TAKING STOCK

An Update on Vietnam's Recent Economic Developments

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ACRONYMS AND ABBREVIATIONS

EG	Economic Group
FAO	Food and Agriculture Organization
FDI	Foreign Direct Investment
GC	General Corporation
GDC	General Department of Customs
GDP	Gross Domestic Product
GSO	General Statistics Office
HASTC	Hanoi Securities Trading Center
HCMC	Ho Chi Minh City
HOSE	Ho Chi Minh City Stock Exchange
IMF	International Monetary Fund
JSB	Joint-Stock Bank
ODA	Official Development Assistance
P/E	Price/Earnings Ratio
SBV	State Bank of Vietnam
SOCB	State-Owned Commercial Bank
SOE	State-Owned Enterprise

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SUMMARY

A more uncertain global environment

In the second half of 2007, global macroeconomic conditions became increasingly difficult. Growth forecasts around the world have been revised downwards, and are lower for 2008 than for 2007 (Table 1). Credit markets tightened, as the effects of the turmoil in the U.S. sub-prime mortgage market continued to broaden and intensify. How this turmoil will play out and how it will affect economic growth, trade, and financial flows are among the major uncertainties facing economic policy-makers around the world, including Vietnam.

Table 1: International Economic Environment

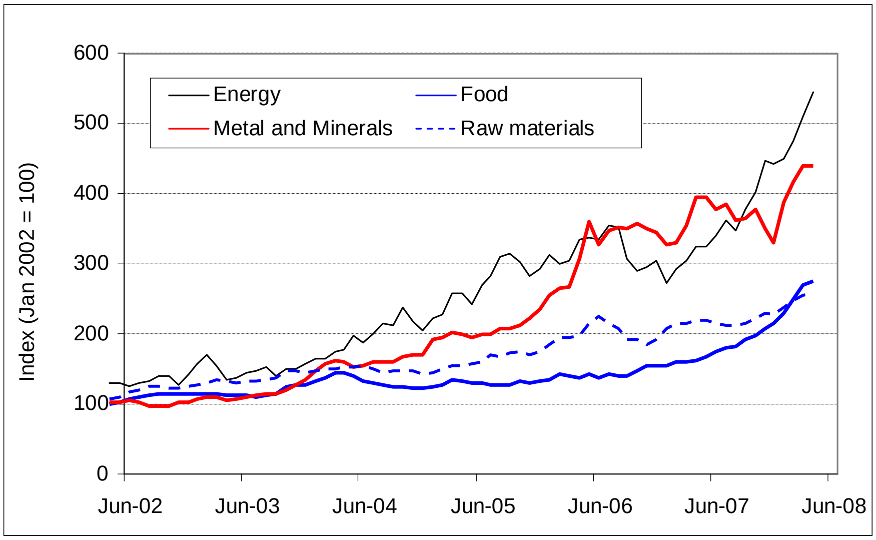
	2007	2008	2009
Gross Domestic Product (GDP) growth (percent)			
World	3.6	2.4 - 2.8	2.8 - 3.2
High income OECD	2.5	1.1 - 1.6	1.4 - 2.0
The United States	2.2	0.5 - 1.4	1.0 - 2.0
Euro zone	2.7	1.3 - 1.7	1.5 - 1.9
Japan	2.1	1.3 - 1.7	1.6 - 2.0
Emerging and Developing economies average	7.9	6.7	6.6
East Asia average	8.7	7.3	7.4
World trade (percent change)	7.5	4.0 - 5.0	5.0 - 6.0
Oil price (US$/barrel)	71.1	108.1	105.5
Non-oil commodity prices (percent change)	15.8	10.0 – 12.0	-10.0 - 0

Source: World Bank (2008) and International Monetary Fund (IMF) (2008).

The direct impact of the U.S. financial turbulence on Vietnam is bound to be limited, as its financial institutions were not active players in the market for the new financial instruments. However, there could still be indirect effects. Investors fleeing the U.S. market could flow into Vietnam, seeking higher returns; or investor sentiments may turn against emerging markets, as they often do during periods of turmoil. Recent increases in secondary market premia suggest that the second scenario is more likely. Perceptions that things are not getting better could set off a herd reaction among investors, even if the fundamentals are still sound.

Sustained increases in the price of food, oil, minerals and construction materials are a more immediate source of concern (Figure 1). The price of oil has tripled since 2003, and prices of non-oil commodities have doubled. This trend has deep roots and will continue for the foreseeable future. However, the trend seems to have accelerated in recent months, especially in the case of oil and food.

Figure 1: World Commodity Price Index

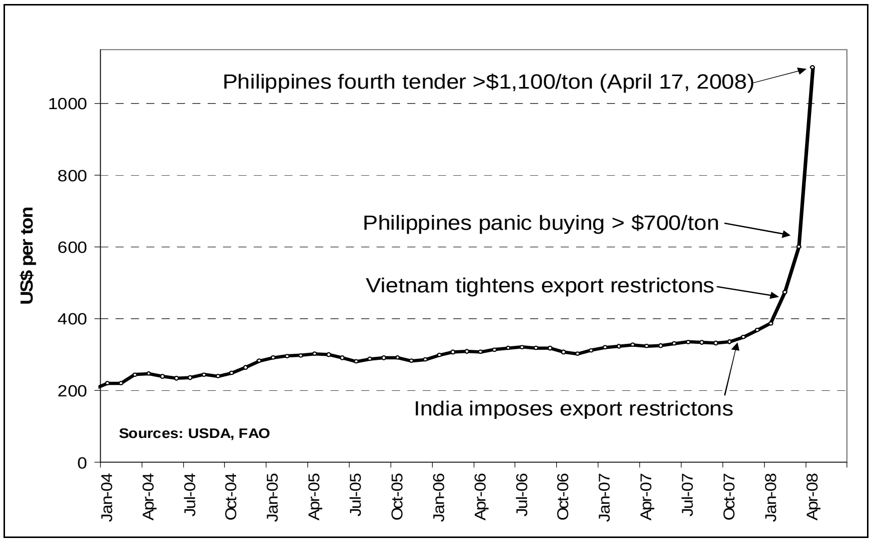


Source: World Bank.

Latent pressure from higher food and oil prices

Developments in the world market for rice are particularly important for Vietnam. Of particular concern is the dramatic increase in the international price since October 2007. Over this period, several developing countries started adopting food security measures, aimed at keeping the domestic price of rice affordable or at building up stocks. While understandable, these measures resulted in a rapid escalation of the international price (Figure 2).

Figure 2: The International Price of Rice

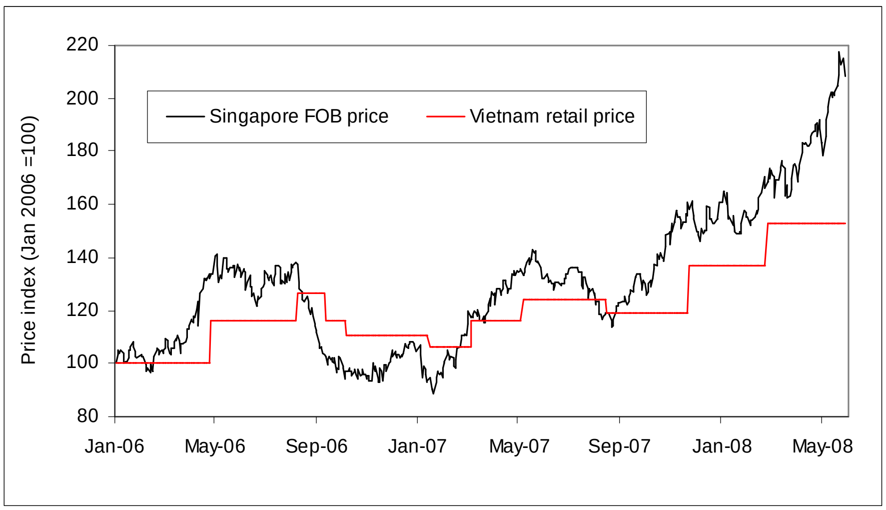


Source: Based on data from the U.S. Department of Agriculture and Food and Agriculture Organization (FAO).

A decline in the international price of rice can be expected once the new harvest comes in. But it is unlikely that the decline will be large enough to bring the international price back to where it was at the end of 2007. Meanwhile, the domestic price of rice in Vietnam has increased by much less than the international price. As Vietnam removes its export restrictions, as it is hoped it will some time this summer, the price gap will be a source of inflationary pressure.

The situation is similar in the case of gasoline. The government has followed a determined policy to remove subsidies to domestic distributors. As a result, the domestic price has followed the international price quite closely (Figure 3). But during 2008, as part of the fight against inflation, the adjustment of the domestic price was postponed. This, again, resulted in a widening gap between domestic and international prices. Sooner or later this gap will need to be addressed, and this too will be a source of inflationary pressure.

Figure 3: The Price of Gasoline in Domestic and World Markets



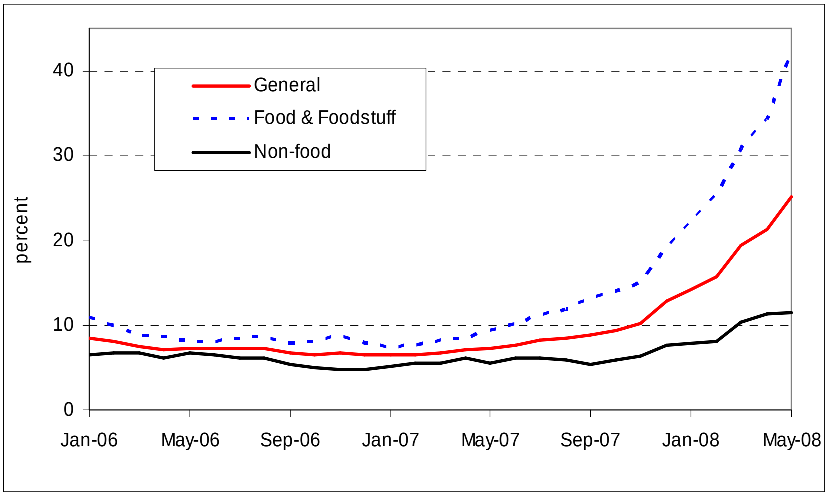
Source: Singapore FOB price is based on the U.S. Department of Energy.

Inflation accelerates

The consumer price index had already started increasing in the first half of 2007, but there was a noticeable acceleration in the last quarter of the year. To a large extent, this acceleration resulted from higher food prices (Figure 4). With a very open economy and a stable exchange rate, higher food prices in international markets were transmitted to domestic prices. Severe winter weather and disease also contributed to make food scarcer, hence more expensive.

However, since the last quarter of 2007 there has also been an increase in non-food prices, which reached over 10 percent (year on year) at the end of the first quarter of 2008. In this case, the main cause is domestic. Credit to the economy increased by 63 percent over the 12 months period ending in March 2008 (Figure 5). By way of comparison, the increase during the preceding 12 months had been 32 percent.

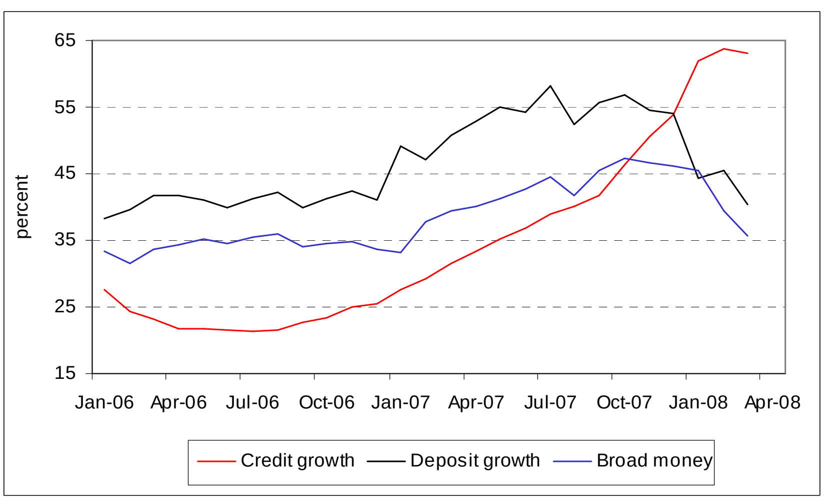
Figure 4: Vietnam Consumer Price Index



Source: Based on data from General Statistics Office (GSO).

Credit growth was caused by the attempt by the State Bank of Vietnam (SBV) to prevent appreciation of the dong in the presence of massive capital inflows. Trying to preserve the competitiveness of exports, authorities bought more than 10 billion U.S. dollars in a single year. But in doing so, they injected the equivalent in dong into the economy. Vietnam was thus confronted with the "impossible trinity" of simultaneously maintaining a nearly fixed exchange rate, an open capital account, and an independent monetary policy. Unless the interventions in the foreign exchange market are sterilized, accumulation of reserves leads to an expansion in the monetary base.

Figure 5: Growth of Key Monetary Aggregates



Source: Based on data from SBV and IMF.

Social impact of higher prices

Vietnam is a major exporter of food products, and its imports of gasoline are comparable to its exports of crude oil. Therefore, the country as a whole should gain from higher food and oil prices. Disaggregated data from expenditure surveys confirm this intuition. The average Vietnamese household produces food worth about 15.4 million dong while consuming food worth 10.2 million dong each year. It produces 1,247 kilograms of rice in a year, while only consuming 582 kilograms. In this context, the findings of recent research suggesting that average welfare in Vietnam increases slightly as prices of food and rice increase seem sensible.

However, there are also distributional effects to consider. Individual households differ in their production and consumption patterns, and there are consistent differences between average households across different parts of the country. The population of Vietnam is predominantly rural and the 73 percent of people who live in rural areas make up 94 percent of all poor people (Table 2). Those who grow rice are 78 percent of the poor. One fifth of all farmers are poor and 23 percent of rice farmers are poor.

Table 2: The Distribution of Poverty across the Population

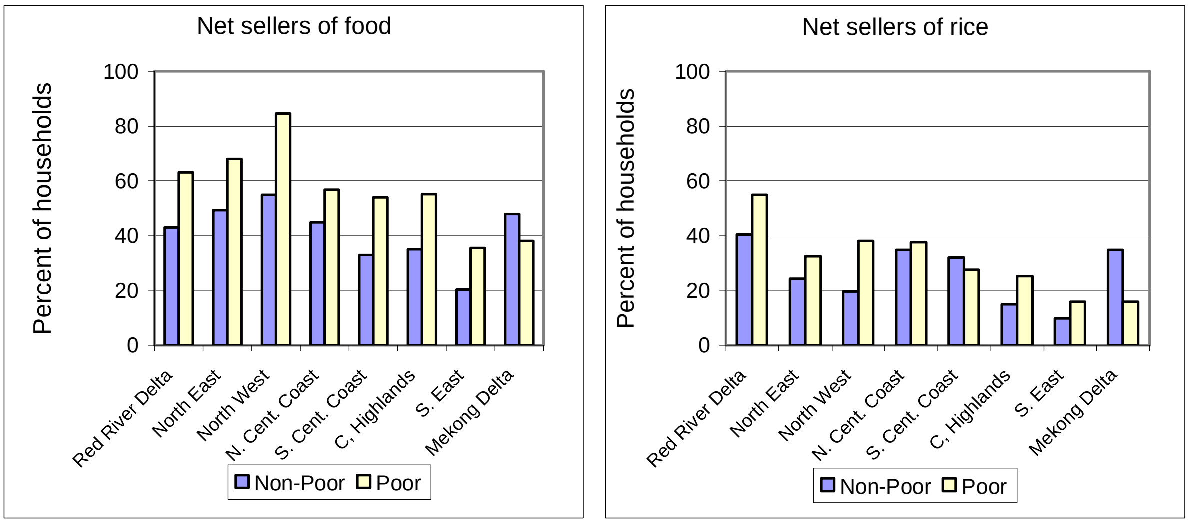
	Percent of population	Poverty rate	Poverty gap	Contribution to poverty
All	100.0	15.9	3.8	100.0
Rural	73.3	20.3	4.9	93.6
Urban	26.7	3.8	0.8	6.4
Kinh and Hoa	86.5	10.2	2.0	55.6
Ethnic minorities	13.5	52.2	15.4	44.4
Non-farmer	29.0	5.0	1.1	9.1
Farmer	71.0	20.4	4.9	90.9
Not growing rice	46.9	7.5	1.7	22.0
Growing rice	53.1	23.4	5.6	78.0

Source: World Bank based on 2006 data from GSO.

An analysis of more disaggregated patterns of purchases and sales of food and rice defies easy generalizations. Not surprisingly, the average urban household is a net food purchaser, buying 8.3 million dong's worth of food a year. However, 12 percent of urban households and 27 percent of poor urban households are in fact net food sellers. Conversely, the average rural household is a net food producer, selling 7.4 million dong of food per year. Yet 46 percent of rural households are net food purchasers. Poor rural households are more likely to be net sellers of food than non-poor rural households. Looking more specifically at rice sales, 7 percent of urban dwellers are net rice sellers, but the share increases to one fifth in the case of poor urban households. Just over one third of all rural households are net sellers of rice, with the share being slightly higher in the case of non-poor households.

Variation across regions is considerable (Figure 6). More than half of the poor households in the north of the country are net sellers of food, while the proportion is somewhat lower in the south of the country. And there is a striking difference in rice sales patterns between the two main rice-producing delta areas. While 55 percent of poor households in the Red River Delta are net sellers of rice, only 27 percent of poor households in the Mekong Delta are. This is despite the Mekong Delta being the "rice basket" of Vietnam.

Figure 6: Households Selling Food and Rice by Region



Source: World Bank based on 2006 GSO data.

Household survey data can also be used to simulate the impact of changes in food and rice prices on household welfare and poverty. One scenario assumes an increase in the farm-gate price of rice by 15.5 percent and of the retail price by 11.2 percent. In this scenario, welfare increases by 4.3 percent for the average household and by 6.3 percent in rural areas. Increases are larger for richer households. Conversely, welfare falls by 1.6 percent in urban areas, with the negative impact being largest on households towards the middle of the distribution. But despite the improvements in overall welfare, 51 percent of all households and 86 percent of urban households are worse off after this price rise. The proportion of households who are worse off is highest in the Northwest region, where it attains 76 percent. The proportion of households which are worse off is higher in scenarios assuming that retail prices increase as much as farm-gate prices.

A surge in imports

In 2007, imports grew by 39.4 percent to reach 6.2 billion U.S. dollars (Table 3). Growth was particularly strong for imports of capital goods (59 percent) due to bulky purchases abroad, including commercial aircraft and equipment for Vietnam's first oil refinery. Steel imports grew by 74 percent and imports of computer and electronic components by 45 percent. Growth was also strong in the case of intermediate goods (41 percent), such as material for garments and footwear, chemical products, plastic materials and animal feed. Imports of consumption goods increased even more rapidly, but from a low base. For instance, the purchase of vehicles under 12 seats grew by 135 percent, to 700 million U.S. dollars, perhaps a sign of the emergence of a high-consumption group in Vietnam.

Table 3: Import Structure and Growth

	Value (US$ million)	Growth (percent)				
	2007	2006	2007	4M-06	4M-07	4M-08
Total import value	62,682	21.4	39.4	6.9	32.8	71.0
Petroleum products	7,710	18.8	29.2	22.4	14.0	70.2
Machinery and equipment	11,123	25.5	67.8	14.2	52.7	47.0
Computer and electronics	2,958	20.0	44.5	15.9	36.1	47.2
Pharmaceuticals	703	9.2	28.3	24.8	23.9	17.9
Garment and leather materials	2,152	-14.5	10.3	-5.4	-5.4	16.3
Iron & Steel	5,112	0.2	74.1	-30.1	72.9	153.1
Fertilizer	1,000	5.9	45.5	5.0	45.7	165.0
Plastics	2,507	28.2	34.4	23.4	34.8	38.1
Fabrics	3,957	24.4	32.6	28.7	22.4	16.2
Chemicals	1,466	20.4	40.7	17.7	35.5	39.6
Chemical products	1,285	19.7	27.6	27.3	23.9	30.4
Automobiles (COMP/CKD/IKD)	1,881	-18.6	93.6	-54.9	-3.9	333.2
Yarns and fibers	741	60.2	36.3	31.3	43.2	28.7
Pesticides	383	25.3	25.4	25.3	27.8	52.4
Cotton	267	31.0	22.1	0.2	49.7	70.5
Paper	600	31.2	26.2	42.8	10.7	60.4
Other	18,835	40.4	27.3	3.1	34.5	85.5

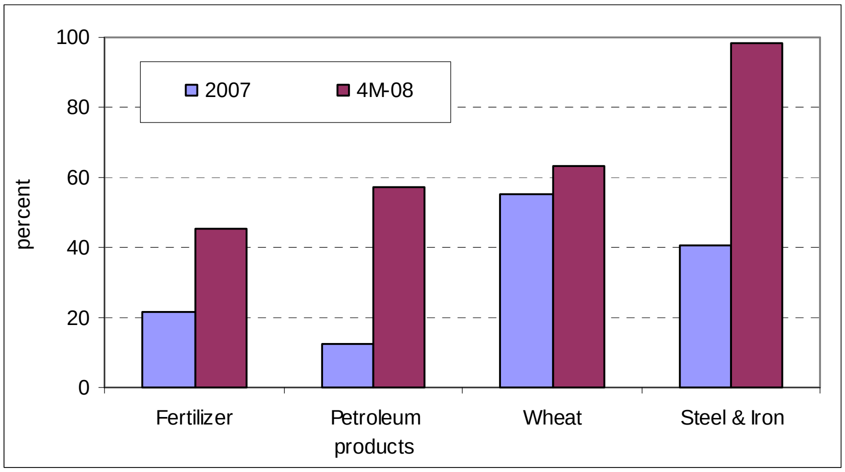
Source: General Department of Customs (GDC) and GSO.

Imports continued to rise in the first months of 2008, reflecting both an expansion in domestic demand expansion and higher international prices. The latter had a strong impact in the case of steel, fertilizer and wheat, resulting in an increase of Vietnam's import bill by 1.6 billion U.S. dollars (Figure 7). In the case of steel, the value of imports increased by 153 percent in the first four months of the year. Yet, the volume of steel imported actually decreased by 15 percent in April. Imports of automobiles also slowed down in April, partly because of higher tariffs. But import value kept growing, reaching a staggering 333 percent since the beginning of the year.

Massive imports of gold contributed to the widening trade deficit. In the first four months of 2008, 43 tons of gold were purchased abroad, for about 1.2 billion U.S. dollars. This is roughly half the total value of gold imports in 2007. Gold is seen as a safe asset in Vietnam, and many seem to be buying it as protection in times of higher inflation and depressed real estate and stock markets.

Imports by foreign-invested companies increased by 47 percent, and accounted for 30 percent of total purchases abroad. Their imports of machinery and equipment rose 55 percent, reflecting strong Foreign Direct Investment (FDI) disbursements in 2007 and 2008.

Figure 7: Average Import Price of Selected Items

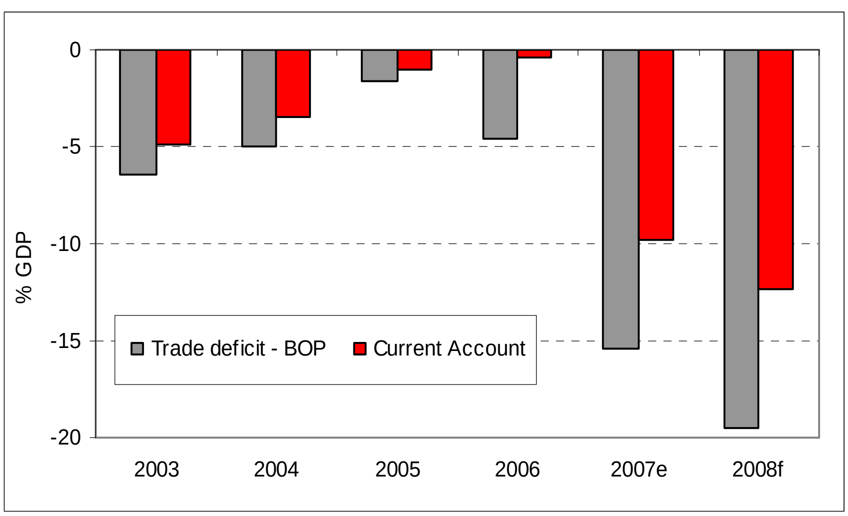


Source: GDC and GSO.

Current account deficit widens

At almost 10 percent of GDP, the deficit of the current account reached an unprecedented level in 2007. The trade deficit, estimated on an FOB basis, reached nearly 11 billion U.S. dollars, or 15 percent of GDP (Figure 8). The flip side of these deficits was a strong inflow of foreign capital.

Figure 8: Trade and Current Account Balances



Source: SBV and World Bank.

The current account deficit was almost entirely financed (94 percent) by non-debt creating FDI inflows and Official Development Assistance (ODA). FDI inflows are estimated to have reached 6.7 billion U.S. dollars, whereas ODA disbursements amounted to 1.6 billion U.S. dollars. Both FDI and ODA disbursements could be much higher if the implementation constraints were eased, as commitments were much higher than the disbursements. Private remittances, mainly from overseas Vietnamese and laborers abroad, are also very high. They are estimated to have reached over 6 billion U.S. dollars, a magnitude similar to that of FDI inflows (Table 4).

Table 4: Summary of the Balance of Payments

	2007	2008f
A. Current account balance	-6,992	-11,346
Trade balance (f.o.b.)	-10,360	-16,207
Freight, insurance and services	-894	-908
Repatriation of FDI profits	-2,168	-2,432
Transfers and remittances	6,430	8,200
B. Financial account balance	17,541	14,847
New FDI investment	6,550	5,800
Medium- and long-term loans	2,045	2,468
Short-term loans	79	94
Portfolio investments	6,243	1,985
Money and deposits	2624	4500
C. Errors and omissions	-381	0
D. Overall balance (=A+B+C)	10,168	3,501
Of which gain in foreign reserves	10,144	3,475

Source: SBV for 2007 and World Bank for projections of 2008.

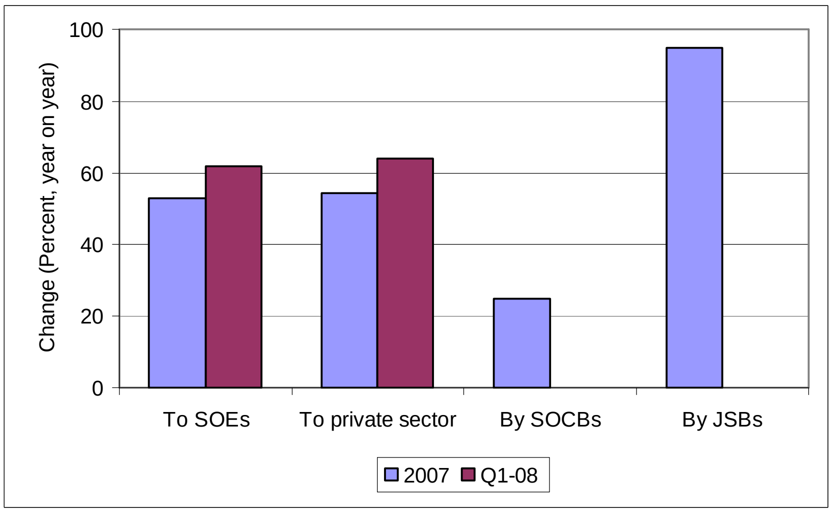
The causes of the overheating

World inflation and an informally pegged exchange rate can explain a large portion of the acceleration in inflation. But increases in non-food prices, the surge in imports and the real estate bubble of end-2007 are linked in one way or another to rapid credit growth. Massive purchases of foreign currency by the SBV resulted in an equally massive increase in dong liquidity. The volume of bank deposits increased rapidly, and with it the volume of bank credit.

Breakdowns of credit growth are revealing of the channels through which SBV interventions led to an overheated economy (Figure 9). There are no major differences by type of borrower. Credit to State-Owned Enterprises (SOEs) grew at almost the same pace as credit to the private sector. However, there is a sharp contrast between the relatively modest growth in lending by State-Owned Commercial Banks (SOCBs) and the extraordinary growth by Joint-Stock Banks (JSBs).

This rapid expansion of JSBs reflects their attempt to rapidly gain market share. However, the competence of these banks' risk management capability varies. Some are supported by credible foreign partners. But it is fair to say that the pace of credit growth of several JSBs is not consistent with a prudent lending practice, and raises concerns about credit quality. Many of the smaller JSBs invested heavily in stock and real estate markets. It is estimated that 10 percent of outstanding bank loans were for real estate in early 2008, compared to 3 percent in early 2007.

Figure 9: Credit Growth and Its Components



Source: SBV for 2007 and World Bank for projections of 2008.

Another potential driver of the overheating of the Vietnamese economy in late 2007 is the diversification of large SOEs out of their core businesses. There is particular concern about Economic Groups (EGs) and General Corporations (GCs). EGs are groups of enterprises each with distinct legal status, which are bound together through mutual investments, capital contributions or other forms of affiliation. They share common long-term economic interests and are organized under the holding company model. All subsidiaries of economic groups are equitized or otherwise restructured. GCs are corporate entities consisting of a wholly state-owned parent or holding company and a group of subsidiary companies which may be wholly state-owned or in which the state holds a controlling interest.

Many of these EGs and GCs diversified into financial sector and real estate activities in recent years, and especially during the asset price bubble of 2007. This diversification raises concerns. The combination of commercial and financial interests under the same entity could result in an inefficient allocation of resources. Such combination could also lead to related-party transactions escaping supervision and creating risks for financial sector stability.

Until very recently, there was a considerable uncertainty as to how much EGs and GCs had invested out of their core businesses. However, a recent assessment by the

Ministry of Finance of investments, liabilities and related-party transactions by these entities suggests that they were not the main driver of the real estate frenzy (Table 5). Their combined investments in the financial and real estate sectors reached about half a billion U.S. dollars, which is certainly not negligible but is much less than the volume of resources channeled by the banking sector.

Table 5: Investments by Economic Groups and General Corporations

Outside Investments (as of December 31, 2007)	Number of EGs and GCs	Amount (billion dong)	Percent of equity	Percent of assets
Investment funds and stocks	13	1,061	0.31	0.13
Stock trading companies	13	420	0.12	0.05
Joint stock commercial banks	19	4,426	1.30	0.55
Real estate	18	1,463	0.43	0.18
Total		7,370		

Source: Prime Minister's report to the National Assembly, May 31, 2008.

The policy response and its implementation

Several months of overheating elapsed before the authorities reacted. By the end of 2007, it was clear that inflation was accelerating, the trade deficit was widening and real estate prices were soaring. Yet, rapid economic growth was still seen as the top priority for Vietnam, and this required both a competitive exchange rate and massive public investment in infrastructure.

This policy choice left the SBV with limited margin to address the "impossible trinity". Capital inflows were at their height and letting the dong appreciate was not an option. The SBV thus tried to restrain credit growth by other means. Successively, it stopped buying foreign currency, raised interest rates, took money out of circulation through not rolling over reverse repos and widened the trading band for the exchange rate. Some of these measures generated anxiety among businesses and financial institutions, but they did not succeed at lowering the growth rate of credit.

Only in February 2008 did the government decide to shift gear and give priority to macroeconomic stability over rapid growth. Some of the practical implications of this change are still being worked out. Overall, the government seems to have chosen what could be labeled as a "macro plus" economic package, one that does not rely exclusively on monetary and exchange rate policy but also involves actions on other fronts. The range of measures announced is actually broad. It includes tightening public expenditures, reallocating government resources out of the banking system and stopping inefficient investment projects, among others.

Some of the clearer measures are related to credit policy. The sale of 20.3 trillion dong in compulsory bonds was announced for March 17. In practice, this was equivalent to raising reserve requirements, except that the interest paid was higher. The total value of the bonds each commercial bank had to purchase was also modulated taking into account its specific circumstances, introducing some more flexibility in application than an increase in the reserve ratio would have allowed. Subsequently, authorities announced that the target was to bring credit growth down to 30 percent in 2008. On May 19 the benchmark interest rate was increased from 8.75 to 12 percent, thus lifting the maximum lending rate to 18 percent (or 150 percent of the benchmark rate under current regulations).

Other recent measures relate to fiscal policy. The central government mandated line ministries, provincial governments and SOEs to review their public investment projects for 2008, with a view of cutting down those with insufficient funding or outdated objectives. In the case of SOEs, a comparison of costs and benefits was also requested. By May 28, 28 ministries and central agencies, 43 provinces and eight EGs had reportedly decided to postpone, delay or stop 995 projects, with 3,983 billion dong in state funding, equivalent to 7.8 percent of the total investment budget. The decision was also made to reduce investment spending to be funded through the issuance of government bonds by 9,000 billion dong, equivalent to 25 percent of original plan. In relation to recurrent expenditures, a 10 percent cut in non-salary items was mandated for the last eight months of 2008. It is expected that this measure will result in 2,700 billion dong in savings.

In addition to these measures, the government has urged ministries, provinces and SOEs to take measures to improve the efficiency of their spending. These include improving the quality of project planning and appraisal, holding project owners and investment decision makers accountable for their investment decision, and enhancing the inspection and supervision of projects. Whether these other measures will make a substantial difference in the level of public spending remains to be seen.

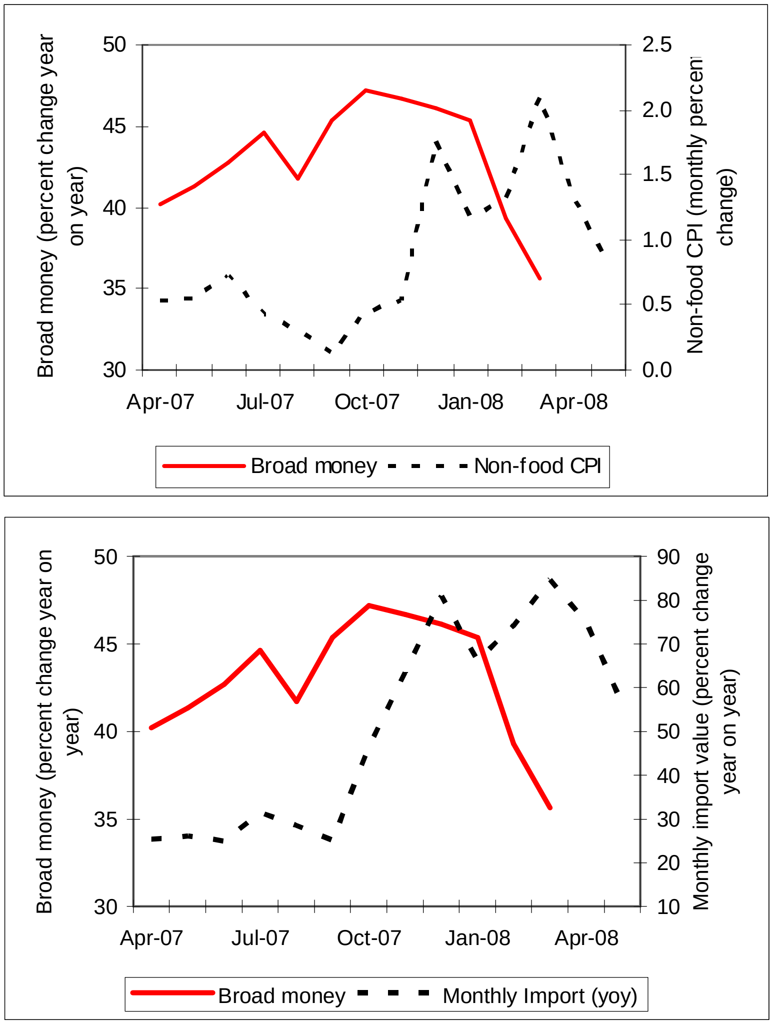
Beyond the specifics, it is clear that this change in policy priorities will lead to a slowdown in economic activity. The government announced that its new target for GDP growth in 2008 is 7 percent, down from the 8.5 to 9 percent range announced at the beginning of the year.

Is it working?

On the surface, it would appear that this policy package has not been particularly effective at stabilizing the economy. Inflation showed signs of deceleration in March compared to February, and in April compared to March. But it accelerated again in May. And the inflation accumulated over a twelve-month period kept growing steadily, to reach 25 percent by end May. Meanwhile, imports stayed in the order of 8 billion U.S. dollars per month, bringing the trade deficit to a record 14.4 billion U.S. dollars in the first five months of the year, compared to 3.8 billion U.S. dollars in the same period of 2007.

However, attention to time lags suggests that the ongoing contraction is having an effect indeed. The inflation figure for May was remarkably high due to panic buying of rice at the beginning of the month. If monthly changes in the prices of non-food items are considered, a deceleration is taking place since March. Similarly, the value of imports remains very high, but its growth rate over the same month in 2007 is also decelerating since March (although it remains strikingly high). Moreover, movements in these two indicators seem to roughly follow the change in the level of broad money with a lag of about three months (Figure 10). If this pattern was confirmed, and the stricter monetary discipline was pursued, there would be some hope to see a gradual decline in non-food inflation and in the monthly value of imports in the coming months.

Figure 10: Time Lags between Impulses and Outcomes



Source: World Bank based on data from SBV and GSO.

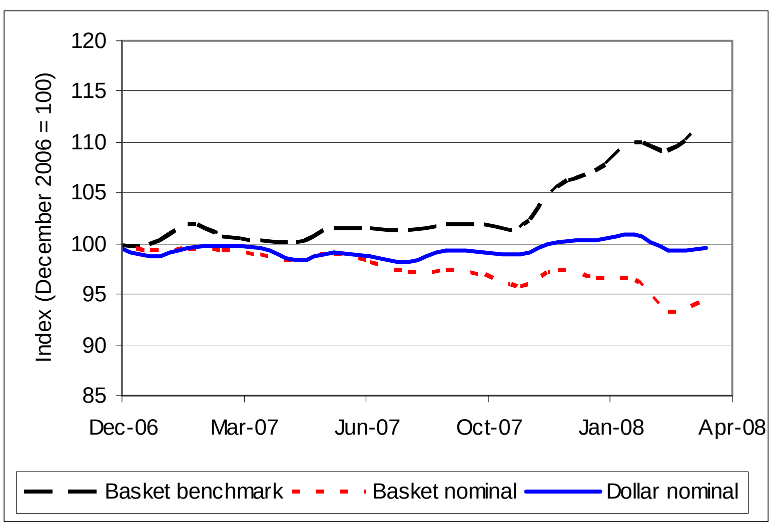
Exchange rate policy

There has been less action in relation to the exchange rate. During most of 2008, it remained stable at roughly 16,000 dong for one U.S. dollar (Figure 11, solid line). Had it not been for market interventions by SBV, the dong would have appreciated in the early part of the year, when capital inflows were still considerable. It would have probably appreciated more recently, when portfolio inflows slowed down to a trickle and the growth of imports led to a large demand for foreign currency.

The apparent stability of the exchange rate hides a sizeable appreciation of the dong in recent months. This was the result of two opposite forces. By implicitly pegging the dong to the dollar, the monetary authorities implicitly allowed a depreciation of the dong. This is because the dollar depreciated against the other major currencies Vietnam uses to import or export goods. If the monetary authority had pegged the dong to a basket of currencies including the Euro and the Yen, with their weights reflecting the pattern of Vietnam's foreign trade, the price of a dollar in dong would have fallen by roughly 5 percent (Figure line, dotted line).

However, during this period the inflation rate of Vietnam was much higher than that of its main trading partners. Given that productivity is unlikely to have changed much in a few months, this gap in inflation amounts to a loss of competitiveness for the Vietnamese economy. Had the monetary authority tried to maintain competitiveness with respect to Vietnam's main trading partners, the price of a dollar in dong should have increased by about 12 percent (Figure 11, broken line). This is a very crude estimate, as it is based on headline inflation, not on production costs. But it suggests that there is room for a gradual devaluation of the dong. At a time when capital inflows have receded, the government can afford to focus on restoring competitiveness. This, in turn, would contribute to containing the trade deficit.

Figure 11: Nominal and Real Exchange Rates



Source: World Bank estimates, based on headline inflation and nominal exchange rates for the United States, the Euro zone and Japan, using trade-related weights.

There is also interest in allowing a greater flexibility of the exchange rate. This would help the economy cope better if capital flows (into the country or out of it) were to increase. The intention to widen the exchange rate band to ± 2 percent has been announced. It would be sensible to implement it at the same time as the depreciation of the reference exchange rate accelerates.

Greater exchange rate flexibility would also expose enterprises, banks and households to the notion of exchange rate risk, and encourage them to reduce their exposure. Currency mismatches are an important source of instability in periods of adjustment. For example, an enterprise whose liabilities are in foreign currency but whose income is in dong would experience a loss if there is a devaluation of the dong. Conversely, a bank which has foreign-denominated assets would benefit from it. Some of these balance sheet effects may cancel out for the economy as a whole. In the example, the enterprise would lose and the bank would gain. However, if the loss is too large the enterprise could go bankrupt and the gain of the bank could not be realized.

Little is known about the extent of currency mismatches in the Vietnamese economy. However, a back-of-the-envelope calculation suggests that they could be large. The country as a whole is in a rough balance, as the value of its external debt is roughly similar to that of its international reserves. But commercial banks are net creditors in foreign currency, given their large net foreign assets, whereas many enterprises (including some large SOEs) are net debtors.

Depressed asset prices

The contraction of credit implemented as part of the stabilization package has had an impact on asset prices. The information available is patchy and mainly anecdotal in the case of the real estate market. However, there is consensus that prices have declined, and selling property takes longer.

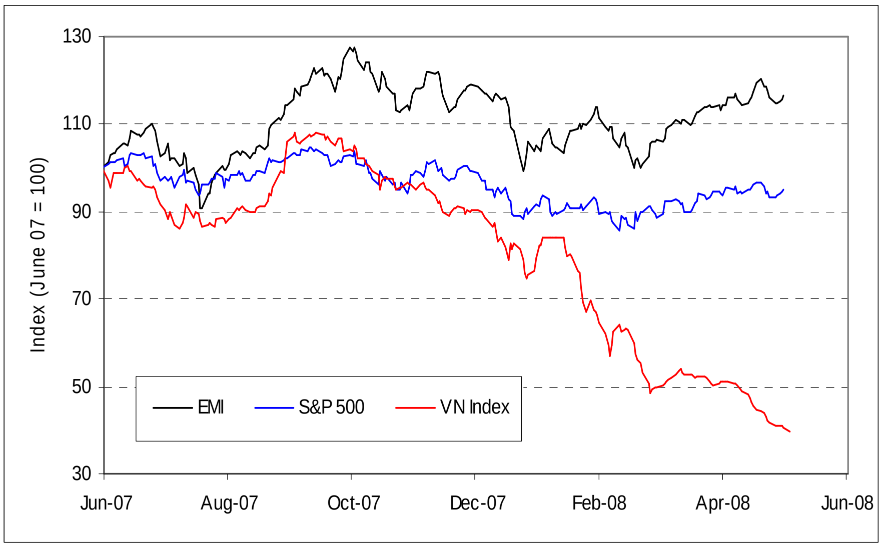
The information is much clearer in the case of share prices. Vietnam's stock market had experienced a boom between 2006 and March 2007. Capitalization on the Ho Chi Minh City (HCMC) and Hanoi stock exchanges reached nearly 29 billion U.S. dollars, or above 40 percent of GDP, up from less than 1 billion U.S. dollars, or 1.2 percent of GDP in 2005. Prudential requirements for banks lending to securities companies and stock investors had cooled down the market since the summer of 2007. But monetary contraction led to a sudden downward spiral in prices, which does not appear to be based on underlying fundamentals. As of June 2008, total capitalization of the two markets is estimated at about 17 percent of GDP or less than half of that in December 2007. In other words, Vietnam's stock market lost around 16 billion U.S. dollars in market value since the beginning of the year (Figure 12).

This decline partly reflects a needed correction after a period of exuberance. But it has probably gone too far in relation to market fundamentals. As of end-May 2008, the average Price-to-Earnings (P/E) ratio in the HCMC stock market was estimated at around 10; it was only 6 or 7 in the Hanoi stock exchange. In order to calm the market, the HCMC stock exchange drastically narrowed the allowable daily trading band from 5 to 1 percent. In the Hanoi stock exchange the band was narrowed from 10 to 2 percent.

These bands have recently been widened slightly to 2 and 3 percent, respectively. This move provided some temporary relief, by making it difficult to sell stocks.

Depressed asset markets are bound to affect the JSBs who lent aggressively for financial and real estate investments. The ever-greening of loans not being serviced may allow banks to gain some time, in the expectation that asset markets will recover. But with higher interest rates, the rolling over cannot indefinitely continues.

Figure 12: Vietnam Stock Exchange Index



Source: HCMC Stock Exchange for Vietnam, Morgan Stanley Capital International for Emerging Market Index (EMI) and Standard and Poor for S&P500 index.

This situation calls for two types of measures. The first one is to move more decisively on the other components of the stabilization package announced in March. So far, the action has been concentrated on monetary policy. Announcements have been made in relation to fiscal policy but the actual cuts in expenditures are yet to take place. The absence of fiscal adjustment implies that all the burden of stabilization falls on the availability of credit.

Second, there is a need to ensure the stability of the financial sector and maintain depositors' confidence in the banking system. So far, stability has been preserved by ensuring that JSBs facing difficulties have access to liquidity. However, sooner or later there could be a need to have some of the weakest JSBs absorbed by stronger and more reputable banks. In an encouraging sign, several foreign banks have already increased their equity state in JSBs to the 15 percent regulatory limit.

Economic activity: targets and forecasts

The outlook is decidedly less favorable than it was a year ago. The government is determined to fight inflation, and the stabilization package should result in a lower growth rate than projected at the beginning of the year. However, the economic fundamentals of Vietnam remain strong, and GDP growth could be more resilient than the official target suggests.

In the first quarter of 2008, GDP grew by 7.4 percent, which is less than during the same period in 2007, but not by a large margin (Table 6). Though first quarter estimates provide little background on the whole year result, recent external and internal economic developments remain encouraging.

Table 6: GDP Growth by Sector

	2006	2007	Q1-06	Q1-07	Q1-08
Total GDP	8.2	8.5	7.2	7.8	7.4
Agriculture, forestry and fishery	3.4	3.4	2.1	2.6	2.9
Industry and construction	10.4	10.6	8.5	9.1	8.1
Industry	10.2	10.2	8.7	9.3	9.0
Mining	0.8	-2.0	0.2	0.1	0.1
Manufacturing	12.4	12.8	11.0	11.9	10.6
Construction	11.1	12.0	8.1	7.9	3.3
Services	8.3	8.7	7.4	8.0	8.1
Retail trade	8.6	8.7	7.7	7.7	7.5

Source: GSO.

The combined agriculture, forestry and fisheries sector grew 2.9 percent in the first quarter of 2008, despite continuing to face animal disease and unfavorable weather, including a harsh winter in the northern and central regions of Vietnam. Provinces of Mekong Delta reported a bumper winter-spring rice crops, with paddy production exceeding 9.9 million tons, half a million tons more than the previous year. Value added from aquaculture recorded an increase of 7.6 percent due to 9.3 percent increase of gross output. This compensated for the slowdown in the poultry and livestock sub-sector, due to the impact of animal disease outbreaks in recent months.

In the first quarter, industrial value added grew 9 percent year-on-year. Value added in the mining sector rose only 0.1 percent due to a decline in crude oil production and manufacturing becomes also declining. Within the industrial sector, the turnover of the domestic private sector expanded 22 percent while that of SOEs grew 7.9 percent year-on-year in the first four months of 2008. The private sector continues expanding and becomes a main creator of employment in Vietnam. The sector that was hit hardest was construction. It grew only 3.3 percent in the first quarter, the lowest rate in many years. The service sector, which has picked up in the last three years, continued to grow rapidly in the first quarter thanks to a strong performance of tourism, transportation and financial services.

Exports grew 27.6 percent year-on-year in the first four months of 2008 (Table 7). The export value of crude oil increased strongly in spite of production capacity constraints, benefiting from high international price. As of April, oil export volumes had decreased by 10.5 percent but its value increased by 46.2 percent. Non-oil exports are also keeping pace with the oil exports.

Beyond the sector-by-sector detail, statistical "inertia" implies that growth in 2008 will remain strong even if the 7 percent target is met for each of the remaining quarters of the year. Given that GDP growth was running at 8.5 percent in 2007, and still at 7.4 percent in the first quarter of 2008, the deceleration will probably be slower than the official target suggests. Even with the growth of construction going down to zero for the rest of the year, and with all other sectors repeating their performance of the first quarter, GDP growth would still be around 7.5 percent in 2008.

Table 7: Export Structure and Growth

	Value (US$ million) 2007	Growth (percent)				
		2006	2007	4M-06	4M-07	4M-08
Total export earnings	48,561	22.8	21.9	25.1	22.0	27.6
Crude oil	8,488	12.1	2.4	15.6	-10.5	46.2
Non-oil	40,074	25.9	27.1	28.0	31.2	23.9
Rice	1,490	-9.3	16.8	-9.0	-7.3	72.7
Other agricultural commodities	4,696	42.0	31.3	34.4	49.7	6.0
Seafood	3,763	22.6	12.1	22.5	20.4	13.6
Coal	1,000	36.6	9.3	47.8	23.4	28.0
Garment	7,750	20.6	32.8	38.7	31.7	24.5
Footwear	3,994	18.2	11.2	21.4	11.0	15.7
Electronics and computers	2,154	19.7	26.1	23.7	27.5	33.9
Handicraft	825	10.9	30.9	10.8	21.6	8.6
Wood products	2,404	23.7	24.4	31.9	24.2	22.5
Other	11,996	38.7	37.6	32.9	47.1	30.5

Source: GDC and GSO.

From this perspective, the cost of taking a firm stance on inflation would not be too high in the short term. The government can afford to effectively adopt the measures in its stabilization package without facing a large drop in growth rates in the short term. Admittedly, this statistical "inertia" would mostly vanish by the second year. And it also would result in a slow picking up of growth rates once the tight policy stance is relaxed. For now Vietnam can clearly afford to give priority to economic stability.