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Vietnam: Evolution of the VND

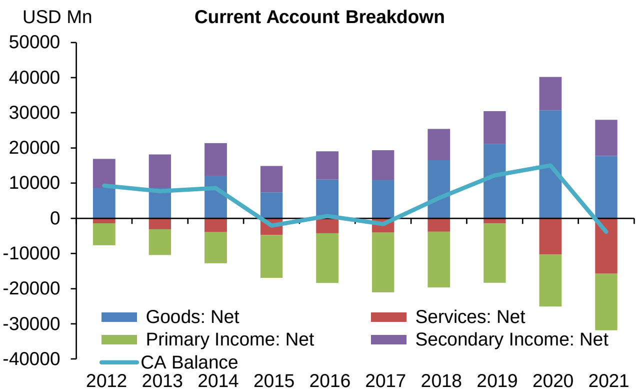
In a nutshell: Over the past decades, the ***VND has evolved to become a more stable and resilient currency*** *from one which was prone to episodic periods of devaluation. The underlying reasons for the transformation are fundamental and structural rather than temporal cyclicality.* ***First, on the trade front, good balance has turned a durable surplu****s from persistent deficits as result of their stellar industrial base growth. Second, Vietnam's economic transformation from patchwork of agricultural activity and low value added manufacturing to* ***an industrial hub attracting persistent FDI inflows****. Third,* ***the size of their economy*** *(in PPP terms) has almost* ***caught up with regional peers*** *Malaysia and Philippines. In this rapid growth, they have* ***avoided dollarization*** *with improvement in macroeconomic stability as* ***inflation remains better anchored*** *and* ***foreign reserves accumulation rose****. The macroeconomic stability came alongside* ***a change in monetary policy regime*** *to a more flexible basket-based market exchange rate which is more reflective of financial market conditions.* ***Dollarisation risk in Vietnam has stepped down considerably over the past decade as the share of foreign currency deposits declined from over 60% in 2003 to 13% in recent years. Foreign currency deposits continue to make up a stable share of GDP and this signals a steady availability of foreign currency within the domestic banking system. Cost of accessibility (indicated by FX spread) to the VND has also improved*** *over the years****.***

While VND's fundamentals have come a long way, ***several risks remain****. Access to the VND remains fairly impeded internationally, alongside a* ***financial market (debt and equities) which has not deepened*** *and widened significantly* ***relative to the pace of economic growth****. The level of financial innovation* ***still needs to catch up with regional peer****s such as Malaysia and Philippines despite closeness of economic size. Second, risks of latent volatility for VND remains as* ***the influx of foreign reserves*** *has been boosted at an exceptional pace due to FDI (within financial account) and the* ***sustainability*** *of this* ***exponential growth*** *trend* ***is suspect*** *though levels remain durable. A deeper money market alongside improved currency access would be necessary prerequisite for transitioning to a fully flexible VND that has wider international circulation.*

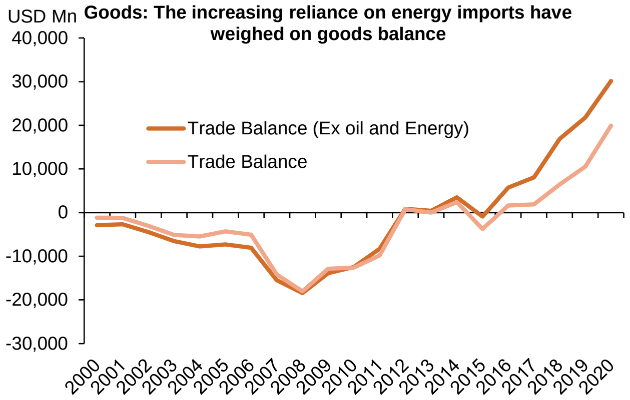
The VND's Journey

From a currency prone to episodic periods of devaluation just over a decade ago, the VND has evolved to be a far more stable and resilient currency. Clearly, there are solid fundamental reasons behind Vietnam's evolution and it is worth exploring each one in turn to evaluate the VND's currency (no pun intended).

Current Account Evolution



Source: CEIC; Mizuho Bank

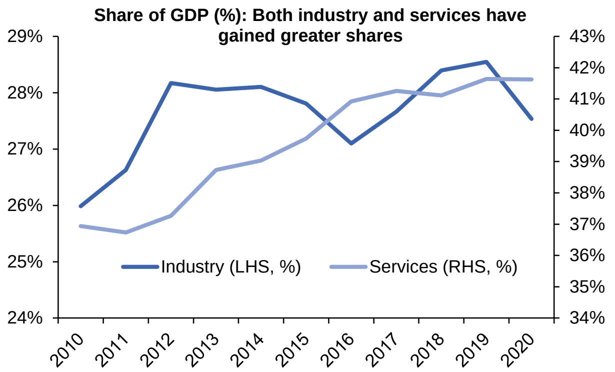


Source: CEIC; Mizuho Bank

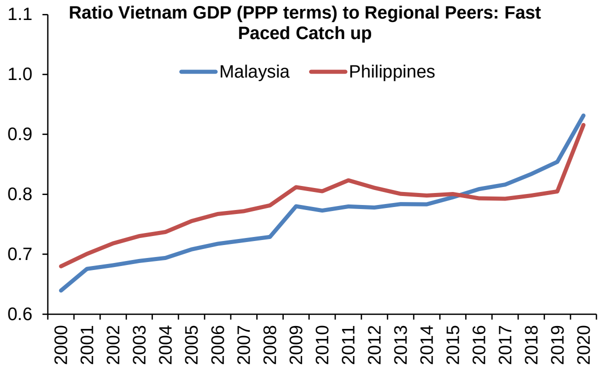
The current account has largely been in a surplus position over the past decade. **Structurally**, the underlying **trade balance for goods has turn from persistent deficits to one of a consistent surplus** since 2012 as a result of **strong fundamental industrial support base** in the Vietnamese economy.

However, alongside these structural improvements, one of the remaining **weakness is Vietnam's increasing reliance on imported energy sources** which drags the goods balance. This weakness though is an expected consequence of the industrial establishment in Vietnam outpacing that of domestic energy development and associated infrastructure investments. The latter understandably require greater amount of domestic funding, coordination and expertise which were rather lacking relatively compared to inflows of foreign investment into the country by MNCs with historical experience and technical know-how.

Vietnam's Industrial Evolution



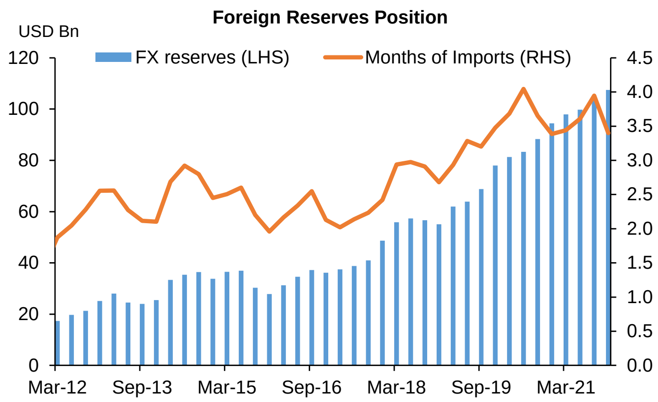
Source: CEIC Mizuho Bank



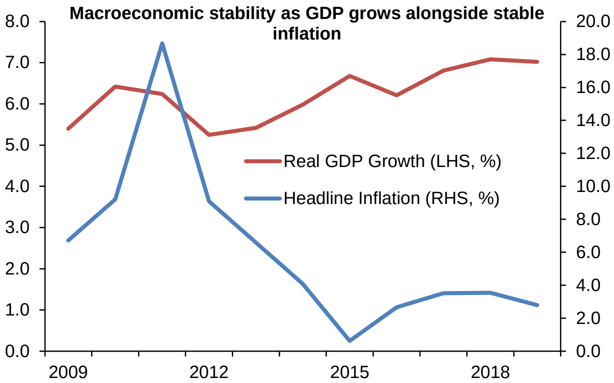
Source: CEIC; Mizuho Bank

Vietnam's economy has strengthened in an emphatic manner over the past decade evolving over the last decade from a patchwork of agriculture activities and low value added good production to the current industrial hub and attractive FDI destination among ASEAN peers. This is evident with the industrial sector grabbing a large share of economic activity even as GDP expands at a rapid pace, as the agricultural sector's share dwindles. On purchasing power parity basis, **Vietnam's GDP has grown 1.8 times from 2010** and has narrowed the gap with regional peers significantly from **being 60-70% the size of Malaysia/Philippines in 2000 to near 90% their economic size in 2020**.

In this evolution, the government was able to overcome the dollarization of the economy. This corresponded with improvements in the macroeconomic environment and a steady accumulation of foreign exchange reserves.

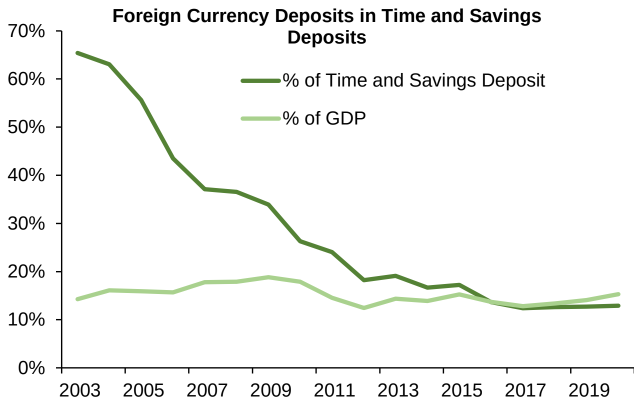


Source: CEIC, Mizuho Bank

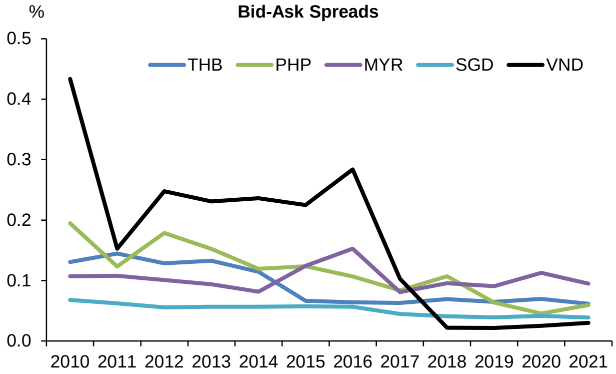


Source: CEIC, Reuters, Mizuho Bank

Macroeconomic **policy management has also come a long way** as inflation is now more well anchored which helps preserves the real returns of assets and in turn translating to VND stability. The State Bank of Vietnam's efforts to adopt a **relatively more flexible exchange rate regime in 2016** by using nominal effective exchange rate framework with a basket of 8 currencies to set **daily reference rates** based on historical previous day trading outcomes. This allows a more market based exchange rate regime and **prevents speculative hoarding of foreign currencies** under an occasionally adjusted fixed rate.



Source: CEIC; Mizuho Bank



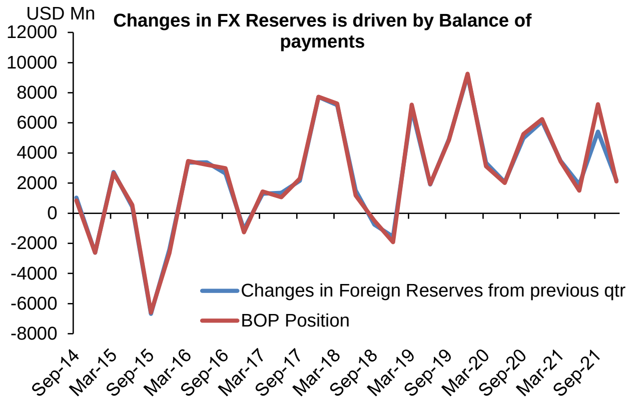
Source: Reuters, Mizuho Bank
Note: Calculation is based on Difference between Bid price and Ask price, divided by Ask price

Therefore, dollarisation risk in Vietnam has stepped down considerably over the past decade as the share of foreign currency deposits declined from over 60% in 2003 to 13% in recent years with **improvements in macroeconomic environment** enabling the VND to function as a **good store of value**. **On the other hand, foreign currency** deposits continue to make up a **stable share of GDP** signals a steady availability of foreign currency within the domestic banking system as **foreign currency deposits grew alongside VND deposits**, albeit at a more moderate pace. **Cost of accessibility to the VND has also improved over the years** as the bid-ask spread has decline to levels comparable to regional peers.

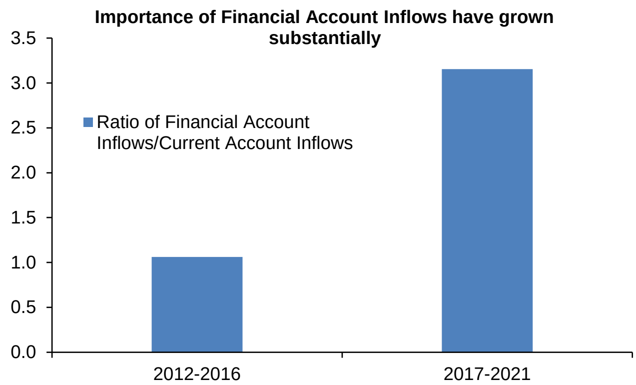
VND – More Flexible and Resilient but Far From Freely Floated

While risks surrounding the VND have greatly reduced over the past decade, the question is whether this means that the VND is elevated to the status of freely traded currencies? First, the VND remains largely a rather heavily managed float rather than a complete free float. Access to the VND remains fairly impeded internationally, alongside a **financial market (debt and equities)** which has **not deepened and widened significantly relative to the pace of growth of its economy**. The level of financial innovation will still need to catch up with regional peers such as Malaysia and Philippines despite closeness of economic size.

The lag of financial market development is a relative one, partly due to the fact that much of their **industrial growth has been inorganic via the strong infusion of foreign capital over a short span** of time. The industrial sector has evolved to one of satellite manufacturing bases for the likes of Korea, Japan and Taiwan. The good news is that this trend should continue over the medium term and entrench further to allow for the domestic industrial sector to flourish.



Source: CEIC; Mizuho Bank



Source: CEIC; Mizuho Bank

Second, **risks of latent volatility for VND remains** as the **influx of foreign reserves has been boosted at an exceptional pace due to FDI (within financial account)** and the **sustainability of this exponential growth trend is suspect** though levels look to remain durable. Relative to the current account, the financial account surpluses have grown in importance as Vietnam has become a key FDI destination for foreign MNCs with the "China Plus one" strategy benefiting from their geographical proximity to China, low cost base and growing slew of FTAs. The ratio of financial account inflows to that of current account from 2017-2021 is three times that compared to 2012-16, underscoring the fact that despite the establishment of MNCs production facilities in Vietnam boosting exports, the continued inflow of investments still overwhelmed.

Correcting for the trend will feed into a more robust VND. Nonetheless, a **deeper and more liquid money market alongside improved currency access would be necessary prerequisite for transitioning to a fully flexible VND that has international circulation**. This though will require the build up to a more substantial level of FX reserves as through the lens of their import needs, their foreign reserve increase thus far is milder from 2.2 months of imports in 2012 to 3.6 months in 2021 – a 64% rise, compared to their stock of foreign exchange reserves which has accelerated from about US$20bn in 2012 to almost US$110bn at the end of 2021 – a ten-fold increase. These conditions will naturally require the passage of time and continued institutional reforms to ensure permanence of VND stability.

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