THE UNCERTAINTY?

Short-term Tactical Responses

In the short term, to limit the practice of rerouting and disguising Chinese goods as Vietnamese products, the Vietnamese central and local governments should adopt a more selective policy in attracting FDI. The local governments should closely scrutinize and reject investment projects that show signs of rerouting and disguising practices. However, we are worried that these suggestions cannot be effectively enforced due to legal barriers and the short-term thinking of local officials. Furthermore, Hanoi may not want to be criticized by Beijing for specifically targeting Chinese investors.

At the same time, Vietnam can and should act more decisively against pollution-intensive investments through more stringent environmental requirements and enforcements. This is an urgent issue that the government should not neglect—the negative impacts on citizens’ health can be serious and can worsen Vietnamese citizens’ negative attitudes towards Chinese investors.

To help domestic producers compete with Chinese and US’s exports of food and agricultural goods, the Vietnamese government needs to be more proactive in helping domestic companies, especially SMEs, to access capital and promote Vietnamese high-quality brands. Stringent food safety requirements and promotion of safe and high-quality agricultural products can be effective solutions in this endeavour.

Strategic Response 1: Moving towards a Truly Market Economy

In order to lessen the risk that Vietnam goods could suffer high US tariffs due to Chinese goods being rerouted through Vietnam to the US, Vietnam has to move towards a true market economy.

Having managed Canada and Mexico, the United States is now moving towards trade and investment deals with EU and Japanese partners with the “poison pill” provision against “non-market” countries.¹⁹ Meanwhile, it is being remarked that Vietnam is a “New China”²⁰ or a “mini China”.²¹ The Vietnam’s government should be aware of the risks associated with being classified as a non-market economy and should prepare appropriate solutions to address these risks.

So far, we have not seen much evidence of the domestic media and economic experts in Vietnam paying proper attention to this situation. If the trade war spreads, it is likely that Vietnam will encounter new problems arising from being branded as a “new China” or “mini China”. Although Communist Party of Vietnam (CPV) documents do indicate that Vietnam always pursues a socialist-oriented market economy, Vietnam has been recognized as a market economy by 69 countries, including important trading partners such as ASEAN countries, EU countries, Australia, India, Japan and New Zealand. However, the US still thinks that Vietnam is a non-market economy.²²

If Vietnam does not speed up the negotiating process to be recognized by the US government as a market economy, it is likely that Vietnam will face a lot of difficulties when the “poison

pill” provision is triggered and applied to non-market economies like Vietnam. This is a risk that Vietnam cannot underestimate.

Vietnam seems to be moving in the right direction to meet the market economy criteria under Article 19 U.S.C. 1677 of the United States by aiming to completely abolish subsidies on electricity, petroleum and medical services. Meanwhile, many experts still keep to the line that currency devaluation is the most effective weapon for increasing Vietnam's competitiveness. This is usually an attractive option given the myopia of strategic planning in Vietnam, partly due to the association of strategic planning timelines to the tenure of CPV and government leaders.

The negative side of the devaluation policy or the lack of transparency of the exchange rate regime may see Vietnam being classified as a non-market economy, and even a currency manipulator by the US. Therefore, in our opinion, the exchange rate policy needs to be more flexible and transparent for Vietnam to avoid being listed by the US government among countries that manipulate their currencies. To identify whether the exchange rate is market-oriented as the SBV claims, our study suggests that Vietnam needs to have a mechanism to control the “power on exchange rate”.²³

The long-term benefit of being a true market economy for Vietnam is not just about being officially recognized by the United States as a market economy to avoid the effect of the so-called “poison pill” provision. The most important benefit of being a true market economy for Vietnam is to help current and future leaders remove self-imposed barriers to sustainable growth.

One of the self-imposed barriers is the emphasis of the current economic model on state-owned enterprises (SOEs), most of which have the lowest productivity in the economy. Moving towards a true market economy will require the government to stop subsidizing the underperforming SOEs, which will allow more efficient allocations of resources in the economy.

Strategic Response 2: More Efficient Public Investment to Promote Sustainable Growth

Trade tension is one of the reasons that lead to IMF's decision to lower its global economic growth forecasts for 2018 and 2019. The growth of five ASEAN countries, including Vietnam, is expected to be at only 5.3% this year and 5.2% next year. We believe the impact of trade tension on long-term growth is a major risk to Vietnam. Therefore, a radical solution to cope with a long-lasting trade war for the government needs to undertake serious reforms.

For a developing economy that relies heavily on exports and foreign investment like Vietnam, the ability of government in implementing fiscal policies to support economic growth is essential. Deputy Prime Minister Vuong Dinh Hue has pointed out that the government has paradoxically failed to spend the planned budget on public investment, and that that is one of the main reasons for the country not achieving the expected growth rate.²⁴

The problem of the unspent budgeted public investment is that "the Ministry of Finance is holding excessive funds while the economy is starved of capital." The excessive funds are financed by bonds issued by the Ministry of Finance or equitized SOEs. The Ministry of

Finance is accumulating hundreds of trillions of dongs while several infrastructure projects are unable to access the approved funds.²⁵

An example for this situation is that even national key strategic projects such as the North-South Express Highway project were delayed over the past three years for lack of funds, although the government had in fact allocated funds for this project. The reason is that the Ministry of Transport had to deal with 112 inspection and audit teams.²⁶ It was the disbursement procedures and the disruptions caused by these inspections that seriously delayed the projects and left domestic and foreign investors with a bad impression of such projects.

These shortcomings are attributed to the new Public Investment Law passed by the National Assembly in 2015. Even this law helps to significantly reduce rampant and inefficient investment, it also inadvertently creates a new constraint on Vietnam's future economic growth. In a recent announcement, the government of Vietnam officially acknowledged this new bottleneck.²⁷

The government of Vietnam intends to comprehensively revise the Public Investment Law and submit a new draft for consideration by the National Assembly by the end of this year. However, such a revision is not viewed favourably by the Standing Committee of the National Assembly. The Vice Chairman of the National Assembly has argued that a comprehensive revision is unnecessary,²⁸ while the Chairwoman of the National Assembly also affirmed that “In the next meeting of the Standing Committee of the National Assembly, I will provide evidence that the bottlenecks are driven by problems in the implementation process of the Public Investment Law, not the law itself”.²⁹

The disagreement between the government and the National Assembly may represent the lack of consensus among Vietnamese leaders regarding the efficiency of public investment in the country. For example, while there is a shortage of funding for hospitals, schools and infrastructures, the Ho Chi Minh City People's Council approved a plan to build a concert hall that costs 1.5 trillions of Vietnam dongs in Thu Thiem. This decision faced large public opposition and many see this spending as “a waste of money” and “a case of skewed priorities”. The city is after all facing urban flooding, traffic jams and overloaded public infrastructure on a daily basis.³⁰

These questionable decisions could be reasons for some members of the National Assembly and the public supporting controlling measures such as inspections and over-complicated disbursement procedure. However, these excessive controls may also prevent Vietnam from investing in crucial infrastructure and educational projects for long-term growth.

To address this public investment bottleneck, we suggest that the Public Investment Law be revised to allow for much-needed public investment funds to be disbursed for strategic projects. This approach should also be complemented with a plan to use the unspent funds held by Ministry of Finance to stimulate the economy through tax reductions. These measures are complements rather than substitutes because many national strategic infrastructure projects still require public investment.

CONCLUSION

Our analysis suggests that Vietnam's socialist-oriented market economy, which has not yet been recognized by the US as a true market economy, is increasingly vulnerable to external shocks when trade tensions are high. The CPV leaders and the government seem to be relatively slow in removing growth barriers and have been distracted from economic reforms. In the longer term, this lack of decisiveness and commitment may result in Vietnam missing short-term gains and suffering serious damage from negative external shocks caused by trade tensions.

A comprehensive economic reform which aims at achieving a true market economy and making wiser public investments will enable Vietnam to absorb external shocks in the future. That is particularly important in the context of a long-lasting global trade tension.

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