

EMERGING ASIA ECONOMICS FOCUS

16th Sep. 2009



Vietnam is back on track and set for strong growth

- **The Vietnamese economy grew rapidly from 1995 to mid-2008 on the back of China-style free market reforms which have lifted exports and foreign investment, and brought a big reduction in poverty levels. Vietnam's progress has been interrupted since mid-2008 by domestic overheating and the global financial meltdown, but a major credit expansion has now got its economy moving forward again. We expect that GDP growth will stay strong over the long run.**
- **Loose fiscal policies, big interest rate cuts, and a large state-orchestrated increase in bank lending have lifted economic growth.** The challenge now is to take some steam out of the credit surge whilst ensuring sustained economic recovery and that any moves in the markets do not become disorderly. This will be tricky. But capital inflows should continue to pick up and low debt levels mean that the fiscal stimulus can be pulled back gradually. GDP growth in Q3 is forecast to have picked up to 5.0-5.5% y/y. It should accelerate further going into 2010 and then stay strong in 2011.
- **A first hike in policy interest rates looks imminent.** Inflation has probably bottomed and should reach a pace that forces rates up sooner in Vietnam than elsewhere in Asia. Core inflation remains relatively high, the economic slowdown has been shallow and excess capacity is limited, whilst further currency depreciation is likely. **The central bank has already started to rein in the credit surge and, we forecast, will lift policy rates to a peak of 12% by end 2010, from 7% now.**
- **Local currency bonds will likely stay under pressure and sustained currency depreciation should be expected too, whilst stocks will probably underperform the region and be volatile.** Bond yields should climb further given the GDP rise and prospect of higher policy rates, as well as due to increased supply. Higher capital inflow should provide some support for the Vietnamese dong (VND) but large external deficits will persist and the VND real effective exchange rate has appreciated relative to major trading partners. GDP recovery should bring faster corporate profits growth and provide continued support for stocks as well, but monetary tightening will curb the upside.
- **The main risk to the outlook is that domestic policies are not tightened enough.** In this event, GDP growth near term would be stronger than our forecast, and Vietnam's asset markets would be much firmer too. But Vietnam would soon suffer a repeat of its 2007-2008 overheating. **The other main risk is that the upswing in the major economies is even weaker than we expect.** Should global risk appetite crash again, Vietnam would suffer disproportionately given its large foreign financing need.

Kevin Grice

North America

2 Bloor Street West, Suite 1740
Toronto, ON
M4W 3E2
Canada
Tel: +1 416 413 0428

Europe

150 Buckingham Palace Road
London
SW1W 9TR
United Kingdom
Tel: +44 (0)20 7823 5000

Asia

#26-03 Hitachi Tower
16 Collyer Quay
Singapore 049318
Tel: +65 6595 5190

Managing Director
Chief International Economist
Senior International Economist

Roger Bootle (roger.bootle@capitaleconomics.com)
Julian Jessop (julian.jessop@capitaleconomics.com)
Kevin Grice (kevin.grice@capitaleconomics.com)

Vietnam is back on track and set for strong growth

In this *Focus*, we provide some background on the progress Vietnam has made since the introduction of free market reforms, benchmarking this against China. We then outline Vietnam's economic and markets outlook through to 2011. Finally, we look at the factors which should support a sustained high GDP growth rate over the long run, whilst noting the development challenges which Vietnam will eventually have to tackle.

Vietnam has come a long way

GDP growth was strong between 1995 and 2008 averaging 7.5% pa. (See Table 1.) This came on the back of free market reforms that have largely followed the China model. Agriculture has been de-regulated and private sector foreign investment has been encouraged into low-cost labour-intensive manufacturing for export. But, in contrast to China, Vietnam has substantial natural resources too, and foreign investment has also been channelled into commodities and commodity-related exports; such as oil, coal, rubber, rice, coffee, and fish products.

Rapid GDP growth has brought a big improvement in Vietnam's social indicators, including a sharp drop in poverty, and a rise in adult literacy to the levels matching the rest of Asia and the developed economies. (See Table 1 again.)

State-owned enterprises still play a large role in the economy, accounting for around 38% of GDP, 50% of exports, and 50% of banking sector assets. But globalisation was accelerated by the 2001 trade agreement with the US (the US is now Vietnam's largest trading partner) and by WTO membership from early 2008. Exports have climbed to 78% of GDP, making Vietnam one of the most open economies in Asia, whilst foreign direct investment (FDI) inflows in 2008 were equivalent to 10% of GDP. Gross domestic investment as a share of GDP has climbed too but the rise in gross domestic savings has not kept pace. This means that Vietnam typically runs large external shortfalls, with the gap covered by FDI, shorter term private sector capital

inflows, and some foreign debt. The **perennial need for foreign financing has limited the rise in FX reserves, has brought sustained currency depreciation, and has held down Vietnam's debt rating.**

TABLE 1: VIETNAM & CHINA COMPARED

| 2008, unless otherwise stated | Vietnam | China |
|---------------------------------------|---------|---------|
| Nominal GDP \$bn, market fx rates | 91.1 | 4,400.0 |
| Nominal GDP \$bn, at PPP rates | 240.4 | 7,912.9 |
| Population, m | 86.2 | 1,328.0 |
| GDP per head, \$, market fx rates | 1,057 | 3,313 |
| % earning <\$2 per day, early 1990s | 86 | 79 |
| % earning <\$2 per day, mid-2000s | 48 | 36 |
| Adult literacy rate, % of total | 96 | 98 |
| Real GDP growth, %, 1995-2008 | 7.5 | 9.7 |
| Inflation, %, 1995-2008 | 6.4 | 3.3 |
| Investment, % of GDP | 41 | 44 |
| Savings, % of GDP | 27 | 50 |
| Exports of goods & services, % of GDP | 78 | 37 |
| Current account, % of GDP, 2002-08 | -4.3 | 6.6 |
| Foreign Direct Investment, % of GDP | 9.8 | 3.5 |
| FX Reserves, \$bn, now | 23e | 2,130 |
| No of months import cover, 2009 | 5 | 22 |
| FX rate change/US\$, % from 01/01/02* | -18 | +18 |
| S&P Foreign Currency Debt Rating | BB | A+ |

*-ve indicates depreciation, +ve appreciation, e = estimate. Sources - Asia Development Bank, Bloomberg

An overheating crisis 10 years after the rest of Asia

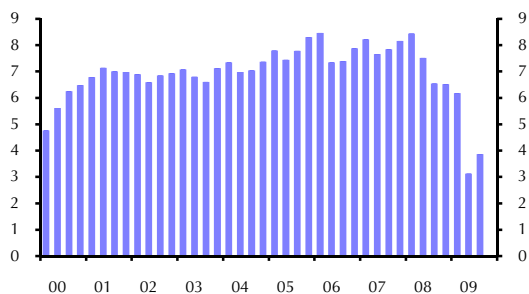
Especially strong capital inflows from 2005, as well as high public sector spending, brought an unsustainable rise in domestic credit growth and in imports. The inevitable results were asset bubbles in stocks and property, higher inflation, and a surge in the external deficit which put more downward pressure on the Vietnamese dong (VND). **Monetary policies were tightened in early 2008 but stabilisation efforts were then overtaken by the global financial crisis.** This hit Vietnam's

commodity exports as prices crashed, and its manufactured goods exports as the major economies moved into recession. The collapse in risk appetite also meant that capital inflows dried up and the VND came under even more downward pressure. As elsewhere in the region, Vietnam responded with a range of fiscal and monetary easing measures including rate cuts. But, and **as in China, support for the economy has largely come through a government-orchestrated increase in commercial bank lending.**

Recovery underway and likely to be sustained

The economy bottomed out in early 2009 and has picked up since then. GDP growth in January-June accelerated to 3.9% y/y (see Chart 1), up from 3.1% in Q1 which was the weakest y/y gain since at least the early 1990s. Vietnam does not publish quarterly GDP. But the first half figures suggest that Q2 y/y growth accelerated to around 4.6%.

CHART 1: VIETNAM GDP GROWTH (% Y/Y)



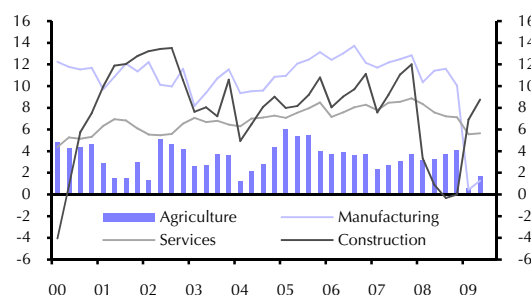
Source - CEIC

On the expenditure side, investment led the way down last year and is leading the way back up in 2009. Much of the investment financed by the credit surge is needed and will probably benefit the economy for the long run. But the investment to GDP ratio at 41%, although not quite as high as in China, is above the average for Asia as a whole and far above the major economies average of around 18%. **The risk is that too much investment now will create an overcapacity problem in the future, depressing corporate sector profitability, and eventually causing a wave in bad debts.** In addition, some of the surge in credit will have

leaked into the stock market and into property and if left unrestrained for too long, threatens to quickly bring another overheating crisis.

On the sector side, agriculture improved in Q2 after a weak Q1, on increased crop production and higher prices. (See Chart 2.) This has helped to support rural sector incomes and offset a big fall in overseas worker remittances. Services sector growth has slowed but not crashed, whilst manufacturing has started to bottom out after collapsing in early 2009 as the global financial crisis hit foreign demand and FDI.

CHART 2: VIETNAM GDP GROWTH BY SECTOR (% Y/Y)



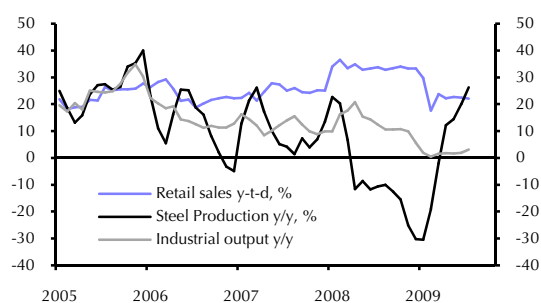
Sources - Thomson Datastream, CEIC

Less positively, given concerns about potential overheating, the biggest turnaround has been in construction. This sector crashed in 2008 as the property bubble burst, but has seen an equally striking rebound in 2009 on the credit expansion. In mid-2009, growth was back up to 9% y/y, not far short of 12% y/y peak in late 2007.

Monthly data show a similar picture of robust domestic demand and a gradual reduction in the stress on industry, although the exports improvement so far has been small. Imports have come back more sharply, yet another sign that Vietnam could be in the early stages of developing another bubble in its asset markets. Retail sales growth has eased from over 30% y/y in early 2008 but in January-August 2009 was still up a strong 22% y/y (see Chart 3), reflecting low rates, the sharp fall in inflation which has lifted real household incomes, as well as government fiscal support

measures which have averted a severe deterioration in the labour market. Industrial output has stabilised and should start to pick up too. But it is no surprise that **the biggest rebound has come in the areas, such as steel production, most leveraged to construction and to the property market.**

CHART 3: VIETNAM RETAIL SALES, INDUSTRY & STEEL (%)



Source - CEIC

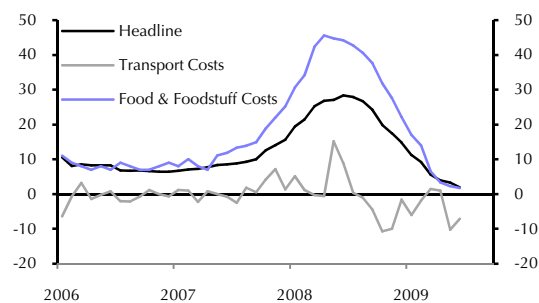
Monetary policies will be tightened over the next one-to-two years and some of the fiscal stimulus will be pulled back too. But, given low government debt, there is no need for a draconian tightening and the GDP improvement should not stall or go into reverse as a result. The impact of lower rates, the fiscal stimulus, and increased bank lending, should also continue to come through for some time. Domestic demand is likely to keep leading the way. But global conditions should gradually improve too and bring firmer exports, higher industrial output, and a likely strong pick up in FDI. **We forecast that GDP will climb by 5.0-6.0% by end 2009, in line with the latest government target. We then expect GDP growth to accelerate further in 2010-11, to 6-7%.**

Inflation set to rise

Headline inflation has come down sharply since mid-2008 and slowed to only 2.0% y/y in August (see Chart 4), the lowest annual gain since early 2002. **Inflation is down on softer economic activity and, as elsewhere in Asia, due to base effects which have depressed the y/y change in energy/transportation costs.** Measures of core inflation, which exclude food and energy/transport, have followed a similar trajectory. But the

slowdown has been more gradual, to 4% y/y in August, which is relatively high for Asia. In addition, monthly inflation, although down to 0.2% in August, has averaged 0.5% m/m since April, which means that headline inflation more recently has been running around 5% pa.

CHART 4: VIETNAM INFLATION (% Y/Y)



Sources - Bloomberg, Thomson Datastream

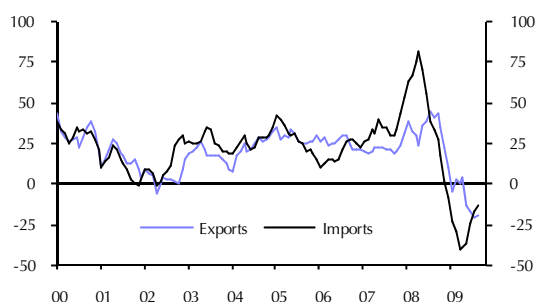
With activity picking up and base effects set to disappear soon, inflation y/y likely bottomed in August or September. The speed of the pick-up, we judge, will be relatively rapid given Vietnam's shallow economic slowdown and the small degree of excess capacity that has been opened up. Given that starting-point inflation is already high for the region, we expect a quick move up toward inflation gains which will bring higher policy interest rates. **We forecast that inflation will end 2009 around 7% and will peak at 12% around mid-2010.** After that, inflation should then slow as the monetary policy tightening we anticipate kicks in.

The balance of payments is improving again

The merchandise trade deficit has narrowed but not by enough to significantly reduce the large current account short-fall. Commodity exports have been helped by a big increase in the volume of oil, rice, and coffee shipments, but the hit from far lower foreign demand has been greater. Meanwhile, imports crashed in late 2008/early 2009 on the domestic slowdown, lower prices, and the big fall in oil product purchases following the opening this year of Vietnam's first oil refinery. **Nevertheless, imports have stabilised well ahead of exports** given that domestic demand, particularly construction

and related sectors, has picked up well ahead of foreign demand. (See Chart 5.)

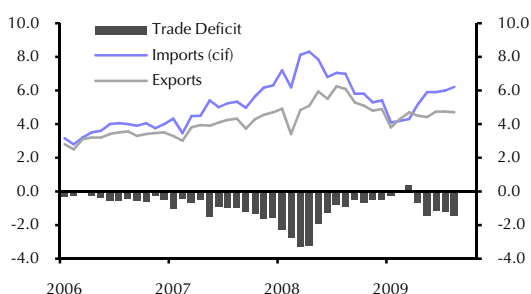
CHART 5: VIETNAM EXPORTS & IMPORTS (% 3M Y/Y)



Source - Thomson Datastream

January-August exports were down 14% y/y in value terms whilst imports were down 38%. This reduced the merchandise trade deficit to \$5.12bn from \$15.2bn in 2008's equivalent period. (See Chart 6.) During the rest of this year and in 2010-11, export receipts are likely to pick up, especially given the prospect, according to industry sources, of a further big rise in the volume of coffee and rice shipments. But oil export volumes are likely to stay under pressure and imports will rise too. As a result, this year's trade shortfall is still likely to come in around \$8bn, another big number but well down on 2008's deficit of \$17.8bn. **The merchandise trade deficit is likely to widen again in 2010 and 2011, but should still stay below last year's level.**

CHART 6: VIETNAM TRADE DEFICIT (US\$Bn)

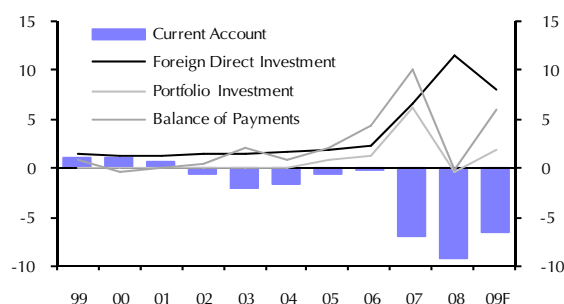


Source - Thomson Datastream

Elsewhere on the external accounts, the most important item is overseas worker remittances, which climbed to \$7.2bn in 2008, 8% of GDP. This

year, Vietnam's remittance inflows have slumped to a greater extent than has been the case in the Philippines, because its inflows come mainly from the US. In the first half of 2009 remittances dropped to \$2.73bn, about half last year's first half level. As a result, the current account deficit in 2009 is still likely to be large, at around \$6bn and 7% of GDP. (See Chart 7.) In 2010, remittances will probably pick up again and, with the merchandise trade deficit set to stay lower than in 2008, a narrower external shortfall is likely. Nonetheless, **the deficits will stay large for the region and will keep Vietnam vulnerable to risk appetite shifts.**

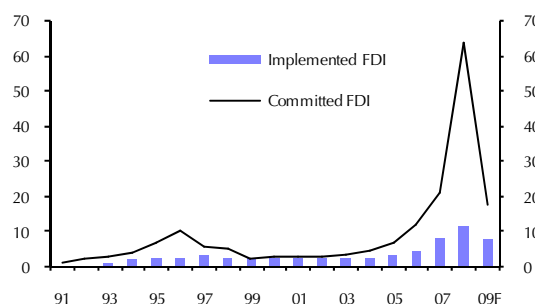
CHART 7: VIETNAM BALANCE OF PAYMENTS (% OF GDP)



Sources - Bloomberg, Capital Economics

Financing, though, should be more comfortable. FDI is down sharply in 2009. (See Chart 8.) But inflows are likely to climb by year end, and in 2010-11, on better investor sentiment as global financial conditions continue to stabilise. Portfolio inflows into Vietnamese stocks have also picked up this year and, we suspect, will keep improving.

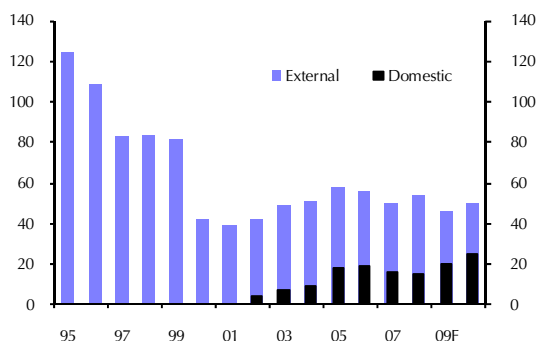
CHART 8: VIETNAM FOREIGN DIRECT INVESTMENT (US\$Bn)



Sources - CEIC, Capital Economics

Timely data are not available but, according to the central bank, foreign reserves held steady at around \$23bn in the first half of 2009. This is enough to finance only around five months' imports, a low ratio for the region. But the writing off of debt owed to the former USSR in the late 1990s, plus deficit financing largely through FDI flows, means that **external debt is modest at 39% of GDP** (see Chart 9) with most on concessional terms. **Domestic debt started to build in the early 2000s but is low too, at around 20% of GDP.**

CHART 9: VIETNAM GOVERNMENT DEBT (% OF GDP)



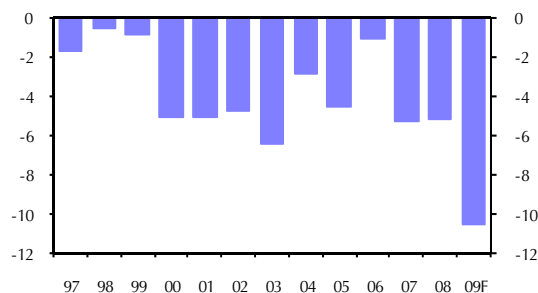
Sources - IMF, Capital Economics

Gradual fiscal tightening likely

Fiscal policies shifted in late 2008 to supporting GDP growth, with the additional stimulus totalling around \$7bn, equivalent to 8% of GDP and on this basis one of the largest in Asia. As well as the interest rate subsidy, the support has included a large reduction in corporate tax for small- to medium- enterprises, and hand-outs to low income groups. Revenues have also inevitably been hit by the economic slowdown and, on top of this, there is an overdependence on tax receipts from the oil sector. **The overall fiscal deficit is likely to rise to around 10% of GDP in 2009, double the shortfall of recent years** (see Chart 10), and the increased debt issuance has caused some digestion problems for the local bond market. The fiscal stimulus will be pulled back over the next 1-2 years. **But, given moderate debt levels, there is no need for a sharp tightening soon.** Barring a major policy mistake, the economic upswing will continue. The exit from

loose fiscal policies will also probably come last, once the authorities have reined back the credit expansion and raised rates.

CHART 10: VIETNAM FISCAL BALANCE (% OF GDP)

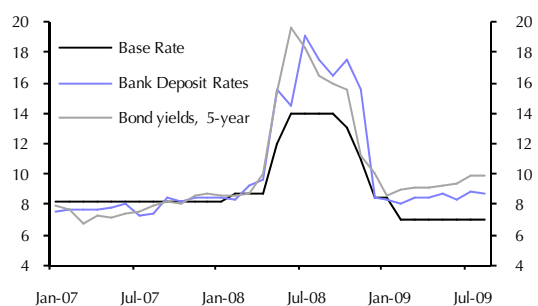


Sources - IMF, Capital Economics

Credit expansion now being reined back

Aggressive monetary tightening to mid-2008 from the State Bank of Vietnam (SBV) changed to aggressive easing in late 2008/early 2009, as the global financial crisis intensified. The main policy rate (the base rate) was cut to 7.0% after hitting 14.0% in mid-2008 (see Chart 11), whilst a credit expansion scheme, operated via an interest rate subsidy, was introduced in early 2009. The subsidies (only available on VND lending) cut funding costs by an average four percentage points. Loan maturities were pushed out too.

CHART 11: VIETNAM INTEREST RATES (%)

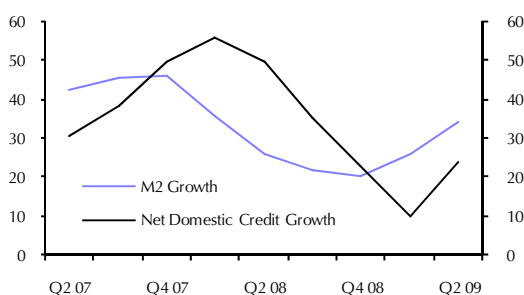


Sources - Bloomberg, Thomson Datastream

As a result, **bank loan growth has ballooned.** After slowing to 10% y/y in March, credit growth accelerated to 24% y/y in June (see Chart 12) and total domestic credit at the end of July was some 23% higher than at the end of last year. Domestic

credit relative to GDP was already high for the region at end 2008 at around 95% (the equivalent ratio in Thailand was 84%, although China was up at 126%). Moreover, **credit growth in Vietnam has been very strong for a number of years, with the lending to GDP ratio doubling since 2002. Therefore, allowing a rapid expansion in lending for much longer could be dangerous.**

CHART 12: VIETNAM MONEY SUPPLY & CREDIT (% Y/Y)



Sources - Bloomberg, Thomson Datastream

Admittedly, rapid credit growth is not necessarily unusual or undesirable in a fast-developing economy. But **Vietnam has a recent track record of overheating and Vietnamese banks are weak compared to the region, especially the state-owned institutions.** In short, there are too many banks, and non-performing loans, although low at 3% of all loans on Vietnamese criteria, would be far higher on international classifications. A cap on commercial lending rates, at no more than 1.5 times the SBV base rate, also constrains the ability of banks to price loans according to borrower creditworthiness. Loan growth in 2009 has also outstripped the rise in deposits, forcing some banks to lift their deposit rates. This means that, with the subsidy programme having done its job, the SBV needs to tighten policies again. The tricky task is exiting at a pace that doesn't threaten recovery but is fast enough to avert another overheating problem.

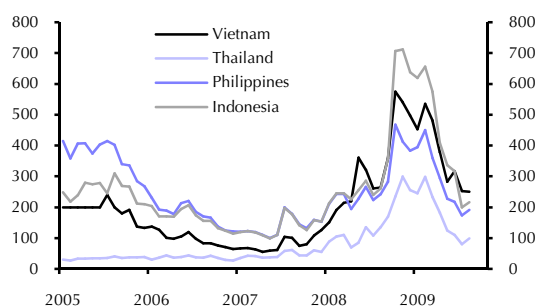
The SBV has already announced that it will cap 2009 credit growth at 30%, which implies a sharp slow-down in new lending during the rest of this year. The intention is still to run the credit expansion scheme to the end of 2011 but new

versions look set to be on a far smaller scale and less generous. It is also likely that bank reserve requirements and bank liquidity requirements will be moved up soon; we judge over the next three months. But a first hike in the SBV base rate is also probably not far away.

We expect a hike by end 2009 but this will likely depend on Q3 GDP which will be published (suspiciously early) in late September. We forecast that reported Q3 GDP will have accelerated to the 5.0-5.5% government target range. But, if Q3 GDP does not hit this target, the SBV is likely to wait until early 2010 before moving rates up. For now though, we forecast that the SBV base rate will rise to 7.5% by end 2009 and to 12% by end 2010 before then falling back in 2011. As elsewhere in Asia before the global financial crisis, policy rates in Vietnam were held low in real terms to facilitate GDP growth. **A reasonable assumption for the long run is that the authorities will aim to stabilise the real (inflation-adjusted) policy rate at a higher level. This suggests that the SBV rate should settle in the 10-11% range rather than the around 8% norm up to 2008.**

Country risk should continue to improve

5-year credit default swaps (CDS) widened out sharply at the height of the global financial crisis given Vietnam's large external deficit and the dependence on FDI and other capital inflows. (See Chart 14.) But country risk perceptions have improved since then and we expect CDS premiums to move lower in the period to end 2011, as the external deficit stays narrower and FDI picks up. Nevertheless, a return to the pre-crisis low looks unlikely. In addition, **given Vietnam's higher vulnerability relative to elsewhere, the CDS premium is likely to stay wider than in the Philippines and Indonesia,** even though Vietnam's premium had moved lower up to 2007.

CHART 13: VIETNAM CREDIT DEFAULT SWAPS (BASIS POINTS)


Sources – Bloomberg, Thomson Datastream

Bonds to stay under pressure

The local bond market is dominated by local banks with foreign participation at less than 5% of debt outstanding. Auctions in 2009 have struggled to achieve full take-up due to increased supply and as the loan subsidy programme has encouraged banks to prioritise state enterprise and private sector lending. Benchmark 5-year yields have held around 10% for most of 2009 but dipped to a low of 8.5% in mid-February. A sustained move up in yields is likely over the next 1-2 years as the SBV hikes to base rate. Another mandatory bond auction (there was one March 2008) also cannot be ruled out. We expect 5-year bond yields to rise to a peak of 12% by end 2010. (See Table 2.)

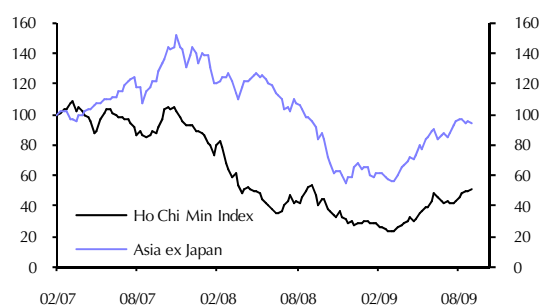
TABLE 2: VIETNAM ECONOMIC AND MARKET FORECASTS

| %, ex. the FX rate | 2008 | 2009F | 2010F | 2011F |
|--------------------------------|--------|--------|--------|--------|
| GDP Growth | 6.8 | 4.5 | 7.0 | 6.0 |
| Consumer prices, an. av. | 23.1 | 7.1 | 10.0 | 6.0 |
| Consumer prices, end period | 19.9 | 7.0 | 8.0 | 6.0 |
| SBV base rate, an. av. | 8.25 | 7.10 | 7.00 | 8.50 |
| SBV base rate, end period | 7.0 | 7.5 | 12.0 | 10.0 |
| 5-yr bond yield, end period | 9.8 | 10.1 | 12.0 | 11.0 |
| Dong per US dollar, an. av. | 16,544 | 17,800 | 18,500 | 19,500 |
| Dong per US dollar, end period | 17,485 | 18,200 | 19,000 | 20,000 |

F = forecast. Sources - IMF, country data, Bloomberg, Capital Economics

Vietnam stocks to stay a wild ride

Vietnam stocks have underperformed the region since 2006. (See Chart 14.) The market crashed by more than elsewhere in 2008 given that Vietnam had become more overvalued than the region and thanks to the heavy foreign exposure. At the market peak, foreigner ownership accounted for around 50% of total market capitalisation, a share that dropped to 30% by the end of 2008. Unlike the rest of Asia, where shares started to rally from November on China's fiscal stimulus, Vietnam continued to struggle until its loan subsidy programme was announced in early 2009 (and the major markets bottomed). Foreign inflows have picked up since then and Vietnam is up around 70% year-to-date, in line with the gain in the rest of Asia ex Japan.

CHART 14: VIETNAM STOCKS RELATIVE TO REGION


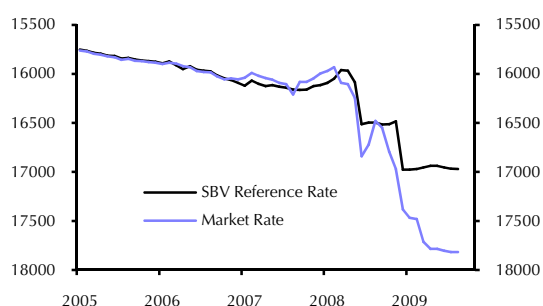
Sources – Bloomberg, Thomson Datastream

With monetary policy set to tighten soon, Vietnamese stocks will probably under-perform the region. But more absolute upside still looks likely if, as we expect, Asian markets more generally move higher. The prospect of further listings by state-owned enterprises may also tend to hold equities back. But market capitalisation as a percentage of GDP, at 11% at end 2008, is far below the 65% in China, the 38% in Thailand, and the 70%+ in Asia's most developed economies. This means that market capitalisation can rise faster than likely nominal GDP on a sustained basis, and should provide long run support for equities.

More currency depreciation likely

The VND exchange rate is managed via a crawling peg regime within a trading band relative to the US dollar. The authorities responded to 2007-08 crisis by increasing the trading band, from 0.75% to 5.0% around the SBV reference rate, and by implementing several small devaluations of the reference rate. (See Chart 15.)

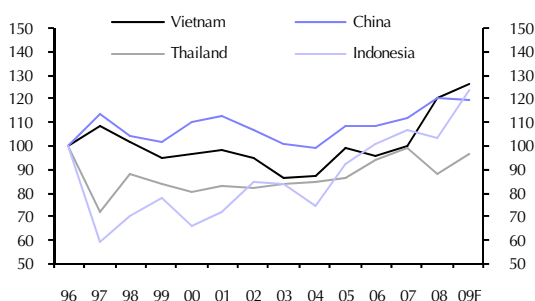
CHART 15: VIETNAM DONG EXCHANGE RATE



Sources – Bloomberg, Thomson Datastream

The cumulative devaluation against the US dollar since the beginning of 2008 has been 11%. But local inflation has risen by more, so the VND has climbed further in real trade-weighted terms. **Since the late 1990s we estimate that the VND is up almost 30% in real terms, a bigger inflation-adjusted appreciation than has occurred in China, Thailand or Indonesia, over the same period.** (See Chart 16.)

CHART 16: VIETNAM REAL EFFECTIVE FX RATES (1996 = 100)



Sources - IMF, Thomson Datastream, Capital Economics

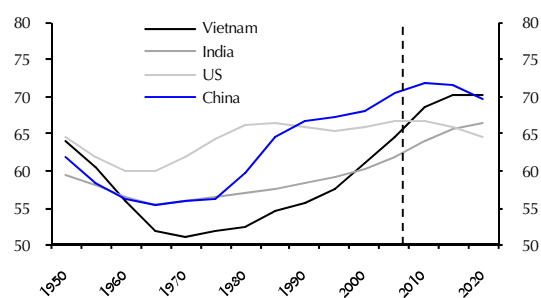
In our forecast period we expect that the combination of current overvaluation, the large external deficit, and local inflation higher than

elsewhere will bring more nominal depreciation. The authorities will continue to manage the currency tightly to avert large moves. The prospect of higher interest rates should also be supportive. But this probably just means that the depreciation is gradual and controlled rather than steep and disorderly. **With the gap between the SBV reference rate and the market rate now up to 5%, another small devaluation looks imminent. We forecast that VND per US dollar will fall to 18,200 by end 2009 and then to 20,000 by end 2011.**

A good long run outlook

According to UN forecasts, Vietnam's population is likely to rise to around 110m by 2035, from 86m now. The dependency ratio (the working age population as a percentage of the total) should also rise further over the next 5-10 years before topping out. (See Chart 17.) This is a formidable positive force which will continue to support labour-intensive manufacturing and household spending. Therefore, **labour force growth is likely to stay stronger than in China, and in the region as a whole, for a long time.**

CHART 17: VIETNAM DEPENDENCY RATIO (%)



Source – UN

Productivity growth is also likely to stay strong too. GDP per head is low, Vietnam's political environment will probably remain stable, and its policy makers should continue to benefit from the successful economic development experience of its neighbours. There is always the chance of a major political upset or policy mistake but the risk of this happening looks low.

Good policies, allied to market size and low production/labour costs, should ensure that FDI inflows in Vietnam remain strong. Agriculture's share in total employment is also far higher than its GDP share (see Table 2), so there is still plenty of scope for labour to continue to shift into manufacturing and into services where productivity growth is faster. The urbanisation rate is also low for the region and will inevitably move higher, which will trigger new investment opportunities and support high productivity growth as well.

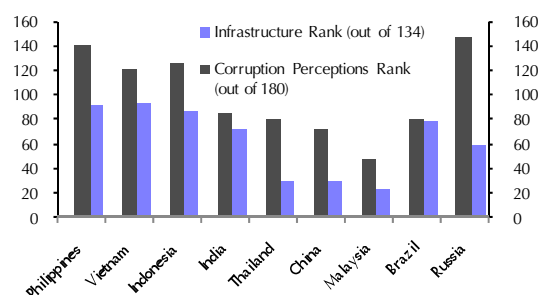
TABLE 2: VIETNAM & CHINA: STRUCTURAL FACTORS

| All 2008 | Vietnam | China |
|------------------------------------|---------|---------|
| Population, m | 86.2 | 1,328.0 |
| Population growth % pa | 1.2 | 0.5 |
| Urban population, % to total | 28 | 46 |
| Population under 14yrs, % of total | 28 | 20 |
| Adult literacy rate, % of total | 96 | 98 |
| Investment spending, % of GDP | 41 | 44 |
| Household spending, % of GDP | 68 | 36 |
| Agriculture, % of GDP | 22 | 11 |
| Industry, % of GDP | 40 | 49 |
| Services, % of GDP | 38 | 40 |
| Agriculture, % of employment | 54 | 41 |
| Industry, % of employment | 15 | 21 |
| Services, % of employment | 31 | 38 |

Sources - Asia Development Bank, United Nations

The main development challenges are likely to come over the medium term, as per capita incomes move up and once the productivity gains from labour force shifts and deepening the capital stock have been exhausted. At higher per capita incomes, GDP is increasingly determined by using the capital stock and labour force more efficiently; so-called total factor productivity (TFP) gains. TFP gains are determined by factors such as the quality of the education system, the amount spent on research and development, the quality of infrastructure, and the ease of doing business. It is in these areas where Vietnam falls down and currently ranks poorly relative to other Asian countries. (See Chart 18.)

CHART 18: VIETNAM BUSINESS RANKINGS (2008)



Sources - World Competitiveness Report, Transparency International

The good news for Vietnam is that these constraints typically kick-in and need to be tackled when a country hits middle-income status, which is usually classified as a GDP per capita of US\$2,000+ pa. Middle-income status in Vietnam, given its current per capita income of \$1,050-1,100, is still around 12 years away. Until then, catch-up, favourable demographics, labour force shifts, and high investment should keep Vietnam growth strong. Pulling everything together, we judge sustainable long run GDP growth to be 6-7% pa.

Summary

The successful implementation of free market economic reforms has brought sustained strong GDP growth since the mid-1990s. But Vietnam suffered an overheating crisis in 2007-08 and its adjustment was complicated by the global financial crisis. Nonetheless, **a big expansion in bank lending has got the economy moving forward again, and sustained recovery looks assured.** The challenge now for the authorities is to exit stimulatory monetary and fiscal policies quickly enough to avert another overheating crisis, without also threatening the economic recovery. This will not be easy. But we still expect GDP to accelerate and average 6-7% pa over the long run. SBV policy rates are likely to move up soon and government bond yields should rise. Stocks should have more upside but will probably under-perform the region, whilst orderly depreciation of the VND will likely continue.