TAKING STOCK

An Update on Vietnam's Recent Economic Developments

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CURRENCY EXCHANGE RATE: US$ = VND 16,481
GOVERNMENT FISCAL YEAR: January 1 to December 31

ACRONYMS AND ABBREVIATIONS

CDS	Credit Default Swap
FDI	Foreign Direct Investment
FOB	Freight on Board
GDP	Gross Domestic Product
GSO	General Statistics Office
HASTC	Hanoi Securities Trading Center
HOSE	Ho Chi Minh City Stock Exchange
ICP	International Comparison Program
IMF	International Monetary Fund
JSB	Joint-Stock Bank
MOF	Ministry of Finance
MOLISA	Ministry of Labor, Invalids and Social Affairs
MPI	Ministry of Planning and Investment
NPL	Non-Performing Loan
ODA	Official Development Assistance
SBV	State Bank of Vietnam
SOE	State-Owned Enterprise
VAT	Value Added Tax
VDB	Vietnam Development Bank
WTO	World Trade Organization

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The story of the year 2008 is one of two successive crises.

During the first part of the year, Vietnam was confronted with the overheating created by massive capital inflows, resulting in accelerating inflation, a ballooning trade deficit, a real estate bubble and many investments of dubious quality. A determined reaction by the government, especially since March 2008, was successful at stabilizing the economy. In spite of surging world prices of food and oil, a tight monetary policy and some measure of fiscal restrain burst the real estate bubble, gradually brought down the inflation rate and reduced the trade deficit to manageable levels. In the process, economic activity was also affected, with the first half of 2008 seeing the worst growth performance in years. The overall economic situation was fragile around May, when markets were nervous about a possible balance of payment crisis, but it gradually became apparent that the stabilization package was working. With still booming approvals for Foreign Direct Investment (FDI) projects, Vietnam seemed ready to renew with rapid economic growth.

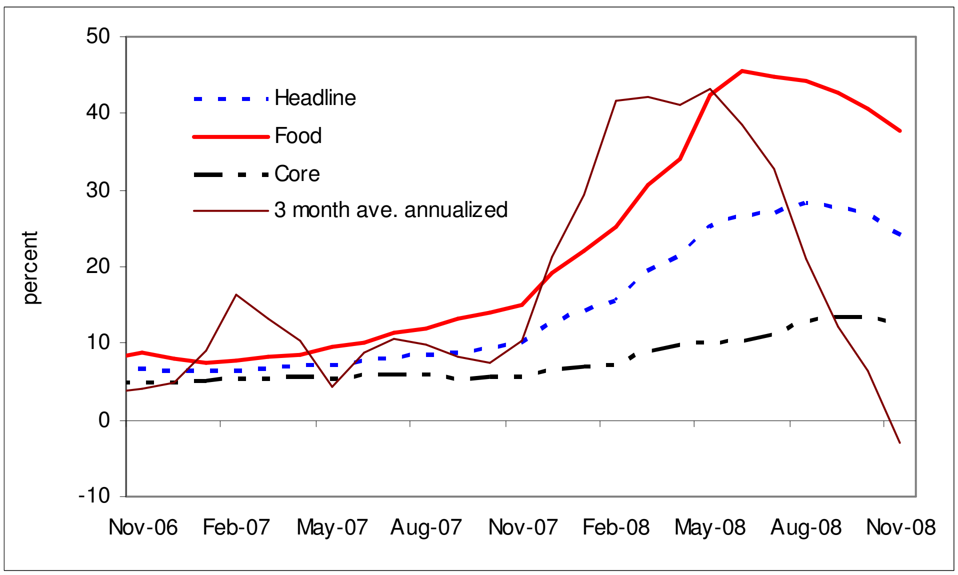
That was when the second crisis hit. In the second half of 2008, financial difficulties in a risky segment of the mortgage market in the United States developed into a global financial crisis of unprecedented proportions. Fear paralyzed activity in industrial countries, bringing credit to a halt and even threatening to derail international trade. Economic forecasts for industrial countries in 2009 are revised often, and the adjustment is always downwards. How much this global turmoil will affect Vietnam is still unclear. Its banking sector has not been directly affected, because its does not hold the financial products at the center of the current crisis, and is only marginally owned by international banks which could be exposed to such products. But the growth of Vietnamese exports is bound to slow down, approvals of new FDI projects will decrease dramatically, and even FDI disbursements on already approved projects may dwindle. Together with the fallout from the burst of the real estate bubble, this will create difficulties for many enterprises, resulting in a higher proportion of non-performing loans (NPLs) and affecting the banking sector indirectly. The rapid rate at which poverty had been falling in Vietnam will also be reduced.

The government of Vietnam reacted swiftly to the overheating of the first part of the year, and it deserves credit for its clear success at stabilizing the economy. Confronted with the crisis of the second half of the year, it is hoped that it will react in a determined manner too. In practice, an appropriate reaction would entail giving the first priority to economic stability, ensuring appropriate monitoring of the banking sector, supporting the consolidation of smaller weaker banks, and responding flexibly to any instability stemming from the balance of payments. But an appropriate reaction may also require supporting economic activity if the downturn in exports and FDI disbursement becomes substantial. The stabilization effort of the first half of the year created some room of maneuver to sustain aggregate demand and, in particular, the development of much needed infrastructure. But in doing so, it will be important to keep in mind the structural weaknesses exposed by the overheating of the first part of the year. An effort to support economic growth amidst the global turbulence needs to be accompanied by determined reforms, so that it does not lead to the asset price bubbles and dubious investments of the first part of the year.

From domestic overheating to global crisis

Six months ago, the primary concern was how to dampen the overheated economy and control inflation that was threatening to spiral out of control. Since then, the stabilization package announced by the government in March 2008 appears to have worked. Inflation is coming down. The year-on-year rates are still high while the legacy of the spike in prices towards the end of 2007 is being worked out, but the three months moving average has declined rapidly after peaking in May 2008, and has dipped to negative in November (Figure 1). Government certainly deserves credit for its swift and effective policy response to economic overheating.

Figure 1: Inflation Rate



Source: General Statistics Office (GSO)

However, when the domestic situation had barely started to ease, the international economic environment deteriorated dramatically. The world economy is entering a major downturn, caused by the most dangerous shock in mature financial markets since the 1930s. Developing country growth will fall sharply in 2009 through several channels (Table 1). Exports will decelerate as a result of falling demand in the advanced economies. Primary commodity prices have plunged at the prospect of falling world demand. This reversal, while providing a ray of light for commodity importing nations in the wake of the huge price increases of the past 1-2 years, also poses the need for adjustment in commodity exporters, which until recently were enjoying boom conditions. Private portfolio and bank lending flows to developing countries have fallen sharply, combined with extraordinary declines in stock prices, significant currency depreciation and sharp increases in external borrowing costs. Trade finance has been disrupted. Over a longer horizon, foreign direct investment may also weaken because of weaker growth prospects. There are also concerns that official development assistance (ODA) flows could be affected by tighter budgets in advanced countries and that political pressures for more protectionist policies could gather force.

Table 1: Global Economic Outlook

	2007	2008e	2009f	2010f
GDP growth (percent change)				
World	3.7	2.5	0.9	3.0
High income countries	2.6	1.3	-0.1	2.0
United States	2.0	1.4	-0.5	2.0
Euro zone	2.6	1.1	-0.6	1.6
Japan	2.1	0.5	-0.1	1.5
Developing countries	7.9	6.3	4.5	6.1
East Asia	10.5	8.5	6.7	7.8
China	11.9	9.4	7.5	8.5
World trade volume (percent change)	7.5	6.2	-2.1	6.0
Oil price (US$/barrel)	71.1	101.2	74.5	75.8
Non-oil commodity prices (percent change)	17.0	22.4	-23.2	-4.3
Interest rates, $ LIBOR, 6-month (percent)	5.3	3.3	1.9	2.5

Source: World Bank

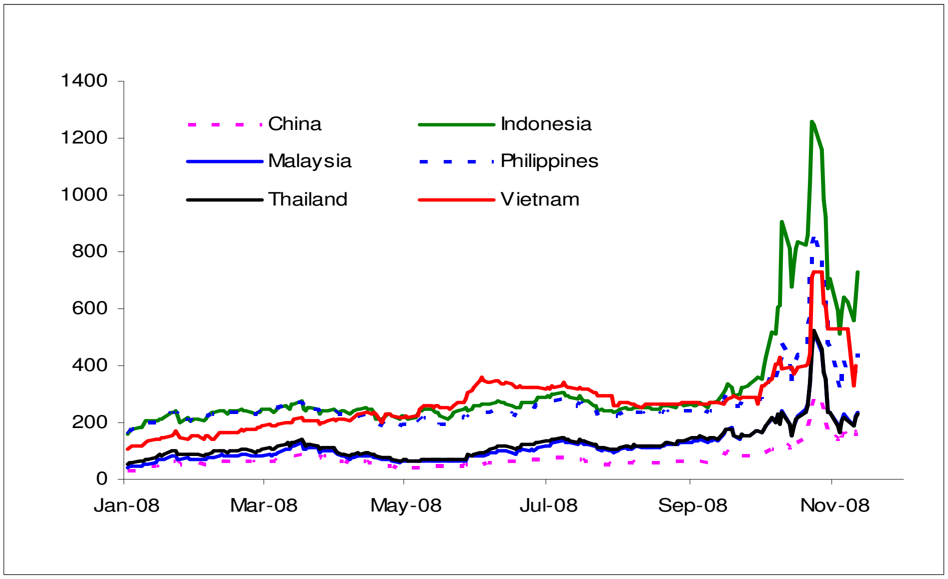
A volatile market sentiment

The unfolding global financial crisis will affect countries whether or not the past and current policies are fundamentally sound, and sometimes even punish countries which have done everything right. Market perceptions about Vietnam had deteriorated in the first half of 2008, but were recovering in the second half, before the global financial crisis hit. The credit default swaps (CDS) market for Vietnamese debt is very thin because the government has very little debt held by private creditors (110 million US Dollars, or about 6 percent of total stock of public external debt outstanding at the end of 2007, which is mere 0.5 percent of foreign currency reserves of the State Bank of Vietnam (SBV)).

Nevertheless, the CDS market provides an interesting insight into the perception of market participants on creditworthiness of the Vietnamese government (Figure 2). It started the year out in between the countries in the region with low default risks, as perceived by the market (China, Malaysia, and Thailand) and those with high risk (Philippines and Indonesia) (Figure 2). Its perceived risk overtook the “high risk” neighbors’ around April. Its risk fell back below Indonesia’s in the second half of September, and stayed at the similar level with the Philippines’ in recent months.

It is clear that in the eyes of market participants, Vietnam’s domestic turbulence of the first half of the year is dwarfed by the recent global events. The CDS spike of late 2008 is much more dramatic than the increase observed towards May. This is despite the fact that Vietnam is not directly exposed to the mortgage-related derivatives. Indirect impacts expected from the global economic slowdown do not justify the spike fully. It is inferred that the Vietnamese government needs to brace for tough times ahead, despite the relatively strong fundamentals of its economy.

Figure 2: Five-year Credit Default Swaps

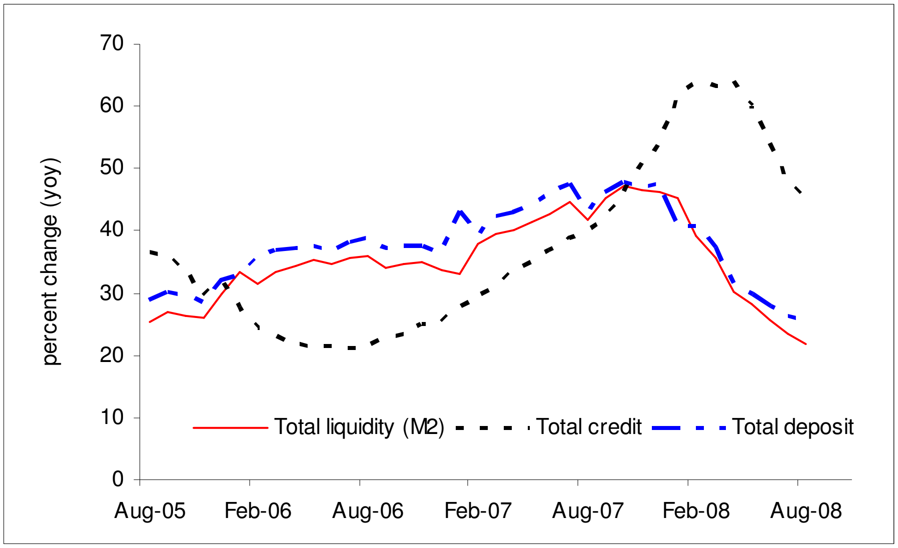


Source: Bloomberg

From tight to loose monetary policy

Vietnam had experienced a huge credit expansion in 2007. At the end of the first quarter of 2008, the yearly credit growth reached an alarming 63 percent. Monetary aggregates had grown rapidly, reflecting the pace of economic expansion, ongoing monetization of the economy, and strong credit demand. Broad money had risen by some 46 percent in December 2007 while credit growth continued at rates in excess of 54 percent in December 2007 (Figure 3). A large part of the growing credit was issued by Joint Stock Banks (JSBs), whose credit growth reached 100 percent during the same period.

Figure 3: Key Monetary Aggregates



Source: SBV and International Monetary Fund (IMF)

As part of the stabilization package adopted in March 2008, the SBV adopted a tight monetary policy. The tightening took place through successive and eventually quite strong measures. The SBV stopped purchasing foreign exchange from late 2007 when the inflationary trend started accelerating. Then, in early 2008, it sold compulsory bills to further absorb VND liquidity in the banking system while simultaneously introducing a cap on deposit interest rates. As a result, credit growth declined sharply and raised concerns of a credit crunch in June and July.

The monetary stance has been relaxed recently in response to the unfolding global crisis. After a period at very high levels, interest rates are now going down (Table 2). In late November, the SBV issued a decision encouraging commercial banks to concentrate on providing credit for production, agriculture and rural development, export and import of essential goods, and to small and medium enterprises.

Table 2: Key Interest Rates

Effective date	Policy rate (%)	Refinancing rate (%)	Discount rate (%)
February 1, 2008	8.75	7.5	6.0
May 19, 2008	12.0	13.0	11.0
June 11, 2008	14.0	15.0	13.0
October 21, 2008	13.0	14.0	12.0
November 5, 2008	12.0	13.0	11.0
November 21, 2008	11.0	12.0	10.0
December 5, 2008	**10.0**	**11.0**	**9.0**

Source: SBV

From fiscal restrain to fiscal stimulus

Fiscal balance remains manageable as a result of prudent fiscal policies in general, high oil prices during most of 2008, and a significant fiscal tightening as a part of the stabilization package. In this respect, the government intends to cut back its expenditure by 48 trillion dong (4.2 percent of GDP in 2007), by reducing general government expenditure (excluding salaries and some social entitlements, see below), and cancelling or postponing inefficient or non urgent public investment projects. It also announced its intention to abolish petroleum-related subsidies.

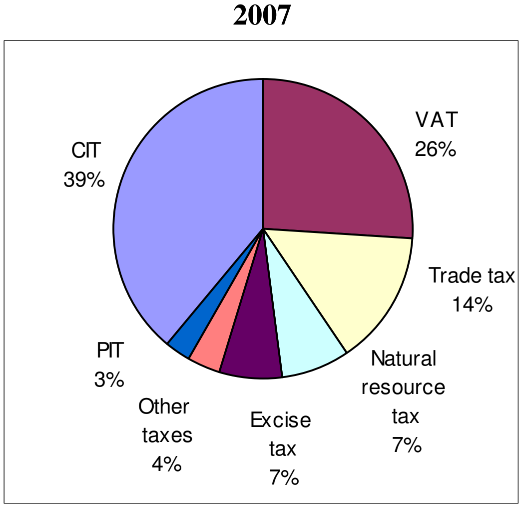
The overall fiscal deficit for 2008, including off-balance items and Vietnam Development Bank (VDB) activities is forecast to be around 93.6 trillion dong (6.2 percent of GDP), up from 5.6 percent of GDP in 2007. However, forecasts often register capital expenditures based on plans and in 2008 actual expenditures are bound to be lower than planned. Part of the reduction is involuntary. First, in response to the high cost of construction materials, many contractors walked away from public investment projects, preferring to pay the fines rather than to incur the additional cost. Second, as part of the stabilization package, line ministries and provincial governments were requested to compile a list of all their ongoing projects having lost their relevance, being poorly implemented or lacking appropriate funding. On the basis of this information, the Ministry of Planning and Investment (MPI) adjusted, downscaled or stopped 1,145 public projects with a total value of more than 30 trillion dong, accounting for 12.7 per cent of planned investment.

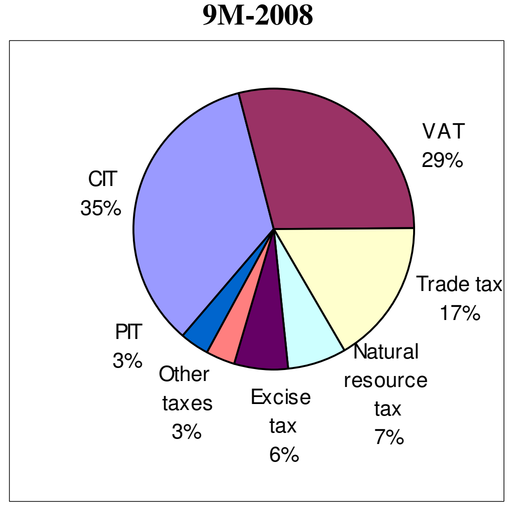
Assessing the fiscal position of Vietnam is difficult, because of the gap between planned and actual expenditures, which results in carryovers of revenue amounting to several percentage points of GDP. Usual estimates of the budget deficit (such as the one putting it at 5.6 percent of GDP in 2007) treat carryovers as finance. Counting them as revenue considerably changes the perception. On that basis, for instance, the budget deficit of 2007 amounted to 3.2 percent of GDP. Even without that correction, data for the first three quarters of 2008 indicate a slight surplus for the central government. This suggests that Vietnam has undergone considerable fiscal adjustment in 2008. However, this good performance is also due, to a large extent, to buoyant oil-related revenue, which is estimated to account for around 21 percent of total budget revenue in 2008.

Total tax revenues, excluding oil, are projected to increase by 26 percent in 2008, largely due to the increase in value-added tax (VAT) and import-export tax (Figure 4). Contrary to many predictions, the share of trade-related revenue has not declined, in spite of tariff reductions associated with the implementation of the World Trade Organization (WTO) commitments and the continuation of those under the ASEAN Free Trade Area. This is partly due to the fact that tariff reductions under the WTO are not very large. More importantly, imports are surging so that tariffs apply to a wider tax base. Moreover, the government has begun to implement a customs modernization program that will not only facilitate trade but is also expected to improve efficiencies of revenue collection.

Figure 4: Composition of Tax Revenues

(percent of total tax revenues)





Source: Ministry of Finance (MOF)

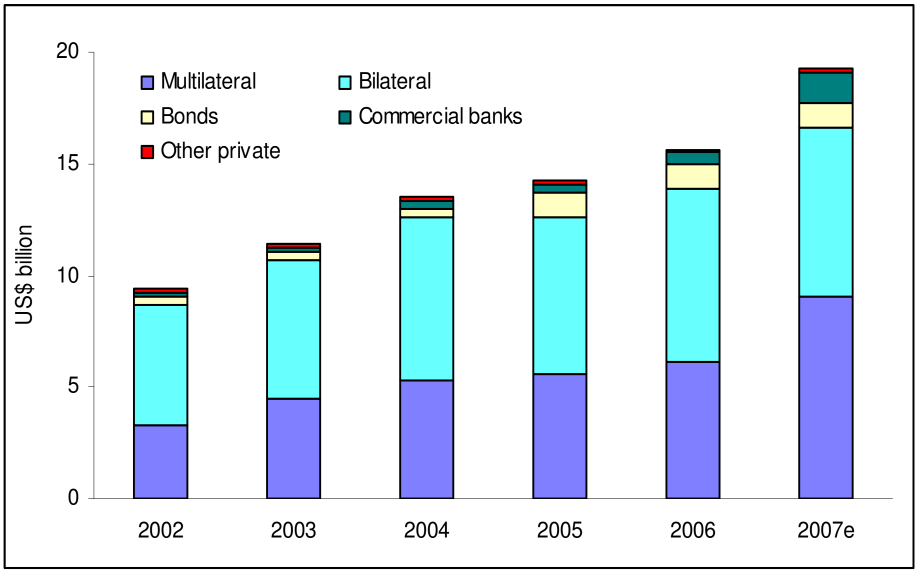
Concurrently with the cuts, the government made a number of decisions which are expected to exert considerable fiscal pressure in subsequent years. It approved a 15 percent increase in pension and social subsidies starting October 2008, three months ahead of the plan. Subsidies to low-wage civil servants and military personnel were also approved. It has also redefined the national poverty line in 2008, which will have important implications for spending in the social sectors. These measures, while costly, are important to alleviate the impacts that poor and vulnerable segments of the population are likely to suffer due to the recent bout of double-digit inflation and the global financial crisis.

The government is currently preparing a stimulus package to face the global downturn. The package is organized around five groups of measures: 1) promoting production and exports, 2) supporting consumption and investment, 3) further loosening the financial and monetary stance, 4) reducing poverty and providing social welfare, and 5) strengthen public sector management at all levels. The fiscal implications of this package are still unclear, but an increase in expenditures can be anticipated. Current discussions set the additional level of expenditures at around one billion dollars, or roughly one percent of the expected GDP of 2008.

Public debt remains sustainable

An ongoing sustainability analysis of public debt suggests that Vietnam's external debt position is robust even taking the global financial crisis is taken into account. The total public external debt is estimated to stand at 25 percent of GDP (31.5 percent including the private sector) at end of 2008. With nearly two-thirds of this debt on highly concessional terms, the ratio of debt service to exports will remain very low, at about 5 percent. Vietnam is therefore considered at a country at a low risk of external debt distress (Figure 5).

Figure 5: Public External Debt



Source: MOF

Stress tests show that Vietnam's debt could become difficult to manage if there was a large (30 percent) or sustained depreciation of dong. There would also be risks in the event of an unexpectedly large borrowing by the government in non-concessional terms, or if large contingent liabilities were to materialize.

GDP growth is slowing down

The stabilization package adopted in March 2008 resulted in a lower growth rate than projected at the beginning of the year. In the first nine months of 2008, GDP grew by 6.5 percent, the lowest level since 2000 (Table 3).

Table 3: Gross Domestic Product (GDP)

	2006	2007	Q1-08	Q2-08	Q3-08
Total GDP	8.2	8.5	7.4	5.8	6.5
Agriculture, forestry and fishery	3.4	3.4	2.9	3.1	4.7
Industry and construction	10.4	10.6	8.1	6.0	7.2
Industry	10.2	10.2	8.9	7.7	10.0
Construction	11.0	12.0	3.3	-0.5	-1.9
Services	8.3	8.7	8.1	7.2	6.6

Source: GSO and World Bank estimates

The combined agriculture, forestry and fisheries sector grew 3.6 percent in the first nine months of 2008, despite continuing to face unfavorable weather events, including typhoons and drought conditions. Value added from agriculture recorded an increase of 3.1 percent due to a bumper harvest of summer crops: rice output increased by more than 1 million ton counting only the summer harvest.

In the first nine months, industrial value added grew 7.1 percent year-on-year. Value added in the mining sector fell by 4.7 percent due to a decline in crude oil production. The sector that was hit hardest was construction which decreased 0.3 percent (the worst performance in many years) mainly due to the burst of the real estate bubble. Within the industrial sector, the turnover of the domestic private sector expanded 21 percent while that of state-owned enterprises (SOEs) grew 5.5 percent year-on-year.

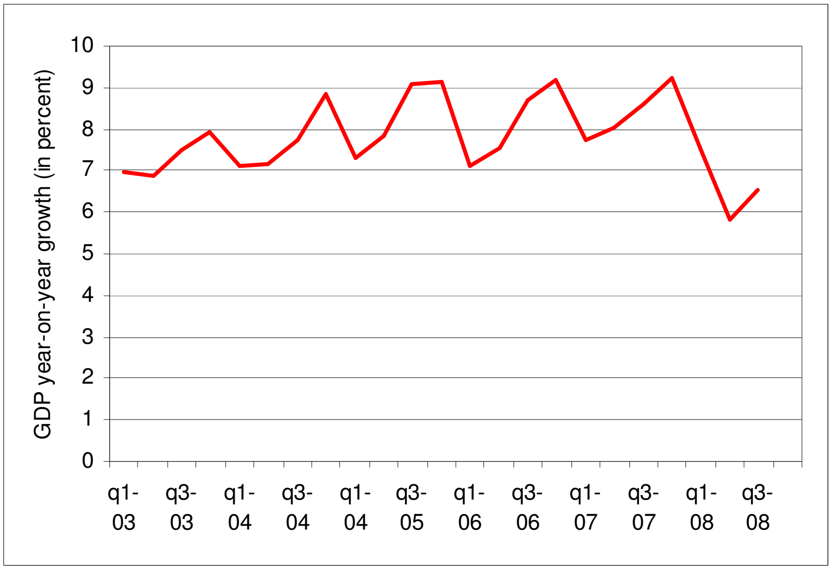
The retail sales index, an indicator of consumption, grew by nearly 31 percent in the first 10 months of 2008 compared with 23 percent in the same period of 2007. However, the retail sales could increase only 6 percent if it excluded the effect of price increase.

Domestic loosening versus global recession

There is ample consensus that the global financial crisis will affect Vietnam, resulting in lower growth rates in 2009. But there is much less consensus on how large the impact will be. Part of the uncertainty stems from the frequent revision of the growth forecasts for industrial countries, which for now is consistently for the worse. But there are other sources of uncertainty at play.

One of them concerns Vietnam's recovery from its own macroeconomic turbulence. The stabilization package of March 2008 included considerable monetary tightening and some fiscal contraction. These measures resulted in a noticeable economic slowdown, especially in the second quarter of 2008. Compared to the same period of the 2007, GDP growth declined from 7.4 percent in the first quarter to 5.8 percent in the first semester. However, economic activity started to recover as the economy stabilized, with the GDP of the first three quarters of 2008 being 6.5 percent above the corresponding figure for 2008 (Figure 6). A further relaxation of the contractionary policies adopted in March 2008, as inflation risk recedes, could result in faster economic growth. Whether and to which extent will the domestic stimulus may counter the international downturn is unclear at this stage.

Figure 6: Recent Economic Growth Rates in Vietnam



Source: GSO

There is also uncertainty regarding the impact of economic activity among foreign partners on economic activity in Vietnam. Given the limited exposure of the Vietnamese financial sector to "toxic" financial products, and the limited share of the capital of Vietnamese banks owned by international institutions exposed to such products, the global economic crisis is not likely to impact Vietnam's financial sector. On the other hand, it can be expected to have an impact on the demand for Vietnamese exports and on the inflow of investment capital. But how large this impact could be is uncertain. For instance, if Vietnamese products are competitive they may not be among the first to suffer from a decline in imports from industrial countries.

Exports growing rapidly… for now

Export performance remained encouraging in 2008, despite a lackluster global economy. Figures for the first eleven months of the year show overall exports increasing by an impressive 34 percent, of which non-oil exports rise by 35 percent (Table 4). The ratio of merchandise exports to GDP increased both for total and non-oil exports. In spite of production capacity constraints, the value of oil exports is still strong. As of November, oil export volumes had decreased by 10 percent in annual terms but earning from oil exports had increased by 31 percent. It is noteworthy that the increase in the value of oil exports in the last two years was driven almost entirely by prices, rather than quantities. Vietnam has also gained from high price of commodities where earning from rice exports increased by 89 percent in the first eleven months of 2008 given the fact that the government has intervened in rice export in April in the concern of food security and domestic price stabilization.

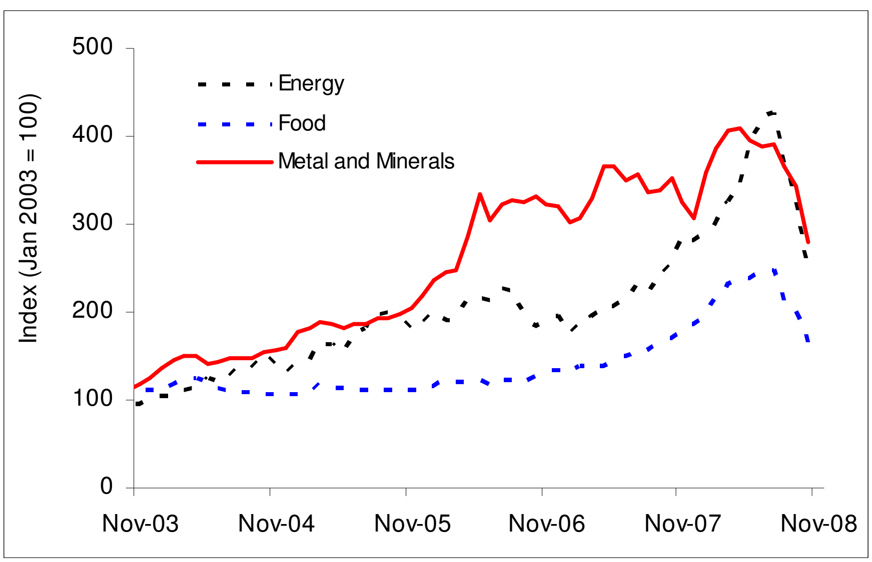
Table 4: Export Value and Growth

	Value ($mn), 2007	Growth %			
		2006	2007	11M-07	11M-08
Total export value	48,561	22.8	21.9	20.0	34.0
Crude oil	8,488	12.1	2.4	-2.3	30.9
Non-oil	40,074	25.9	27.1	26.0	34.7
Rice	1,490	-9.3	16.8	14.0	89.1
Other agricultural commodities	4,696	42.0	31.3	33.0	20.2
Seafood	3,763	22.6	12.1	11.9	24.8
Coal	1,000	36.6	9.3	9.1	50.5
Garment	7,750	20.6	32.8	32.0	19.1
Footwear	3,994	18.2	11.2	9.5	18.3
Electronics and computers	2,154	19.7	26.1	24.6	29.5
Handicraft	825	10.9	30.9	32.1	87.5
Wood products	2,404	23.7	24.4	23.7	18.6
Other	11,996	38.7	37.6	35.5	51.1

Source: GSO.

Better prices for key export commodities helped secure a higher dollar value of exports so far in 2008. Value of coffee export jumped 6.6 percent in the 11 months of the year, rubber increased 25 percent, and cashew nut rose by 47 percent. The better price of commodity exports helped to compensate the decline of their export volume. However, the international prices of many commodities are expected to fall sharply in 2009 (Figure 7).

Figure 7: International Commodity Prices



Source: World Bank

Imports booming and then slowing down

The strong investment of the previous two years, combined with a surge of import prices had resulted in a rapid rise in imports. The main import categories witnessing increases were machinery and equipment, petroleum products, and other production inputs needed for the fast expanding economic activities. The import value of machinery and equipment, which accounts for about 17 percent of total imports, shot up 35 percent year on year in the first ten months. Steel imports rose by 46 percent in value and 9 percent in volume that forces steel importers to find the way for re-export in the anticipation of its demand slowdown in 2009. Imports of automobiles also slowed down since the second half of the year, partly because of higher tariffs. But import value kept growing, growing by a staggering 95 percent compared to the same period last year (Table 5).

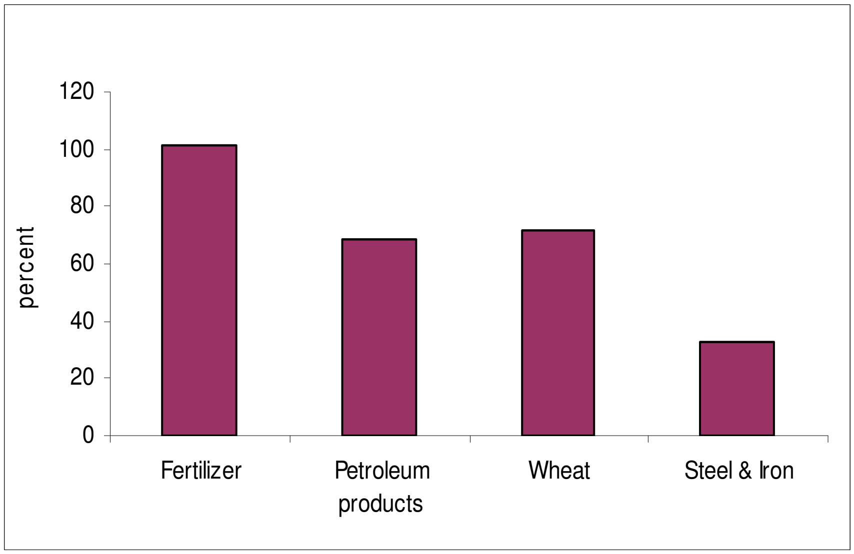
Table 5: Import Structure and Growth

	Value ($mn), 2007	Growth (percent)			
		2006	2007	10M-07	10M-08
Total import value	62,682	21.4	39.4	33.1	38.4
Petroleum products	7,710	18.8	29.2	20.0	58.3
Machinery and equipments	11,123	25.5	67.8	56.3	34.6
Computer and electronics	2,958	20.0	44.5	43.8	28.1
Pharmaceuticals	703	9.2	28.3	28.1	20.8
Garment and leather materials	2,152	-14.5	10.3	22.4	13.3
Iron and steel	5,112	0.2	74.1	61.5	46.3
Fertilizer	1,000	5.9	45.5	33.6	69.7
Plastics	2,507	28.2	34.4	33.7	23.8
Fabrics	3,957	24.4	32.6	50.4	15.0
Chemicals	1,466	20.4	40.7	38.5	30.3
Chemical products	1,285	19.7	27.6	41.6	31.3
Automobiles (COMP/CKD/IKD)	1,881	-18.6	93.6	89.6	94.7
Yarns and fibers	741	60.2	36.3	34.7	10.4
Pesticides	383	25.3	25.4	36.8	34.8
Cotton	267	31.0	22.1	25.4	65.4
Paper	600	31.2	26.2	24.3	28.9
Other	18,835	40.4	27.3	17.0	38.5

Source: GSO

The surge of import value has been also caused by a sharp increase in import prices. Rising import price of petroleum products, steel, fertilizer and wheat in the first nine months of 2008 increased Vietnam's import bill by 2.3 billion dollars (Figure 8).

Figure 8: A Surge of Import Prices in 2008



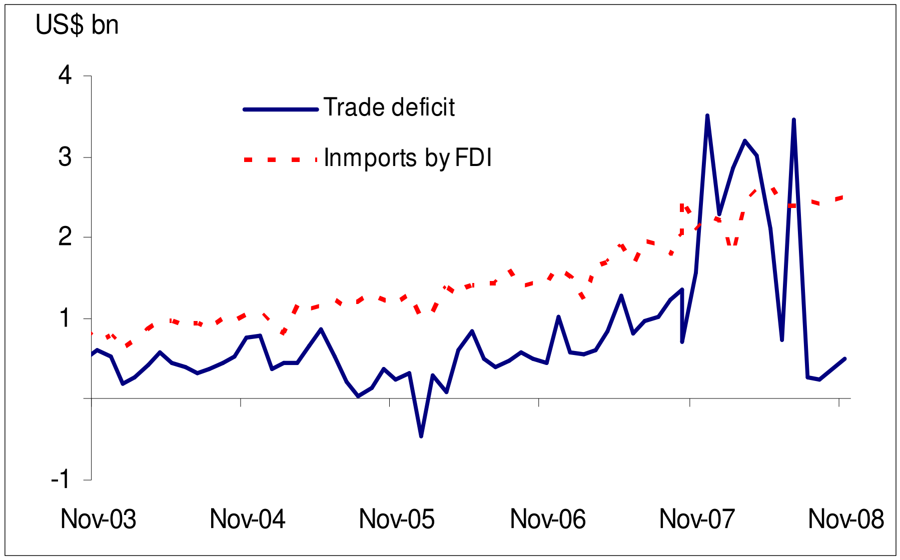
Source: GSO and World Bank estimates

A high but declining trade deficit

The trade deficit is expected to widen to about 20 percent of GDP (on an f.o.b basis) by the end of the year. It is a large deficit by any measure. But there are indications that the year 2008 was something of an anomaly, rather than the beginning of a new trend. The deficit spiked in December 2007, nose-dived in June 2008, possibly reflecting the temporary administrative measures to curtail imports, and has come down to well below the historic trend since August. Moreover, in the case of Vietnam, even a relatively sizable trade deficit could be sustainable. Throughout recent history, the trade deficit has been driven by capital inflows, and not the other way around. Foreign direct investment, in particular, creates import demand in the short term, and export supply in the medium term (Figure 9).

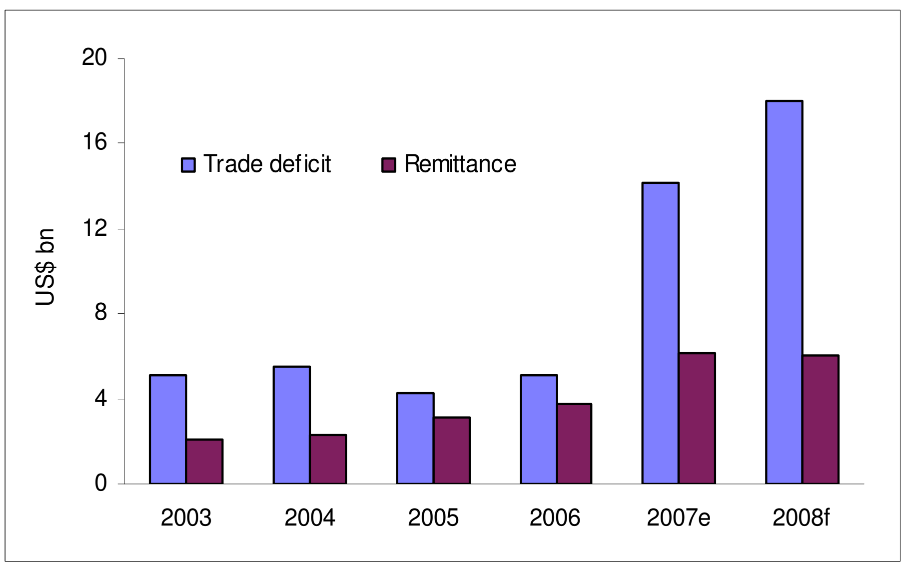
Vietnam enjoys a large remittance inflow from abroad which can be used to finance imports. The inflow has increased steadily in recent years, as the Vietnamese overseas community ages, renews with the country, and invests in it (Figure 10). However, the increase has not kept pace with the surging trade deficit in the last two years. It may also slow down significantly due to the global crisis, although there has been no sign to this effect so far.

Figure 9: Trade deficit and FDI imports



Source: GSO

Figure 10: Trade deficit and Remittances



Source: IMF and GSO

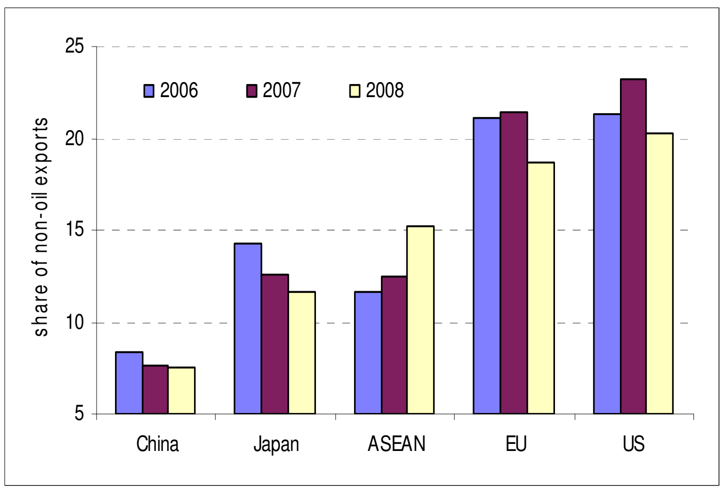
Despite the large remittance inflows, the deficit of the current account reached an unprecedented level of almost 10 percent of GDP in 2007. The deficit continued to widen in 2008 and could reach nearly 12 percent of GDP. What will happen in 2009 will crucially depend on the performance of exports and FDI disbursements in the context of a massive global economic slow down.

How well with exporters cope?

Global import demand is bound to decline in 2009, perhaps dramatically, and that is bound to adversely affect Vietnamese exporters. However, the impact could be mitigated if Vietnam held better than its competitors, and managed to gain market share amidst the turbulence. A few markets and products are key in this respect.

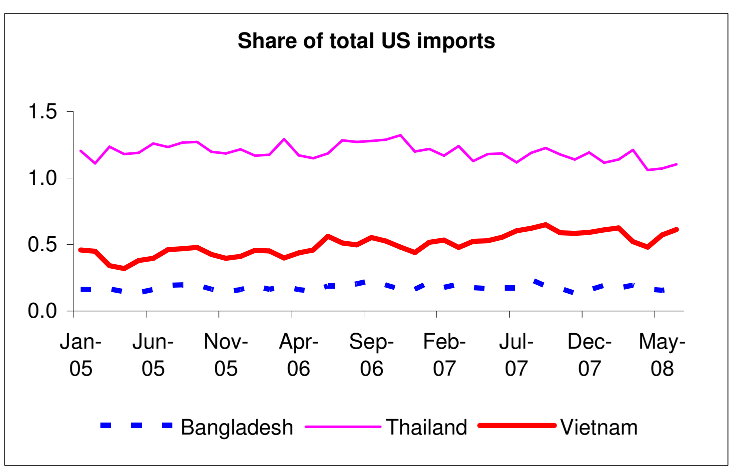
In terms of markets, the United States, whose share has been growing in the last years, continued to be the main destination for Vietnamese products in 2008, absorbing over 20 percent of total non-oil exports (Figure 11). As in previous years, the other key destinations were the European Union, countries in ASEAN, Japan, and China. So far, Vietnam has been doing well in the United States market, steadily increasing its share relative to competitors such as Bangladesh or Thailand (Figure 12).

Figure 11: Key Export Destinations



Source: GSO

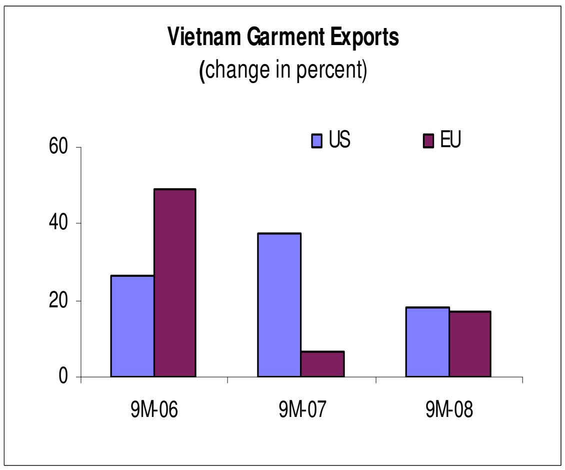
Figure 12: A Growing Market Share

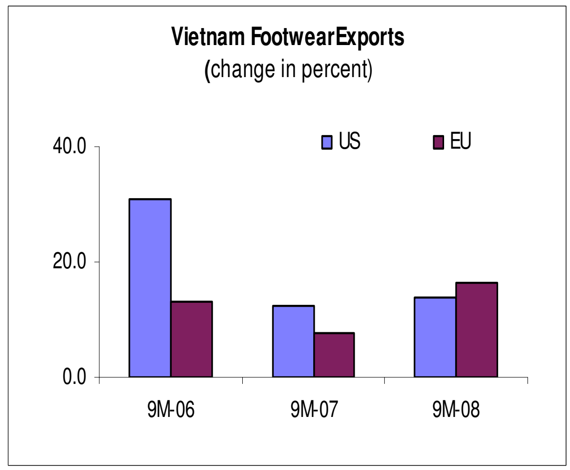


Source: IMF

In terms of products, garment and footwear are still Vietnam's main exports. Garment sales abroad increased by 19 percent in the first 11 months of the year. The United States is the largest market in this case, accounting for 57 percent of Vietnam total garment exports (Figure 13). With Vietnam becoming a WTO member, the United States lifted quotas that had been imposed on garment exports. However, they were replaced by a new monitoring scheme for five "sensitive" categories. Garment producers have been concerned that the monitoring scheme may be used to restrict exports. Even though the scheme does not itself imply that an anti-dumping suit is imminent, the very fact of monitoring is believed to be having a chilling effect on orders.

Figure 13: Garment and Footwear Exports





Source: GSO

Exports of footwear grew by 18 percent in the first 11 months, despite an antidumping suit in the EU, which account for nearly half of Vietnam total footwear exports. It is noteworthy that footwear exports to the EU and the United States rose by 16 percent and 14 percent, respectively, higher growth rates than those of last year.

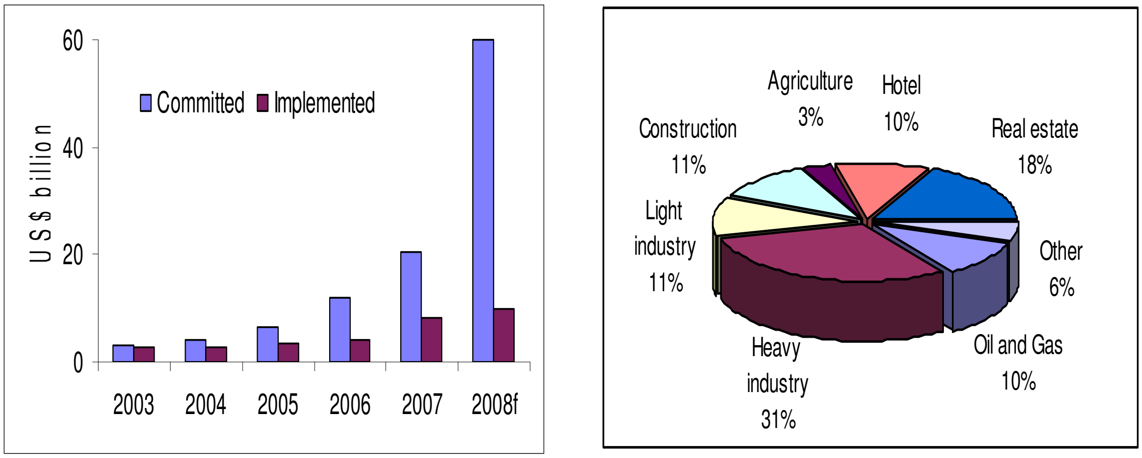
Foreign investment: approvals and disbursements

Committed FDI is estimated to reach a record high of around 60 billion dollars this year. Disbursements, including those by domestic partners, rose by 38 percent on the year to the end of October 2008, representing about 10 percent of GDP (Figure 14).

FDI commitments have clearly received a boost from Vietnam's accession to the WTO. Investors have viewed WTO membership as not only offering wider investment opportunities, but have also been comforted by the predictability and "lock-in" to policy reforms that it entails. The disbursements have not slowed down visibly since the global crisis started to unfold. The situation may change as some of the countries of origin for these investments face more difficult economic conditions. A country of particular concern is Korea, given its large share of FDI. However, among the new FDI projects approved to

September 2008, investments by Korean companies accounted for a mere 2.4 percent of the total. The bulk of new FDI approvals were from Malaysia (26.4 percent), Taiwan (15.3 percent), Japan (12.9 percent), and Singapore (7.2 percent).

Figure 14: FDI Trend and Composition



Source: MPI

The approval of new FDI projects is bound to decline dramatically in 2009. But the actual inflow will crucially depend on the disbursement rate on existing projects. With the volume of projects approved in 2008 being extremely large, the net outcome in terms of FDI disbursements is uncertain. One important question is how multinational companies will respond to the global economic downturn. Many of them were attracted to Vietnam as the "+1" country in a "China +1" strategy. The question is whether Vietnam will be the "-1" country when the time of closing factories arrives.

A suffering banking sector

The monetary tightening of early 2008 was successful at bursting the real estate bubble and bringing inflation down. But it also reduced liquidity and brought economic activity down, putting considerable stress on banks. Tight liquidity required banks to offer competitive deposit rates by squeezing their profit margin while limiting the access to credits particularly by small- and medium-scaled enterprises. On the other hand, Vietnam's regulation caps the lending rate at 150 percent of the base rate. During the period between June and October, commercial banks' profit margin was squeezed between this cap and the deposit interest rates. The cost of required reserves alone more than wiped off any profit margin. Yet, the high lending severely limited access to credit by small and medium enterprises. Smaller banks who had lent aggressively during the overheating period, especially in support of real estate investments, were the ones suffering the most from stabilization.

The recent loosening of the monetary policy seems to have provided banks with adequate liquidity and widened their profit margin. It included allowance to redeem or liquidate the compulsory SBV bills and generous remuneration and reduction of required reserves as well as interest rate cuts. However, banks are still suffering from the earnings squeeze, due to the high interest rates offered by the weakest banks.

As for borrowers, the substantial decline of residential property market since late 2007 has reduced the value of the collateral backing a large portion of bank credit. Fortunately, the restrictive lending regulations play a mitigating role in this case. Indeed, Vietnamese banks were not allowed to lend for property beyond 50 percent of its value, and the latter is set at 70 percent of the market reference point. With loans not exceeding 35 percent of the initial value of the collateral (= 0.5 x 0.7) there is room to absorb a large decline in property prices. A bigger source of concern at this point is the potential impact of the global slowdown on the repayment capacity of exporters.

Until all commercial banks become compliant with the new Vietnamese accounting regulations, available data do not allow accurate estimations of how large NPLs might be. According to the official data based on Article 6 of SBV Decision 493, it is estimated to be around 3 percent of total bank loans. Yet, numbers based on Article 6 are measured in terms of actual delinquency that has already happened in the past. In an increasingly weakening economic environment, a more forward looking Article 7 of the Decision, which is in line with an international standard approach, is likely to produce a higher figure if applied. Unfortunately, its adoption is likely to take some more time since it requires banks to develop an internal credit risk rating system for their borrowers.

A positive side of the picture is that JSBs in Vietnam appear to be fairly well capitalized as many of them aggressively raised new equity while having high earnings during the boom year of 2007. The progressive minimum capital requirements set by the SBV also motivated them to do so. There are nine small banks which have not met the required capital level by the end of 2008, and they may need to be consolidated through mergers or acquisitions in one way or another. Yet, the adequate capital should work as a buffer for the banking system as a whole to cope with possible increases of NPLs in coming times. In addition, Vietnam's largest banks are still state-owned, and occupy half of the banking system. The country's modest public debt and fiscal room are reassuring of the government's capacity to ensure their stability. Thus, Vietnam seems unlikely to suffer from a major banking crisis.

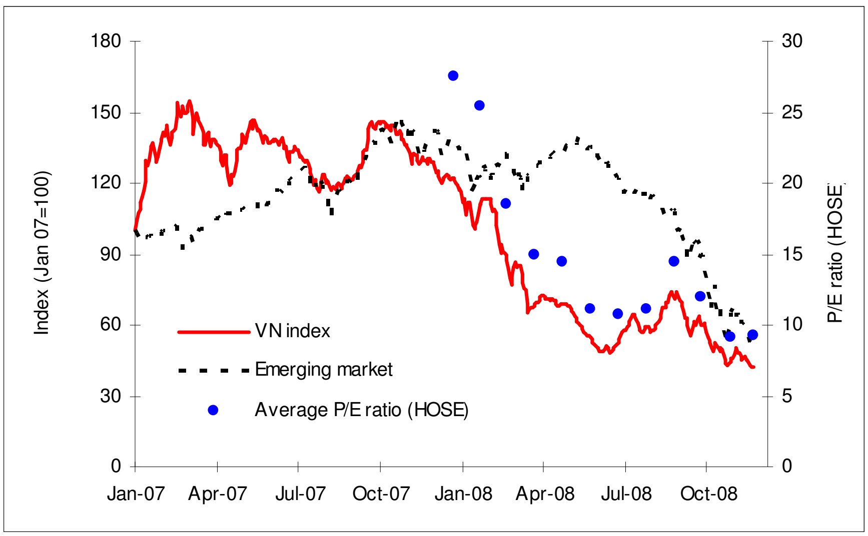
A depressed (but sound) stock exchange

The combined market capitalization of the Ho Chi Minh Stock Exchange (HOSE) and the Hanoi Stock Trading Center (HaSTC) grew dramatically between December 2005, when it accounted for roughly 2 percent of GDP, and March 2007, when it peaked at 43 percent. By way of comparison, the target set in February 2006 by the government was to reach a stock market capitalization of 15 percent of GDP by 2010. In light of these developments, the 2010 target was revised up to 50 percent in August 2007.

Share prices declined subsequently (Figure 15). Concerned about a possible bubble, the government imposed a cap on bank lending to purchase securities, at 3 percent of outstanding loans first and 20 percent of chartered capital later. Then, the stabilization package adopted in March 2008 constrained liquidity even further. More recently, the global financial crisis has prompted foreign investors to sell shares and repatriate their proceeds. As a result of all these developments, stock market capitalization had declined to 15 percent of GDP by end-2008.

However, the decline in share prices should not be interpreted as a set back, or even as a major slowdown, in the development of the equity market in Vietnam. The number of listed companies has increased by fivefold to reach 329 by the end of November, 2008. Out of them, 167 are with HOSE and 162 with HaSTC.

Figure 15: Vietnam Stock Exchange Index



Source: HOSE and Morgan Stanley Capital International

An expected slowdown in poverty reduction

Vietnam experienced a sharp increase in food and fuel prices in late 2007 and the first half of 2008, linked to rapidly rising inflation. Although inflation has fallen, attention is now focused on the emerging impacts of the global financial crisis. But it is difficult to predict what the impact of the crisis on poverty and living conditions in Vietnam will be. The crisis is still unfolding and adjustment will take place over time, transmission channels are likely to be complex, and impacts will depend to a large extent on how Vietnam actually manages the crisis.

Reassuringly, a simulation analysis suggests that under any likely growth scenarios, overall levels of poverty will continue to fall in Vietnam, albeit at a slower rate than in recent years. The analysis is based on the estimated elasticity of the poverty rate (the proportion of persons living below the poverty line) with respect to per-capita GDP. Previous analyses using household survey data suggest that in the case of Vietnam this elasticity lies in the range of 1.5 percent to 1.9 percent. Earlier periods are characterized by higher elasticities than later periods, and the choice of base year can introduce substantial variation. The simulation analysis is based on conservative 1.5 percent elasticity.

Three growth scenarios are considered to forecast the poverty rate of 2008 and 2009. The first one is a simple, hypothetical counterfactual, to reflect what would have happened in the absence of domestic overheating and global turbulence. This scenario assumes that the Vietnamese economy would have continued to grow at 8.2 percent in 2008 and 2009, which is roughly the pace of previous years. In the second scenario, GDP grows at 6.75 percent in 2008, falling slightly to 6.5 percent in 2009. The third scenario is more pessimistic, with GDP growing at 6.75 percent in 2008, and by a meager 5 percent in 2009. The comparison between the last two scenarios and the counterfactual indicates the impact of macroeconomic conditions on poverty.

The predicted slowdown in poverty reduction is not large, even against a high-growth counterfactual and using a conservative estimate of the elasticity of the poverty rate to economic growth (Table 6). Even in the most pessimistic scenario, poverty levels are still anticipated to fall from 16 percent in 2006 to 12.4 percent of the population in 2009. This is compared to predicted poverty rate of 11.5 percent in the counterfactual. Although a 5 percent rate of growth is low for Vietnam, it should still lead to continuing reductions in aggregate rates of poverty.

Table 6: Simulating the Poverty Impact of the Economic Slowdown

Year	Percent of Population below the Poverty Line:		
	Counterfactual 8.2 percent in 2008 and 2009	Optimistic: 6.75 percent in 2008, 6.5 in 2009	Pessimistic: 6.75 percent in 2008, 5 in 2009
2006 (actual)	16.0	16.0	16.0
2007 (estimate)	14.5	14.5	14.5
2008 (forecast)	12.8	13.1	13.1
2009 (forecast)	11.5	12.1	12.4

Source: World Bank

While overall poverty levels would continue to fall, even in the event of a serious slowdown, there are no grounds for complacency. Certain groups among the poor may be particularly exposed to potential impacts of the economic slowdown. The crisis is already having adverse impacts on employment and wages, particularly in export sectors and there has been a sharp slowdown in construction. Although many of the poor still depend primarily on agriculture, income diversification and wage employment in non-farm sectors has become an important strategy for moving out of poverty. The share of workers in non-farm sectors rises rapidly with increasing wealth. But opportunities are likely to become less as a result of the economic slowdown, leaving many rural poor households stuck in agriculture. Although agriculture has been good to Vietnam's poor, agriculture growth averages at best 3 to 3.5 percent a year and long term prospects are limited. In rural areas, there is disquieting evidence of rising inputs costs and falling profitability.

Poverty in Vietnam and the New Global Poverty Estimates

The World Bank recently released new estimates of the number of people living in extreme poverty in the developing world. They are based on information from household surveys covering 116 countries as well as updated International Comparison Program (ICP) estimates of the cost of living in these countries. According to these new data, 1.4 billion persons still live in extreme poverty.

At 950 million, previous estimates of global poverty were lower. Two main reasons explain this difference. First, price data from the latest round of the ICP in 2005 indicated the cost of living in poor countries had been under-estimated in earlier rounds. When the cost of living was increased, the number of people estimated to be living in extreme poverty would also increase. Second, new data were used to revise the "extreme poverty" threshold. National poverty lines for the world's 15 poorest countries were valued at an average of 1.25 dollar per person per day, substantially above the earlier "one dollar a day" poverty threshold. Taken together, both adjustments increased estimates of the overall level of extreme poverty in the world, but did not alter global trends. The level of poverty has fallen from over half the world's population in the early 1980s to a quarter of the world's population in 2005, an average reduction of one percentage point per year.

What do the new global estimates mean for Vietnam? The global methodology is designed to assess regional and global progress over time, also to make consistent comparisons across countries and regions. But the new international poverty threshold is not "better" than Vietnam's own national poverty lines. There are two of them. The first, produced by GSO, is defined as the cost of a food consumption basket allowing a daily intake of 2,100 calories per person per day, plus the cost of a related non-food consumption basket that allows for a healthy life. According to this line, poverty levels have fallen from 58 percent of the population in 1993 to 16 percent in 2006. An alternative poverty line, produced by the Ministry of Labor, Invalids, and Social Assistance (MOLISA), was initially based on per capita rice requirements, but revised in 2005 to better reflect the 2,100 calorie benchmark used in GSO calculations. In 2006, the Government of Vietnam set the official poverty line at VND 260,000 per person per month for urban areas and VND 200,000 for rural areas. In light of Vietnam's recent high rates of inflation, MOLISA has proposed to increase the urban poverty line to VND 300,000 for households living in rural areas and VND 390,000 for urban residents.

But how does Vietnam compare to other countries in East Asia? Herein lies the strength of the global estimates. Based on the recently released World Bank estimates, Vietnam success at reducing poverty between 1993 and 2005 rivaled those of neighboring countries such as China and Indonesia, and exceeded progress in the Philippines, a country that had far lower levels of poverty in the 1990s.