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Cambodia and Vietnam in the US-China Trade War: Not All Good News

Both countries face opportunities, but investors cannot overlook the lingering risks.

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With China's demographic dividend gradually disappearing in recent years, production costs have soared in the world's second largest economy. Facing rising labor costs coupled with mounting environmental pressures in the country, many Chinese and foreign multinationals have opted to relocate their factories from China to Southeast Asia, where labor costs are relatively lower than in the neighbor to the north. More recently, the intensification of the U.S.-China trade war has driven yet more of these companies to the ASEAN region as they set to offset a major risk to their businesses.

That said, it is overly simplistic to assume that the business environment in Southeast Asia is excellent for foreign investors. This is especially important considering that recent reports on the trade war's benefits for several ASEAN countries (as made by several consulting companies and think tanks) have fallen short of covering the lingering risks of these economies. In fact, many foreign investors continue to encounter difficulties in their business operations in Southeast Asia, with two perfect examples being the beneficiaries of the U.S.-China trade war: Cambodia and Vietnam.

Cambodia

In Cambodia, the business environment continues to be complicated despite the trade war's opportunity for the nation. According to Ken Loo, secretary general of the Garment Manufacturers Association in Cambodia (GMAC), 70 garment factories have been shut down in the country thus far, already twice the number of factories that ended their operations last year. The reasons, of course, are multipronged.

First, there's the continuing increase of labor costs in Cambodia. From 1997 to 2019, labor costs in Cambodia rose 4.5 times, from as low as $40 per month to as much as $182 per month. And if employee benefits and various subsidies are included, the costs are expected to surge to about $210 per month. Such labor costs overshadow those of Bangladesh, Sri Lanka, India, Myanmar, Pakistan, and Laos.

Second, supply chain links are also far from perfect in Cambodia. Currently, the infrastructure and supporting facilities of the country's manufacturing industry are relatively weaker than China's and this, in turn, results in increased business costs for foreign investors.

Third, Cambodian workers have lower productivity compared to their Chinese counterparts. According to industrial analysts, the productivity of Cambodian garment factories is only about 60 percent of China's while it is also behind Cambodia's two ASEAN counterparts (Vietnam and Indonesia), which both recorded 80 percent of Chinese productivity.

Fourth, there is also a prevalence of labor protests in Cambodia. In recent years, labor protests have become a new risk for foreign investors operating in the country — unlike the past, when investors could safely dismiss such risks in their business operations.

Finally, it is still uncertain whether the advantage of Cambodia's low export prices can remain at its current levels. This is especially important in light of the possibility that the EU's tax incentives to the country face the risk of being terminated in the near future.

Vietnam

As for Vietnam, it is touted as the country that has benefited the most from the U.S.-China trade war, as highlighted by Nomura Securities recently. According to the group, 52 percent of Vietnamese goods are enjoying an import substitution effect as a result of the high tariffs imposed by both the United States and China against each other. Among the economies studied in Nomura Securities, Vietnam is the biggest beneficiary from the trade war — with a possible increase of up to 7.9 percent in the country's GDP. But our research team believes that there are potential risks alongside such the historic opportunity for Vietnam made possible by the U.S.-China trade war.

First, like Cambodia, Vietnam also faces the risk of rising business costs. As an export-oriented economy, a large number of concentrated exports certainly lower the prices of export commodities. But at the same time, it also denotes higher prices for imported goods as the country continues to import at the same high rate as before. As such, imported inflation is an inevitable scenario for the Vietnamese economy. This in turn could lead to the rise of wages as factory workers who feel the pinch of inflation may mobilize for labor strikes or protests. And the Vietnamese government may acquiesce to such demands from the workers as the best means of controlling inflation. If all these scenarios occur, Vietnam risks losing its most important advantage: being a low-cost haven for foreign investors.

Second, whereas Vietnam's economic growth was as high as 7.08 percent in 2018 (far exceeding market expectations), one also has to recognize the risk of a development bottleneck faced by the Southeast Asian economy. A particular manifestation is the mushrooming of high-rise buildings in the cities despite the lack of supporting fundamentals for such a real-estate boom. This is an alarming indication that the wealth created by the manufacturing sector is rapidly moving over to the real estate sector instead of being recycled in the former. Furthermore, the shocking figure of foreign direct investment — as shown by the $10.8 billion of FDI poured into Vietnam in the first quarter of 2019 — will also make the Vietnamese economy more vulnerable to foreign capital. This, in turn, increases the volatility of Vietnam's economy as foreign capital enters and leaves the market based on the investors' market sentiments. With such a high degree of external dependence, it is expected that any externally induced shock to the Vietnamese economy will be both rapid and impactful.

By all means, it is unquestionable that Cambodia and Vietnam will benefit from the U.S.-China trade war in the short term due to the global restructuring of the industrial supply chain and manufacturing transfers. But unlike China, their smaller economies (and thereby, reduced market sizes) bring along risks that are worth more comprehensive and deeper assessment by foreign investors. Rising costs, development bottlenecks, less competitive workforces, weaker supply chain links, and more frequent labor movements may be risks for both Cambodia and Vietnam in the coming years — with the end result being that these countries end up facing the same predicaments experienced by China for the past years. Last but not least, it should be noted that in a world where overproduction is rampant and uncontrollable, such a relocation of foreign investment will lead to more unused produced goods around the globe. If an economic crisis breaks out of such a situation, smaller economies like Cambodia and Vietnam will be hit even harder than China.

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