

Vietnam

Vietnam's economic growth remains strong in 2007, mainly fueled by strong non-oil exports, investment and private consumption. GDP grew 8.3 percent year on year in the first nine months of 2007, with industry and manufacturing expanding by 10.2 and 12.5 percent respectively. Agricultural growth stood at 3 percent, with a record growth of aquaculture (9 percent) compensating for a slowdown in the poultry and livestock sub-sector. The last few months have witnessed new avian influenza outbreaks. While these have been marginal, this is an area that will require vigilance by the authorities. The service sector has also recorded high growth in the first nine months of the year (8.5 percent) thanks to strong performance of retail trade, tourism, transportation and financial services.

Domestic consumption and investment have also been strong. Gross and retail sales grew by nearly 23 percent in the year to September 2007. The share of the state sector continues to decrease and represents only about 11 percent of the total by now. Total investment rose by 16.3 percent in the first nine months of 2007. In current prices, it now represents 42.5 percent of GDP. Investment by the domestic private sector increased by nearly 28 percent and now accounts for about 17 percent of GDP.

Foreign Direct Investment (FDI) commitments surged to 10.2 billion dollars in 2006 and US \$9.6 billion in the first 9 months of 2007, a 38 percent increase on a year ago. FDI commitments have clearly received a boost from Vietnam's accession to the World Trade Organization (WTO). FDI disbursement rose by 20 percent on the year to September 2007, representing about 6.8 percent of GDP. While investment by foreign companies and by the domestic private sector has increased strongly, disbursements from the capital state budget are still low, reflecting the slow preparation and implementation of public investment projects.

Export earnings continue to grow rapidly (19.4 percent year-on-year), despite a 10 percent decline in crude oil exports due to production capacity constraints. On the other hand, there has been a strong pick-up in exports of agricultural products, seafood, garments, and footwear (even though seafood and aquaculture exports have faced food safety concerns related to antibiotic residues, as well as environmental problems in the breeding areas). Exports now account for roughly 72 percent of GDP. Among trade partners the United States is the biggest market, absorbing nearly a fifth, followed by EU, ASEAN and Japan. The garments sector, one of the main drivers of export growth in recent years, saw its sales abroad increase by nearly 32 percent in the first nine months. Vietnam is by now one of the top ten garment exporters in the world, with the United States its largest market, accounting for almost 60 percent.

Imports grew by 30 percent in the year to September 2007, driven by a strong investment demand and the input needs associated with industrial expansion. The rapid growth of imports has resulted in a widening trade deficit, estimated to reach 7 percent of GDP in 2007. The current account deficit is expected to reach 3 percent of GDP this year, compared to 0.3 percent in 2006. However, the balance of payments situation remains sound, with the current account deficit largely financed by non-debt creating FDI inflows, official development assistance (ODA) and private remittances. In addition, the high levels of commitments mean that actual inflows could be accelerated if there were concerted efforts to ease implementation constraints. Portfolio inflows also witnessed a sharp increase in 2006 and early 2007, attracted by rapidly developing capital markets, including a booming stock market. Foreign exchange reserves have built up rapidly from \$8.6 billion in 2005 to \$11.5 billion in 2006 and an expected near 20 billion by the end of 2007. External debt accounts for 31 percent of GDP in nominal terms, and 22 in present value terms. Under plausible scenarios, Vietnam remains a country with low external risk.

Inflation has accelerated in recent months, generating considerable debate among policy makers on the appropriate response. The Consumer Price Index (CPI) increased by 8.8 percent in the year to September (7.3 percent from beginning of the year). The annual figure for 2007 is likely to remain in the single digits, but barely. Given Vietnam's very open economy and an exchange rate policy amounting to a peg to the dollar, part of the acceleration in inflation is related to the increase in the price of internationally tradable goods. The index for food and foodstuff products grew by 13.3 percent on an annual basis, the fastest increase since April 2005. There are also concerns that an excessive loose monetary policy might have fueled increases in the prices of non-tradable goods. Credit growth rose sharply, from 25 percent in 2006, to around 35 percent (on an annual basis) towards mid-2007. Growth rates are higher in the case of joint stock banks, and there are concerns about the quality of lending. The State Bank of Vietnam (SBV) expects credit growth to slow down in the coming months, and targets an annual increase of 30 percent for the year as a whole. For now, the main instrument to reduce credit growth has been increasing reserve requirement for banks (from 4 to 10 percent, effective on June, 2007).

The substantial inflow of capital, from FDI, remittances, portfolio investments and ODA has also forced the SBV to purchase large amounts of foreign currency to avoid an appreciation of the exchange rate. While this policy is sometimes justified by the need to preserve the competitiveness of exports, it has also been defended as a way of reducing excessive exchange rate volatility in a country where the structure of possible currency mismatches on the balance sheets of enterprises and financial institutions are not well known and where financial instruments to hedge against exchange rate risk are limited. However, buying large amounts of foreign exchange has resulted in an increase in the money supply. The government has tried to mop up excess liquidity by issuing short-term bonds, but interest rates have not been attractive enough for this policy to be fully effective. In addition, in the medium term the increase in the price of non-tradable goods and services can be expected to be higher than that of tradables. Vietnam is a cheap country, in international terms, and rapid economic growth will be associated with real exchange rate appreciation. Labor earnings, in particular, will grow faster than the CPI, exerting a pressure on labor costs. With an exchange rate policy amounting in practice to a peg, real exchange rate appreciation can only occur through higher domestic prices. This establishes a floor for inflation, even under a tighter monetary policy.

Budgetary revenues and expenditures remained on track during the first nine months of 2007. Using the international definition, the government's objective for the fiscal deficit in 2007 is 3.2 percent of GDP. On current trends, this objective remains attainable. A quarter of the deficit is expected to be financed by the external sources and the rest by domestic sources.

Vietnam's stock market experienced a dramatic boom over the last two years. At the end of 2005, only 41 firms were listed, with a market capitalization of less than a billion dollars, or 1.2 percent of GDP. By the end of September 2007, the number of listed firms had risen to 206, while stock market capitalization had surpassed 22 billion dollars, or 32.4 percent of the estimated GDP. The 2006 Law on Securities was an important milestone in this process.

Whether the market is overvalued remains a hotly debated issue, but fears of a crash have receded. Compared to GDP, stock market capitalization remains below that of India (45 percent) or China (70 percent). Price-to-earnings ratios are not unusually high for a rapidly growing economy and also tend to be inflated by the fact that data on earnings is available with a considerable lag. The earnings of listed companies have actually been increasing very rapidly. After a period of exuberance, until March 2007, the market now appears to be settling. A major state-owned insurer did not do well at its much anticipated initial public offering. The announced listing of several large state-owned enterprises and commercial banks in the coming months could exert substantial downward pressure on equity prices. The government is considering postponing some of those listings for fear of depressing stock prices too much. Foreign players have

remained net buyers, but on declining amounts. Given the downtrend, capital control measures that had been mulled earlier appear to have been shelved for now. However, stronger disclosure requirements, better investor protection and higher caps for foreign investors may be needed to keep up the momentum.