
IMPORTANT NOTICE:

The information in this PDF file is subject to Business Monitor International's full copyright and entitlements as defined and protected by international law. The contents of the file are for the sole use of the addressee. All content in this file is owned and operated by Business Monitor International, and the copying or distribution of this file, internally or externally, is strictly prohibited without the prior written permission and consent of Business Monitor International Ltd.

If you wish to distribute the file, please email the Subscriptions Department at subs@businessmonitor.com, providing details of your subscription and the number of recipients you wish to forward or distribute this information to.

DISCLAIMER

All information contained in this publication has been researched and compiled from sources believed to be accurate and reliable at the time of publishing. However, in view of the natural scope for human and/or mechanical error, either at source or during production, Business Monitor International accepts no liability whatsoever for any loss or damage resulting from errors, inaccuracies or omissions affecting any part of the publication. All information is provided without warranty, and Business Monitor International makes no representation of warranty of any kind as to the accuracy or completeness of any information hereto contained.



The Vietnam Business Forecast Report

Q4 2008

Published by BUSINESS MONITOR INTERNATIONAL LTD

Includes 10-year forecasts to end-2017



ISSN 1745-0764

Analyst: Mark Bohlund

Editor: Yoel Sano

Key Sector Analysts: Lewis Jones, Andrew Thompson

Sub-Editors: Dominic Earnshaw, Anna Phillips

Subscriptions Manager: Dan Xue

Marketing Manager: Julia Consuegra

Production: Lisa Church/Jon Robson/Chuoc Lam

Publishers: Richard Londesborough/Jonathan Feroze

Copy Deadline: August 11 2008

© 2008 Business Monitor International. All rights reserved.

All information, analysis, forecasts and data provided by Business Monitor International Ltd is for the exclusive use of subscribing persons or organisations (including those using the service on a trial basis). All such content is copyrighted in the name of Business Monitor International, and as such no part of this content may be reproduced, repackaged, copied or redistributed without the express consent of Business Monitor International Ltd.

All content, including forecasts, analysis and opinion, has been based on information and sources believed to be accurate and reliable at the time of publishing. Business Monitor International Ltd makes no representation of warranty of any kind as to the accuracy or completeness of any information provided, and accepts no liability whatsoever for any loss or damage resulting from opinion, errors, inaccuracies or omissions affecting any part of the content.

VIETNAM – MACROECONOMIC DATA AND FORECASTS

	2003	2004	2005	2006	2007	2008f	2009f	2010f	2011f	2012f
Population, mn [8]	82.00	83.12	85.02	85.90	87.00	88.20	89.50	90.84	92.00	93.10
Nominal GDP, US\$bn [9]	39.63	45.55	53.05	60.99	71.38	77.69	95.75	118.98	144.39	172.58
GDP per capita, US\$ [9]	483	555	638	710	821	881	1,070	1,310	1,569	1,854
Real GDP growth, % change y-o-y [1, 10]	7.3	7.8	8.4	8.2	8.5	5.5	7.0	8.5	8.5	8.2
Unemployment, % of labour force, eop [11]	5.8	5.6	5.3	4.8	4.5	5.0	4.8	4.4	4.3	4.3
Budget balance, VNDbn [12]	-20,485.0	-50,001.0	-96,399.0	-25,830.0	-75,500.0	-75,980.0	-80,000.0	-75,600.0	-68,392.0	-57,119.0
Budget balance, % of GDP [9]	-7.2	-4.5	-3.8	-3.6	-3.9	-5.8	-5.1	-4.1	-3.2	-2.3
Nominal GDP, VNDbn [11]	613,442.5	715,307.0	839,211.0	973,790.0	1,143,442.0	1,320,675.5	1,531,983.6	1,784,760.9	2,079,246.4	2,416,084.4
Consumer prices, % y-o-y, eop [2, 11]	2.9	9.5	8.4	6.8	12.6	26.4	12.0	5.5	5.0	5.5
Consumer prices, % y-o-y, ave [3, 11]	3.2	4.8	8.3	7.4	8.3	27.6	18.0	7.8	5.2	5.3
Lending rate, %, eop [4, 13]	9.48	10.25	11.03	11.00	10.70	10.10	9.70	9.40	9.30	9.50
Real Lending Rate, %, eop [4, 9]	6.26	5.43	2.73	3.56	2.40	-17.50	-8.30	1.60	4.10	4.20
Exchange rate VND/US\$, eop [13]	15,656	1,001	15,913	16,072	16,018	17,000	16,000	15,000	14,400	14,000
Exchange rate VND/US\$, ave [13]	15,509	15,742	15,859	16,017	16,045	16,509	16,500	15,500	14,700	14,200
Exchange rate VND/EUR, eop [9]	19,695	21,378	18,777	21,209	23,386	25,330	21,760	19,800	19,008	18,060
Exports, US\$bn [5, 11]	20.15	26.48	32.44	39.60	48.39	63.87	75.37	91.95	110.34	132.41
Imports, US\$bn [5, 11]	25.26	32.00	36.98	44.83	60.83	85.16	97.08	116.50	133.98	154.07
Trade balance, US\$bn [6, 11]	-5.11	-5.52	-4.54	-5.23	-12.44	-21.29	-21.72	-24.55	-23.64	-21.67
Current account, US\$bn [11]	-1.94	-1.56	-0.50	-0.16	-6.00	-13.00	-8.00	-9.00	-7.00	-5.00
Current account, % of GDP [9]	-4.88	-3.44	-0.94	-0.27	-8.41	-16.73	-8.36	-7.56	-4.85	-2.90
Forex reserves (- gold), US\$bn [7, 14]	6.22	7.04	9.05	13.38	22.00	20.00	23.00	27.00	31.00	37.00
Import cover, months g&s [9]	3.0	2.6	2.9	3.6	4.3	2.8	2.8	2.8	2.8	2.9
Foreign debt, US\$bn [15]	13.4	15.4	17.2	19.7	21.8	24.0	28.0	34.0	41.0	49.0
Foreign debt, % of GDP [9]	33.8	33.8	32.4	32.3	30.5	30.9	29.2	28.6	28.4	28.4
Foreign debt, % of exports [9]	66.5	58.1	53.0	49.7	45.1	37.6	37.2	37.0	37.2	37.0
Industrial production index, % y-o-y, ave [11]	16.3	16.1	17.2	17.0	17.1	15.2	16.9	16.4	15.7	14.9

Notes: f BMI forecasts; 1 Constant 1994 prices; 2 1995=100; 3 The Oxford Economic Forecasting model is used when generating certain forecasts; 4 Annual average; 5 Goods f.o.b.; 6 Goods f.o.b. minus f.o.b.; 7 Foreign reserves minus gold; Sources: 8 Asian Development Bank, As of July 1; 9 BMI calculation; 10 General Statistics Office, BMI calculation; 11 General Statistics Office; 12 IMF, Ministry of Finance; 13 IMF; 14 Asian Development Bank; 15 World Bank.

Contents

Executive Summary	5
Economy Stabilising, But Major Challenges Remain	
Chapter 1: Political Outlook.....	7
SWOT Analysis.....	7
BMI Political Risk Ratings.....	8
Domestic Politics.....	9
Government's Reform Resolve Intact	
We do not view the current economic slowdown as a larger risk to the standing of Prime Minister Nguyen Tan Dung, the most important advocate of market reform within the higher echelons of the Communist Party of Vietnam.	
TABLE: VIETNAM POLITICAL OVERVIEW	10
Foreign Policy.....	11
Hanoi's Increasing Assertiveness Carries Risks	
We foresee Vietnam continuing to raise its profile on both the regional and global stage through closer involvement with the Association of Southeast Asian Nations (ASEAN) and with the US.	
Chapter 2: Economic Outlook.....	13
SWOT Analysis.....	13
BMI Economic Risk Ratings	14
Economic Activity	15
Slowdown To Sharpen In H208	
We are expecting the Vietnamese economy to decelerate further in H208, with full-year GDP growth coming in at 5.5% as high inflation and tighter lending conditions cut into domestic demand.	
TABLE: VIETNAM – ECONOMIC ACTIVITY.....	15
Balance Of Payments	16
Dramatic Improvement In BoP Expected In H208	
The stabilisation of the dong has been aided by a dramatic improvement in the balance of payments, where the bulging trade deficit has been arrested by government measures to curb imports and boost the export sector.	
TABLE: VIETNAM – BALANCE OF PAYMENTS	16
Exchange Rate Policy.....	17
Still Too Soon To Ease Policy	
The Vietnamese government will continue to cap the appreciation of the dong as the rapid improvement in the trade account and continued FDI inflows put upward pressure the currency.	
TABLE: VIETNAM – EXCHANGE RATE POLICY.....	18
SBV To Keep Rates On Hold	
Banking Sector	19
Banking Sector To Remain Intact	
We continue to see opportunities for foreign investors in the Vietnamese banking sector in spite of the recent macroeconomic turbulence.	
Chapter 3: 10 Year Forecast.....	21
The Vietnamese Economy To 2017	21
A Bumpy Road To Stardom	
We remain positive about Vietnam's growth prospects over the next 10 years, believing that the macroeconomic woes of 2008 will have been a useful exercise for a government still inexperienced in managing a market economy.	
TABLE: VIETNAM LONG-TERM MACROECONOMIC FORECASTS	21
Chapter 4: Special Report	25
Mega-Urban Regions.....	25
TABLE: THE WORLD'S 30 LARGEST URBAN AGGLOMERATIONS	26
TABLE: THE WORLD'S RICHEST CITIES IN 2020 BY GDP.....	29

TABLE: THE WORLD'S FASTEST GROWING URBAN AREAS BY POPULATION.....	33
Chapter 5: Business Environment.....	35
SWOT Analysis.....	35
BMI Business Environment Risk Ratings.....	36
Business Environment Outlook.....	37
TABLE: BMI BUSINESS AND OPERATIONAL RISK RATINGS.....	38
Institutions.....	39
TABLE: BMI LEGAL FRAMEWORK RATINGS.....	40
Infrastructure.....	41
Market Orientation.....	43
TABLE: ASIA, FDI INFLOWS.....	44
TABLE: BMI TRADE RATINGS.....	45
TABLE: TOP EXPORT DESTINATIONS.....	46
Operational Risk.....	48
Chapter 6: Key Sectors.....	49
Tourism.....	49
TABLE: VIETNAM'S TRAVEL INDUSTRY – HISTORICAL DATA AND FORECASTS.....	50
Defence.....	53
Table: Vietnam Defence Sector – Historical Data & Forecasts.....	56
Chapter 7: BMI Global Assumptions.....	57
Global Outlook.....	57
Table: GLOBAL ASSUMPTIONS.....	57
United States.....	58
Eurozone.....	59
Japan.....	61
China.....	62
Commodities.....	63

Executive Summary

Economy Stabilising, But Major Challenges Remain

- We are now seeing our anticipation of a stabilisation of economic conditions playing out as Vietnam retreats from the brink of a balance of payments crisis. Government measures to boost exports and curb imports have prompted a dramatic improvement in the trade account in Q208 while we see inflation peaking at 30% year-on-year (y-o-y) in September before starting to fall gradually over Q408 and 2009. We believe that the lessons learned in 2008 will aid the government in better balancing economic policy goals and thus be conducive for increased macroeconomic stability. We are currently forecasting GDP expansion to slow to 5.5% in 2008 before rising to 7.0% in 2009 and 8.5% in 2010. Looking further ahead, we see Vietnam growing at an average of 8.0% annually over 2013-2017.
- We see no great threat to the position of Prime Minister Nguyen Tan Dung and thus envisage a continuation of market reform once Vietnam's current macroeconomic woes have been addressed. This is because few Vietnamese wish a return to the more directly managed economy of the late 1970s and early 1980s. Support for Dung's market reform agenda is also firm within the ranks of the Communist Party of Vietnam and other key groups in society. Meanwhile, Hanoi has bolstered its international standing through its presence in the UN Security Council, greater participation in the Association of South East Asian Nations and role as a mediator between North Korea and other participants of the 'six-party' talks.
- We have revised down our GDP growth forecast for 2008 another notch from 7.0% to 5.5% as domestic demand takes a severe hit from higher prices and monetary tightening. H208 is likely to be characterised by a divergence between the external sector, which will be boosted by government efforts, and a continued strong demand for commodities and a weaker domestic sector. We are still forecasting an economic recovery in 2009, with growth picking up in the second half of the year as monetary conditions are eased and external demand improves. We foresee a new boom in foreign investment as economic conditions stabilise, which will give impetus to growth in 2010 and 2011.
- Infrastructure development continues to be a key focus for the government as power shortages threaten to curb growth and stoke inflation. The government is now pressing for the completion of a number of power plants in order to keep up with the estimated 16% annual increase in electricity demand. Increased investment into the power sector is, however, likely to be dependent on breaking state-owned **Electricity of Vietnam's** monopoly on power distribution. Progress has also been made on port construction, which is crucial for Vietnam's continued industrial expansion. On the legislative front, the likely adoption of a bill lowering the top corporate tax level from 28% to 25% as of January 2009 will improve business conditions and bolster investment.

chapter 1 Political Outlook

SWOT Analysis

Strengths

- The Communist Party government appears committed to market-oriented reforms necessary to double 2000's GDP per capita by 2010, as targeted. The one-party system is generally conducive to short-term political stability.
- Relations with the US are generally improving, and Washington sees Hanoi as a potential geopolitical ally in South East Asia.

Weaknesses

- Corruption among government officials poses a major threat to the legitimacy of the ruling Communist Party.
- There is increasing (albeit still limited) public dissatisfaction with the leadership's tight control over political dissent.

Opportunities

- The government recognises the threat that corruption poses to its legitimacy, and has acted to clamp down on graft among party officials.
- Vietnam has allowed legislators to become more vocal in criticising government policies. This is opening up opportunities for more checks and balances within the one-party system.

Threats

- Vietnamese dissidents are seeking external help, especially from the US. This could complicate Vietnam-US relations, with Washington having criticised Hanoi over its restrictions on religious freedom.
- Although strong domestic control will ensure little change to Vietnam's political scene in the next few years, over the longer term, the one-party-state will probably be unsustainable.

BMI Political Risk Ratings

Vietnam's decision to raise domestic fuel prices by 36.8% on July 21 came only two weeks after the government stated that fuel prices would be kept unchanged for the rest of 2008. This therefore raises questions about economic policy going forward. Unsurprisingly, July's consumer price inflation rose to a new 17-year high of 27.0%, and could rise even higher in August, since the fuel price hike had yet to be reflected fully in July data. Although there have been no signs of mass public unrest, we continue to view higher fuel prices and inflation as a risk to social stability.

	Short-Term Political	Rank	Trend
Singapore	94.2	5	=
Australia	86.5	13	+
Hong Kong	86.0	15	=
New Zealand	82.1	24	=
China	81.0	28	=
Japan	80.8	31	=
Malaysia	79.4	35	=
North Korea	79.0	37	=
Taiwan	78.3	39	=
Vietnam	78.1	40	=
Laos	77.1	42	=
South Korea	77.1	42	=
Cambodia	70.4	68	=
Thailand	68.3	78	=
Sri Lanka	68.1	79	=
Indonesia	67.7	83	=
Philippines	65.4	88	=
India	62.5	99	=
Bangladesh	57.3	105	=
Myanmar	57.1	106	=
Pakistan	50.2	118	=
Regional Average: 73.6	Emerging Market Average: 65.9	Global Market Average: 68.6	

	Long-Term Political	Rank	Trend
Japan	92.1	5	=
New Zealand	82.7	15	=
Australia	81.2	19	=
South Korea	80.2	21	=
Hong Kong	76.9	34	=
Singapore	74.8	37	=
Malaysia	74.2	41	=
India	71.3	47	=
Taiwan	66.4	58	=
Sri Lanka	62.7	70	=
China	60.4	77	=
Philippines	57.0	89	=
Thailand	56.8	90	=
North Korea	55.1	94	=
Pakistan	54.4	96	=
Vietnam	53.8	99	=
Indonesia	53.6	100	=
Cambodia	51.9	104	=
Bangladesh	50.4	108	=
Laos	46.5	115	=
Myanmar	31.3	130	=
Regional Average: 63.5	Emerging Market Average: 60.4	Global Market Average: 64.0	

Domestic Politics

Government's Reform Resolve Intact

There have been fears that the current inflationary troubles would prompt a backlash against Prime Minister Nguyen Tan Dung's policy agenda and prompt the government to suspend market reform policies in favour of more redistributive measures aimed at alleviating the strains of higher food and fuel prices in order to bolster popular support for the regime.

However, we believe these fears are overblown and that support for Dung's reformist agenda remains strong within the Communist Party of Vietnam (CPV) and other key stakeholders in society. There has, admittedly, been some grumbling among the lower strata of the populace, but expressions of discontent have so far been limited to striking factory workers demanding higher salaries from their – often foreign – employers. This reflects the fact that although the past year's rapid increase in food and fuel prices has eradicated much of the material gains achieved in recent years, few Vietnamese wish a return to earlier days when far-reaching government restrictions limited their economic liberty and prospects for the future.

Moreover, support for the government's reform agenda is robust among the many CPV members who have used their party connections to promote their personal business interests. A majority of younger CPV members have in fact joined the party in order to build a business network among policymakers and other up-and-coming professionals, rather than due to any ideological conviction. The CPV is still dominated, at least in numbers, by an older guard more aligned to traditional communist ideology, but they are seeing themselves increasingly marginalised by a younger generation wishing the party to follow the example of the Communist Party of China.

This admiration has undoubtedly contributed to the government's policy reaction to skyrocketing inflation being fairly moderate. The government has tightened both monetary and fiscal policy through rate hikes and freezes on 'non-essential' public investment, but has not retracted on Dung's efforts of economic liberalisation, despite reported attempts by more traditionalist elements within the Politburo to halt economic reform.

We view this as encouraging, because continued market reform is crucial to maintaining high growth. State-owned enterprises (SOEs) still dominate many areas of the economy, and efforts to increase efficiency at these behemoths have only been partially successful. SOEs have therefore been among those suffering the hardest from the slowing economy, but have reportedly been granted preferential treatment in access to loans and other financing. We therefore do not believe that Vietnam's current economic woes will lead to as large a cull of underperforming SOEs as could be expected. Inefficiencies at state-owned corporations will thus continue to be a drag on GDP growth well into the foreseeable future.

On a more positive note, we do not believe the current slowdown has weakened Prime Minister Dung's position ahead of the next CPV Party Congress, due to be held in 2011. The political outcome of the current economic turbulence is likely to be a shift of the government's policy focus in the short term to stabilising economic imbalances and putting a temporary halt to economic reform measures. The Politburo issued a directive to ministries

BMI VIEW

We do not view the current economic slowdown as a larger risk to the standing of Prime Minister Nguyen Tan Dung, the most important advocate of market reform within the higher echelons of the Communist Party of Vietnam. However, the government will need to recognise the risks of focusing exclusively on reaching growth targets.

and agencies in early August to implement measures to boost exports and cut imports to reduce the trade deficit, while the ongoing so-called 'equitisation' process of making SOEs more efficient and transferring their ownership to private hands through stock market listings is likely to remain on hold for the remainder of 2008 and much of 2009.

A longer hiatus in this reform process would indeed be harmful for growth, but we view 2008 more as a bump in the road to a fully fledged market economy that could in fact be a positive to long-term growth by alerting the government to the risks of focusing exclusively on reaching growth targets. This view is reflected in Vietnam's short-term political risk rating of 78.1, down from a level of 86.7 in 2007, but by all means high compared to countries undergoing similar economic difficulties.

TABLE: VIETNAM POLITICAL OVERVIEW

System of Government	Single-Party Socialist Republic
Head of State	President Nguyen Minh Triet (serving first five-year term)
Head of Government	Prime Minister Nguyen Tan Dung (serving first five-year term)
Last Election	Parliamentary – May 2007 Communist Party Congress – April 2006
Composition Of Current Government	Communist Party of Vietnam
Key Figures	The 14-person Communist Party Politburo, elected by the 160-person party central committee at the national party congress, acts as the <i>de facto</i> highest decision-making body and comprises of the top leadership of the CPV. Its most important members are: Party General Secretary Nong Duc Manh, State President Nguyen Minh Triet, Prime Minister Nguyen Tan Dung and General Minister of Public Security Le Hong Anh.
Other Key Posts	Deputy Prime Minister – Nguyen Sinh Hung Foreign Minister – Pham Gia Khiem Minister of Planning and Investment – Vo Hong Phuc Vice President – Truong My Hoa Central Bank Governor – Nguyen Van Giau
Main Political Parties (number of seats in parliament)	Communist Party of Vietnam (CPV): Founded in Hong Kong in 1930, the CPV has been in power in North Vietnam since independence in 1954 and in the South since the end of the Vietnamese-American War in 1975. Divisions exist within the party between a younger more reform-minded faction originating from Southern Vietnam and an older generation, originating from the North, more aligned to traditionally communist ideology.
Next Election	Presidential and Parliamentary – May 2012 CPV Congress – Spring 2011
Ongoing Disputes	Ongoing dispute with China, Malaysia, the Philippines and Taiwan over Spratly Islands in South China Sea
Key Relations/ Treaties	ASEAN and WTO Member, Temporary seat (2008-2009) on the United Nations Security Council
BMI Short-Term Political Risk Rating	78.1
BMI Structural Political Risk Rating	53.8

Source: BMI

Foreign Policy

Hanoi's Increasing Assertiveness Carries Risks

Vietnam's relations with the US have been improving steadily since the early 1990s, with the two announcing the normalisation of diplomatic relations in July 1995. The relationship has since been a *quid pro quo*, with Washington granting Hanoi improved trade conditions, ultimately paving the way for Vietnam's accession to the World Trade Organisation (WTO) in January 2007, while the latter country has slowly edged closer to the US-aligned group of Asian states (Japan, South Korea and Taiwan), delineating the limits of China's growing geopolitical and military might. Military co-operation between Hanoi and Washington is still very tentative, due to the strong resentment towards the US still felt by many Vietnamese trailing back to US involvement in the Vietnam War ending in 1975.

Nonetheless, US naval vessels made calls at Vietnamese ports in 2007 and Vietnamese observers took part in a multinational naval exercise organised by the US Navy in June in the same year. We expect a continuation of the very gradual progress in military co-operation between Hanoi and Washington, with the latter supporting an upgrade of Vietnam's aerial and naval forces in order to check China's growing military superiority in the South China Sea.

US support was instrumental in allowing Vietnam to take a temporary seat in the UN Security Council (UNSC) on January 1 2008. The admittance of Vietnam into the Security Council has been an important feat for Hanoi, which is now eager to advance its position in world affairs. Vietnam chaired the Security Council in July 2008, dealing with the difficult issue of sanctions against Zimbabwe. Hanoi joined China, Russia, South Africa, Libya and Indonesia in opposing sanctions against President Robert Mugabe and Zimbabwe, arguing for a continuation of negotiations, mediated by South Africa, between Zimbabwe's ruling ZANU-PF and the opposition Movement for Democratic Change (MDC). This contrasts with Hanoi's position on sanctions against Iran, where it gave its support to extended sanctions on March 3. We foresee Vietnam continuing to take a stance in the UNSC similar to that of China and Russia, i.e. supporting efforts against international security threats but safeguarding the sovereignty of nations in matters of internal affairs.

Hanoi Sees US As Counterbalance Against China

The rapprochement between Hanoi and Washington has not been without controversy in the US, with the US Congress demanding an improvement of religious rights in Vietnam ahead of Hanoi's accession to the WTO. US pressure has resulted in a marked improvement for the many Buddhist and Catholic worshippers in Vietnam. The Vietnamese authorities, however, made it clear in March 2007 that their more relaxed attitude to religious worship should by no means be mistaken for increased leeway in questioning one-party rule by jailing Catholic priest Ngyuen Van Lu for eight years on charges of disseminating information to undermine the state.

Yet the crackdown on political dissidents in the second half of 2006 and first half of 2007 has not had a lasting effect on relations with the US. President George W. Bush lauded the steps taken to increase religious freedom in Vietnam after meeting Prime Minister

BMI VIEW

We foresee Vietnam continuing to raise its profile on both the regional and global stage through closer involvement with the Association of Southeast Asian Nations (ASEAN) and with the US. However, there is a risk that Vietnam's growing assertiveness and links with Washington will sour relations with China and complicate regional co-operation.

Nguyen Tan Dung in Washington on June 24 2008. Dung's visit to Washington was followed by an upgrade of USAID's presence in Vietnam to a full country mission, allowing the government agency to expand its development programmes in Vietnam.

Ultimately, Vietnam sees closer relations with the US as a means of balancing the rise of China. Although the 1979 Sino-Vietnamese border war now seems a distant memory, and although Vietnam has sought to emulate China's economic growth model, Hanoi still feels uncomfortable with Beijing's increasing influence in Asia and on the world stage. Vietnam and China are competing for influence in Cambodia and Laos, and dispute ownership of the Spratly Islands in the South China Sea. Thus, there is considerable scope for mistrust. Washington shares Hanoi's rising apprehension about China, and there is thus a coincidence of interests. In time, the US could foster the emergence of a *de facto* Japan-Vietnam-India security triangle aimed at curbing Chinese influence. That said, Vietnam is unlikely to enter a formal alliance such as this, since it does not wish to antagonise China unnecessarily.

Vietnam As A Regional Leader?

Relations with the US have not been the sole focus of Vietnamese foreign policy. Hanoi has in recent years advanced its participation in regional organisations such as the Asia-Pacific Economic Co-operation (APEC) forum and the Association of South East Asian Nations (ASEAN). Vietnam has also used these forums as a means to leverage its influence with regional powers such as China, Japan and South Korea (the so-called ASEAN + 3 dialogue partners).

Over the long term, once it achieves a certain material level of development, it is quite possible that Vietnam, with a population of 85mn people, will seek to become South East Asia's leading geopolitical power. It already has the largest armed forces in the region, with more than 400,000 troops. However, excessive assertiveness would rankle other aspiring regional powers, notably Thailand and Indonesia, leading to new tensions.

Hanoi As A Mediator For North Korea

Finally, Vietnam is in an almost unique position to mediate between North Korea and its antagonists. This is because Hanoi shares Pyongyang's communist ideology (at least nominally) and admires its 'anti-imperialist' stance, while North Korean leader Kim Jong Il is reportedly keen to learn from Vietnam how to modernise his economy without jeopardising one-party rule. Pyongyang may be more amenable to gentle persuasion from Hanoi rather than bowing to pressure from an overbearing Beijing. Moreover, Vietnam has built solid relations with South Korea in recent years, meaning that it communicates with both Korean capitals on a frequent basis. If Vietnam does eventually host Kim Jong Il, as some are speculating, and persuades him to emulate its reforms, this would be a major triumph for Hanoi's foreign policy.

chapter 2 Economic Outlook

SWOT Analysis

Strengths

- Vietnam has been one of the fastest-growing economies in Asia in recent years, averaging growth of 8.0% a year.
- The economic boom has lifted many Vietnamese out of poverty, with the official poverty rate in the country falling from 58% in 1993 to 20% in 2004.

Weaknesses

- Vietnam suffers from substantial trade, current account and fiscal deficits, leaving the economy vulnerable to external shocks. The fiscal picture is clouded by considerable 'off-the-books' spending.
- The heavily managed and weak dong currency reduces incentives to improve quality of exports, and also serves to keep import costs high, thus contributing to inflationary pressures.

Opportunities

- WTO membership has given Vietnam access to both foreign markets and capital, while making Vietnamese enterprises stronger through increased competition.
- The government will continue to move forward with market reforms, including privatisation of the state-owned enterprises sector, and liberalising the banking sector.
- Urbanisation will continue to be a long-term growth driver. The UN forecasts the urban population to rise from 29% of the population to more than 50% by the early 2040s.

Threats

- Inflation and deficit concerns have caused some investors to re-assess their hitherto upbeat view of Vietnam. If the government fails to curb inflation, it risks prolonging macroeconomic instability, which could lead to a potential crisis.
- Prolonged macroeconomic instability could prompt the authorities to put reforms on hold, as they struggle to stabilise the economy.

BMI Economic Risk Ratings

Vietnam's dong currency has stabilised around VND16,725/US\$ after trading at record lows of VND16,850/US\$ in late June and early July. At that time, non-deliverable forward contracts for the dong were pricing in depreciation of 26.7% in six months, and 32.7% over 12 months. Since then, the dong's forward contracts have recovered, and now envisage a drop of 7.7% and 13.0% in six and 12 months, respectively. Black market rates have also converged with the official exchange rate. This is encouraging, especially since the central bank stated on July 25 that it had not intervened in the currency markets since early June nor placed restrictions on the forex market.

	Short-Term Economic	Rank	Trend
Singapore	88.8	2	=
Hong Kong	86.5	5	=
Malaysia	85.2	7	=
Philippines	84.6	9	=
South Korea	82.9	12	=
China	80.8	17	=
India	80.8	17	=
Taiwan	80.2	19	=
Indonesia	77.3	25	=
Japan	76.0	31	=
Thailand	75.8	32	=
New Zealand	69.8	52	=
Australia	66.9	60	=
Cambodia	60.8	75	=
Pakistan	57.7	83	+
Vietnam	53.3	94	-
Bangladesh	47.3	110	=
Sri Lanka	34.0	126	=
Regional Average: 71.6	Emerging Market Average: 60.0	Global Market Average: 62.4	

	Long-Term Economic	Rank	Trend
Singapore	78.8	5	=
Taiwan	77.6	6	=
South Korea	76.8	9	=
Hong Kong	76.0	10	=
Malaysia	72.9	16	=
Australia	71.7	22	=
China	71.6	24	=
Thailand	70.3	28	=
Japan	68.5	35	=
New Zealand	68.0	36	=
India	67.4	39	=
Indonesia	67.4	39	=
Philippines	62.5	52	=
Pakistan	58.4	65	+
Vietnam	54.6	77	=
Bangladesh	53.4	80	=
Cambodia	49.6	92	=
Sri Lanka	47.0	98	=
Regional Average: 66.3	Emerging Market Average: 56.8	Global Market Average: 59.1	

Economic Activity

Slowdown To Sharpen In H208

Our core scenario is that Vietnam will experience a period of below-trend growth through 2008 and 2009 as it deals with rampant inflation and the underlying cause of abundant liquidity, but will avoid a larger balance of payments and economic crisis. The necessary cooling of the economy is evident in the freshly released H108 GDP estimate, which shows a deceleration in growth to 6.5% y-o-y compared to 7.91% y-o-y in H107. The slowdown was most marked in the construction sector, where expansion decelerated from 9.55% y-o-y in H107 to a near standstill of 0.9% y-o-y in H108 as the real estate market collapsed and credit conditions were tightened dramatically. Growth in the manufacturing sector held up better in H108, expanding by 11.4% y-o-y compared to 12.2% y-o-y in the same period last year.

On a more positive note, we foresee relatively higher prices of commodities such as oil, coal, rubber, coffee and rice compensating for some of the weakness of manufactured exports and lifting export growth for 2008 as a whole to a respectable 25%.

Service Sector Next To Be Hit

By subtracting the Q108 figures released in late March from the H108 GDP estimate, we find that the economic slowdown was more pronounced in the second quarter of the year, with Q208 GDP growth coming in at 5.8% y-o-y (quarter-on-quarter comparisons are not helpful due to the strong seasonal nature of data). This is in line with our revised 5.5% GDP forecast for this year, which also encompasses a more marked slowdown of the services sector in the second half of the year. The sector expanded by 7.6% y-o-y in H108, down from 8.5% in H107, but looks set for a sharper slowdown as tighter purse strings and stricter lending conditions cut into private spending.

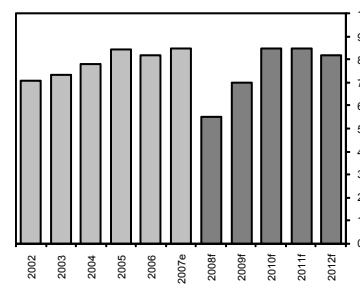
Policy Mistakes Risk To Recovery

There are, however, risks to this scenario, mainly in the form of policy mistakes from the government and central bank, which still do not appear to be fully committed to rooting out inflation at the cost of lower growth. Reports in state-run newspaper *Liberation Saigon* claim that the **State Bank of Vietnam** (SBV) is now contemplating cutting the base rate in

BMI VIEW

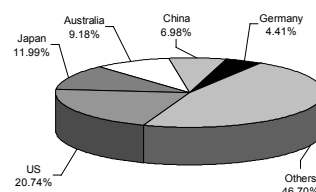
We are expecting the Vietnamese economy to decelerate further in H208, with full-year GDP growth coming in at 5.5% as high inflation and tighter lending conditions cut into domestic demand. We are expecting the economy to start to recover in 2009 with growth picking up towards the end of the year. Vietnam's robust macroeconomic fundamentals are likely to maintain Vietnam's status as an attractive investment destination over the longer term, underpinning growth in 2010 and 2011.

Dip In Growth Expected
Vietnam – Annual Real GDP Growth (%)



Source: BMI

Exposure To US Still High
Vietnam – Exports In 2006 By Destination



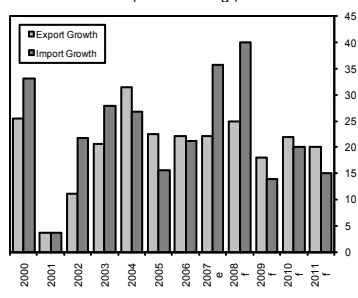
Source: IMF Direction of Trade Statistics

TABLE: VIETNAM – ECONOMIC ACTIVITY

	2005	2006	2007	2008f	2009f	2010f	2011f	2012f
Nominal GDP, VNDbn [2]	839,211	973,790	1,143,442	1,320,676	1,531,984	1,784,761	2,079,246	2,416,084
Nominal GDP, US\$bn [3]	53.05	60.99	71.38	77.69	95.75	118.98	144.39	172.58
Real GDP growth, % chg y-o-y [1,4]	8.4	8.2	8.5	5.5	7.0	8.5	8.5	8.2
GDP per capita, US\$ [3]	638	710	821	881	1,070	1,310	1,569	1,854
Population, mn [5]	85.02	85.90	87.00	88.20	89.50	90.84	92.00	93.10
Industrial prod index, % y-o-y, ave [2]	17.2	17.0	17.1	15.2	16.9	16.4	15.7	14.9
Unemployment, % of lab force, eop [2]	5.3	4.8	4.5	5.0	4.8	4.4	4.3	4.3

Notes: f BMI forecasts. 1 Constant 1994 prices; Sources: 2 General Statistics Office. 3 BMI calculation; 4 General Statistics Office, BMI calculation; 5 Asian Development Bank. As of July 1.

Sharp Slowdown
Vietnam – Export & Import Growth
(% annual chg.)



Source: BMI

BMI VIEW

The stabilisation of the dong has been aided by a dramatic improvement in the balance of payments, where the bulging trade deficit has been arrested by government measures to curb imports and boost the export sector.

August, when it is expecting inflation to be under control. We believe such a move would be premature and that the SBV will need to keep the key base rate at the present 14% until inflation has decelerated markedly and real interest rates are firmly in positive territory. We believe this will not be achieved until early 2009, meaning that tight monetary conditions will continue to be a drag on growth well into next year.

We are still forecasting an economic recovery in 2009, with growth picking up in the second half of the year as monetary conditions are eased and external demand improves. We foresee a new boom in foreign investment as economic conditions stabilise, which will give impetus to growth in 2010 and 2011. This is because Vietnam remains an attractive outsourcing destination for many Japanese, South Korean and Taiwanese firms seeking to maintain their cost competitiveness *vis-à-vis* emerging Chinese rivals. The interest in Vietnam is still strong among foreign groups, such as banks and retailers, looking to get an early foothold in the emerging Vietnamese consumer market. This will lay the ground for a continued rapid economic expansion over 2012-2017 as Vietnam takes its place on the regional stage.

Balance Of Payments

Dramatic Improvement In BoP Expected In H208

Vietnam's ballooning trade deficit has its origin in the country's accession to the World Trade Organisation (WTO) in January 2007. The gradual removal of trade barriers has opened up the Vietnamese market for imported goods that are often both superior and more competitively priced than locally produced alternatives. The lifting of trade barriers has also sparked an increase in imports of input and investment goods as the Vietnamese export sector has gained a better access to important overseas markets. The expansion of the exports sector has thus far lagged import growth, resulting in a 138% increase in the trade deficit to US\$12.6bn in 2007.

The trade deficit widened further in Q108 as imports increased by 75% y-o-y. The underlying factor behind this was the growing concern about inflation and the value of the dong, which prompted Vietnamese to convert their domestic currency holdings into gold, automobiles and other assets, and companies to frontload imports of steel, machinery and other investment goods. Gold imports alone amounted to US\$2.7bn in January through May, making Vietnam the largest gold importer in the world after India. The government

TABLE: VIETNAM – BALANCE OF PAYMENTS

	2004	2005	2006	2007	2008f	2009f	2010f	2011f	2012f
Exports, US\$bn [1,5]	26.48	32.44	39.60	48.39	63.87	75.37	91.95	110.34	132.41
Imports, US\$bn [1,5]	32.00	36.98	44.83	60.83	85.16	97.08	116.50	133.98	154.07
Trade balance, US\$bn [2,5]	-5.52	-4.54	-5.23	-12.44	-21.29	-21.72	-24.55	-23.64	-21.67
Current account, US\$bn [5]	-1.56	-0.50	-0.16	-6.00	-13.00	-8.00	-9.00	-7.00	-5.00
Current account, % of GDP [6]	-3.44	-0.94	-0.27	-8.41	-16.73	-8.36	-7.56	-4.85	-2.90
Forex reserves (- gold), US\$bn [3,7]	7.04	9.05	13.38	22.00	20.00	23.00	27.00	31.00	37.00
Import cover, months g&s [6]	2.6	2.9	3.6	4.3	2.8	2.8	2.8	2.8	2.9

Notes: f BMI forecasts. 1 Goods f.o.b.; 2 Goods f.o.b. minus f.o.b.; 3 Foreign reserves minus gold; 4 Global assumptions correct when forecasts generated.; Sources: 5 General Statistics Office. 6 BMI calculation; 7 Asian Development Bank; 8 OPEC.

has consequently moved to raise taxes on car imports and banned gold imports altogether in late June. These measures have clearly had some traction as monthly imports have fallen from US\$8.3bn in April to US\$7bn in July, with the drastic tightening of monetary policy in May and June also contributing to the reduction.

However, the more import factor behind the dramatic improvement in the trade account in the second and third quarter – the monthly trade deficit narrowed from US\$3.2bn and US\$3.3bn in March and April to US\$736mn and US\$800mn in June and July, respectively – has been the rapid increase in exports. Government measures helped boost exports by 46.9% y-o-y in Q208, with the export growth figure rising further to 53.7% in July on the back of high prices of key commodities such as oil, coal, rice and coffee.

We anticipate the trend of robust exports and weakening imports to continue through H208 as monetary and fiscal tightening reins in domestic demand growth, and we have now trimmed our forecast for the full-year trade deficit in 2008 from US\$24.8bn to US\$21.3bn. The **State Bank of Vietnam** has estimated remittances to come in at approximately US\$8bn in 2008, leaving the current account deficit at approximately US\$13bn, equivalent to a blistering 16.7% of GDP.

With inflows on the financial account in the form of foreign direct investment (FDI) and official development assistance (ODA) showing unexpected strength, we believe Vietnam's overall balance of payments situation will be considerably better in H208. FDI disbursements have been estimated at US\$11bn in 2008 by the Vietnamese Foreign Investment Agency and we expect foreign portfolio inflows to add US\$1bn to this figure. The current account deficit should therefore be well-covered and the rundown in Vietnam's foreign-exchange reserves will only have been marginal over the year.

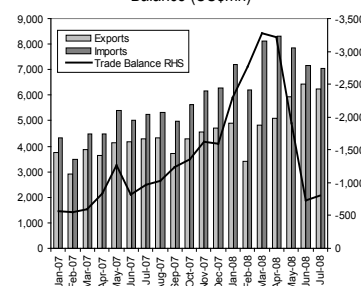
Exchange Rate Policy

Still Too Soon To Ease Policy

The Vietnamese dong dropped to VND16,600/US\$ in early August as the **State Bank of Vietnam** (SBV) intervened to halt the currency's recent appreciation on fears that a stronger dong would impair the ongoing improvement in the trade account. We foresee further intervention as SBV Governor Nguyen Van Niau stated on August 12 that '[t]he State Bank will continue to manage the exchange rate with flexibility based on the market situation and maintain relative stability of the rates in order to promote exports and limit imports,' on the government's website.

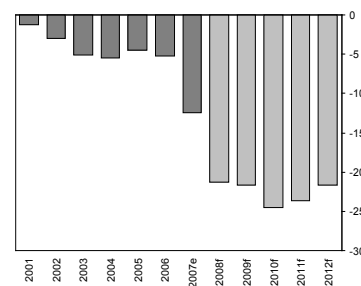
The dong hit a record low of VND16,850/US\$ at the end of June when non-deliverable forwards were pricing in a depreciation of the currency of up to 30% over the next six months as Vietnamese lost faith in the dong and rushed to put their savings in US dollars, gold and other more reliable assets. We regarded those fears as somewhat overblown at the time as consumer price figures were indicating a stabilisation of inflation. Moreover, the Vietnamese authorities tightened monetary policy through a cumulative 525bps of rate hikes implemented in May and June, which served to inject some confidence that the government was taking the threat of inflation seriously.

Government Measures Turn Tables
Vietnam – Monthly Exports, Imports and Trade Balance (US\$m)



Source: BMI

Trade Deficit Stabilising
Vietnam – Trade Balance (US\$bn)



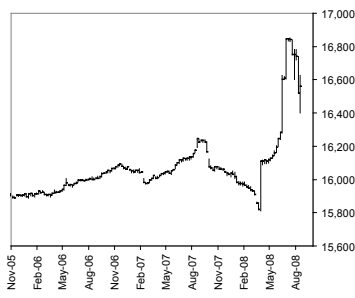
Source: BMI forecasts

BMI VIEW

The Vietnamese government will continue to cap the appreciation of the dong as the rapid improvement in the trade account and continued FDI inflows put upward pressure the currency. We anticipate further government measures to keep the dong stable in H208 and are forecasting the unit to stand at VND17,000/US\$ by year-end, although considerable downside risks remain.

Central Bank Halts Appreciation

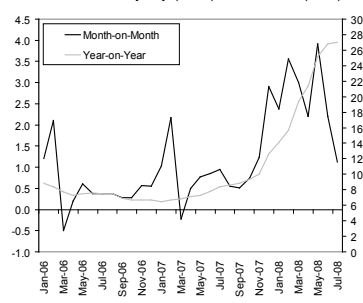
Vietnam – Exchange Rate, VND/US\$



Source: BMI

Inflation Peaks

Vietnam – CPI y-o-y (RHS) and m-o-m (LHS)



Source: General Statistics Office

Consumer price inflation has indeed continued to stabilise in recent months, with the month-on-month (m-o-m) figure falling to a nine-month low of 1.13% in July, although the fuel price hike implemented at the end of July is likely to see the m-o-m figure rising in August (Vietnam releases inflation estimates at the end of each month). We expect inflation to peak at 30.7% y-o-y in September and then start falling with our end-2008 forecast currently standing at 26.4%.

With the government and central bank carefully weighing their twin priorities of reducing inflation and avoiding a sharp slowdown of growth, we believe the SBV will maintain a cap on currency appreciation in H208, in particular if the US dollar maintains its recent strength against the euro and other key global currencies. We have, nevertheless, raised our end-2008 target for the Vietnamese dong from VND18,000/US\$ to VND17,000/US\$. Considerable risks to the downside remain in the form of a rapid appreciation of the US dollar, a new bout of risk aversion towards Vietnam as inflation spikes in August and the possibility that the Vietnamese government may prematurely ease monetary policy in order to cushion growth.

SBV To Keep Rates On Hold

We believe the SBV will be obliged to keep the policy rate at the current 14% well into 2009 in order to bring real interest rates back towards positive territory. We do not preclude the possibility of another rate hike, if investor and popular sentiment towards the dong takes another turn to the worse, but this is not our core scenario. Comments from SBV officials in Q308 have, however, indicated that the SBV still holds a dovish bias and could move to cut rates in Q408 or early 2009 as inflation starts falling.

This would carry the risk of driving up inflation expectations and thus keeping inflation in double digits during a longer period. This in turn would insert a higher degree of uncertainty about prices, weighing on growth in the economy. We nevertheless believe that the SBV's apparent inclination to bring down inflation gradually over the next 18 months may indeed be the wisest option. Rapidly bringing inflation back into single digits from its current level of close to 30% y-o-y would entail considerable downside risks to our GDP growth forecasts of 5.5% and 7.0% for 2008 and 2009, respectively. A sharper deceleration in growth of such sorts would carry risks both to political and macroeconomic stability and thus inhibit foreign direct investment inflows, which are vital for long-term growth. Our core scenario is thus that the SBV will keep the base interest rate at 14% for the remainder of 2008 and only start cutting rates well into 2009 as real interest rates approach positive territory.

TABLE: VIETNAM – EXCHANGE RATE POLICY

	2005	2006	2007	2008f	2009f	2010f	2011f	2012f
Lending rate, %, eop [1,5]	11.03	11.00	10.70	10.10	9.70	9.40	9.30	9.50
Real Lending Rate, %, eop [1,6]	2.73	3.56	2.40	-17.50	-8.30	1.60	4.10	4.20
Consumer prices, % y-o-y, eop [2,7]	8.4	6.8	12.6	26.4	12.0	5.5	5.0	5.5
Consumer prices, % y-o-y, ave [3,7]	8.3	7.4	8.3	27.6	18.0	7.8	5.2	5.3
Exchange rate VND/US\$, eop [5]	15,913	16,072	16,018	17,000	16,000	15,000	14,400	14,000
Exchange rate VND/US\$, ave [5]	15,859	16,017	16,045	16,509	16,500	15,500	14,700	14,200
Exchange rate VND/EUR, eop [6]	18,777	21,209	23,386	25,330	21,760	19,800	19,008	18,060
Forex reserves (- gold), US\$bn [4,8]	9.05	13.38	22.00	20.00	23.00	27.00	31.00	37.00
Import cover, months g&s [6]	2.9	3.6	4.3	2.8	2.8	2.8	2.8	2.9

Notes: f BMI forecasts. 1 Annual average; 2 1995=100; 3 The Oxford Economic Forecasting model is used when generating certain forecasts.; 4 Foreign reserves minus gold; Sources: 5 IMF. 6 BMI calculation; 7 General Statistics Office; 8 Asian Development Bank.

Banking Sector

Banking Sector To Remain Intact

Fears have been raised about the health of the Vietnamese banking sector as the government's sharp tightening of monetary policy and continued restrictions on rate-setting are straining the income and balance sheets of commercial banks. Nevertheless, the interest among foreign players to enter the burgeoning Vietnamese banking market remains firm. Here, we outline some of the main features and risks of the Vietnamese banking sector.

Central bank Governor Nguyen Van Giau stated in early June that the authorities had received 53 applications to establish new banks, 30 of them from foreign institutions. This reveals a continued strong interest in entering the Vietnamese retail banking market among both domestic and foreign players. Consultancy **McKinsey** has forecast that revenue in the Vietnamese retail banking sector will increase by more than 25% annually in the next five to 10 years, underpinned by strong growth and an increased banking penetration.

Vietnam is still a largely unbanked country as most Vietnamese rely on their extended family and neighbourhood associations for their savings and borrowing needs. Only 8-10% of the population use banks for financial services at present, but this figure is rising as younger Vietnamese are more prone to use banks for financial services.

Private and semi-private so-called joint-stock commercial banks (JSCBs) and foreign bank branches continue to expand their participation in the Vietnamese banking market at the expense of the large state-owned commercial banks (SOCBs), which still control roughly two thirds of banking assets. Their market share has, however, been diminishing as JSCBs and foreign banks have expanded their retail branches and increased lending to small- and medium-sized enterprises (SMEs) and households. The scramble for market shares resulted in lax lending practices, which have now exposed some of the JSCBs to rising credit risks as the **State Bank of Vietnam** (SBV) has raised interest rates.

Foreign-invested banks have fared better through Vietnam's macroeconomic woes. Firstly, they have generally been focused on 100% foreign-owned companies, which have been less impacted by high inflation and the drastic tightening of monetary policy thanks to their focus on export markets and access to foreign capital. Secondly, foreign-invested banks have been more prudent in their lending to Vietnamese SMEs and households. Thirdly, foreign-invested banks have largely escaped the stringent demands put on domestic banks by the state authorities.

The government has pledged to focus on curbing inflation in 2008, but has still been wavering in its policymaking as a sharper slowdown in growth would carry risk for overall political stability. The ensuing uncertainty about the direction of policy rates and overall monetary policy has complicated the operating environment for Vietnam's banks. While further interest rate hikes looked likely following the SBV's decision to raise the base rate from 12% to 14% on June 10, only weeks after it upped it by 325bps, the SBV is now signalling that it will not hike rates further and has even indicated that it might lower rates in August as inflation starts to abate. Moreover, the SBV has maintained a high degree of control of the banking sector by setting targets for credit growth (at 30% in 2008) and by limiting interest rates on deposit and lending to 150% of the SBV's base rate.

BMI VIEW

We continue to see opportunities for foreign investors in the Vietnamese banking sector in spite of the recent macroeconomic turbulence. We find it likely that some of the smaller domestic banks will collapse on the back of increased defaults among debtors and insufficient capital, but that the general health of the sector will be maintained. The current strains on the banking sector and the possibility that the government will relax foreign investment restrictions may in fact provide foreign investors with an unprecedented opportunity to enter the Vietnamese market.

Commercial banks, faced with a continued shortage of capital, have competed for deposits by raising deposit rates to 18-20%, squeezing profit margins to a minimum of 1-3pps. Nevertheless, with real interest rates negative and the public's confidence in the dong wavering, bank capital only increased by a couple of percent in May and June as clients opted for buying US dollars, gold and other capital goods as a hedge against inflation and a possible devaluation of the currency. The shortage of capital among domestic banks is thus not likely to disappear any time soon. The SBV has now demanded that commercial banks lower their deposit rates in order to check the race in offered interest rates, fearing that the fierce competition for deposits will put banks at risk of default.

We share this view and see the risk as being most elevated among the smaller JSCBs, established in recent years. Arriving late to the market, they expanded their business through a high degree of lending to real estate and security investment when both markets were booming in 2006 and 2007. These banks are now paying for this extravaganza as the sharp fall of both markets is gradually translating into increased non-performing loan (NPL) ratios. The evidence of this is so far largely anecdotal as most banks are still declaring NPL ratios of 1-3% of outstanding loans disclosed. We believe the actual ratios could be higher as disclosure of bank figures is lacking.

Progress is, however, being made in the transparency of the Vietnamese banking sector. The SBV has asked commercial banks to begin applying internal credit rating schemes and debt classification systems in accordance with international standards as of June 2008, but only a handful of banks have been applying these new standards. This is because the application of the new standards is likely to result in an increase in disclosed NPL ratios of up to 2-3 times according to consultancy **Ernst & Young**. This would require the reporting bank to set aside more capital for bad debt provisions, thus reducing the available funds for lending. While this may weigh on profits, the reported results of the main JSCBs have been respectable in H108.

We still believe there are underlying problems in the Vietnamese banking sector, especially among the smaller more recently established players. These are likely to be disclosed in H208 at the same time as the banking sector is likely to be hit by an imposed slowdown in lending. Credit growth increased by 19.99% in the first six months of 2008 and brakes on lending will have to be applied in H208 in order to keep full-year credit growth below 30% as pledged by the SBV. It remains to be seen how committed the SBV is to this target and it is not unlikely that it will lift restrictions on lending if inflation starts falling in H208.

An easing of government and monetary policy is, however, unlikely to prevent the demise of some of the smaller JSCBs. The SBV has already refuted rumours that it is to put some JSCBs under special supervision. We find it likely that the SBV will have to intervene to recapitalise some of the smaller players in the market while others, in better conditions, will be snapped up by bigger rivals or even be saved by foreign banks seeking a quick entry into the market. We do not find it unlikely that Hanoi will, in fact, relax restrictions on foreigners owning domestic banks in a bid to attract foreign capital to shore up the banking sector.

The Vietnamese Economy To 2017

A Bumpy Road To Stardom

Vietnam's emergence as one of the most promising economies in Asia, if not the world, stems largely from the Communist Party of Vietnam (CPV)'s adoption of market reform policies in 1986. The gradual but steady shift from a largely agrarian country with a high degree of state ownership and government intervention, to a bustling market economy has stimulated the flow of foreign investment and domestic entrepreneurship, which are now the prime drivers of growth.

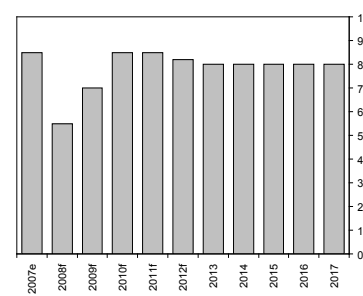
The attractions of Vietnam to foreign, as well as domestic, investors are clear, and include the large, and young population, eager to work hard to improve its lot and open to foreign influences after decades of ineffective ideological indoctrination. Vietnam has enjoyed a growing inflow of direct investment into its fledgling manufacturing sector in recent years as its accession to the WTO in 2007 and low labour costs have made it an attractive outsourcing destination for apparel manufacturers and electronics producers. The development of the foreign-owned manufacturing sector has been spearheaded by Japanese, South Korean and Taiwanese firms, which have become increasingly wary of rising costs of labour on the Chinese mainland, as well as the risks of becoming overly dependent on Beijing in their supply chains.

Continued strong foreign investment into the manufacturing sector will remain the prime driver of growth over the next 10 years, and we foresee Vietnam moving up the value-added chains as the advantages of sourcing production in the country become apparent for a wider range of manufacturing firms. This is evident in the ascent of the Vietnamese electronics sector, which virtually doubled its overseas sales between January 2007 and June 2008. The sector is now emerging as a vital complement to textiles and apparel as primarily Taiwanese manufacturers are moving an increasing share of their operations to Vietnam. The manufacturing sector currently contributes around 25% of GDP, but we see this figure rising to 34% by 2013 and further towards 40% by 2017.

BMI VIEW

We remain positive about Vietnam's growth prospects over the next 10 years, believing that the macroeconomic woes of 2008 will have been a useful exercise for a government still inexperienced in managing a market economy. Policymaking will continue to be crucial as the government strives to clear bottlenecks in infrastructure without overheating the economy, a vital condition for our forecast that Vietnam will maintain GDP growth at approximately 8% annually over the next 10 years.

Growth To Recover
Vietnam – Annual Real GDP Growth (%)



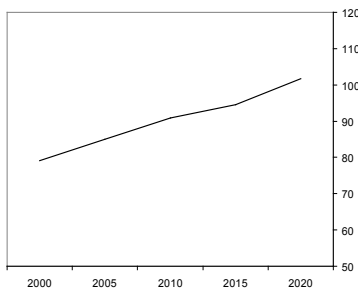
Source: BMI

TABLE: VIETNAM LONG-TERM MACROECONOMIC FORECASTS

	2010	2011	2012	2013	2014	2015	2016	2017
Nominal GDP, US\$bn [3]	118.98	144.39	172.58	200.19	232.22	269.38	312.48	362.47
Real GDP growth, % change y-o-y [1,4]	8.5	8.5	8.2	8.0	8.0	8.0	8.0	8.0
Population, mn [5]	90.84	92.00	93.10	94.20	95.30	96.47	97.60	98.70
GDP per capita, US\$ [3]	1,310	1,569	1,854	2,125	2,437	2,792	3,202	3,672
Consumer prices, % y-o-y, ave [2,6]	7.8	5.2	5.3	4.8	4.8	4.5	4.0	3.7
Current account, % of GDP [3]	-7.56	-4.85	-2.90	1.50	2.15	3.34	4.48	4.69
Exchange rate VND/US\$, ave [7]	15,500	14,700	14,200	14,000	13,500	13,000	12,000	11,000

Notes: f BMI forecasts. 1 Constant 1994 prices; 2 The Oxford Economic Forecasting model is used when generating certain forecasts.; Sources: 3 BMI calculation. 4 General Statistics Office, BMI calculation; 5 Asian Development Bank. As of July 1; 6 General Statistics Office; 7 IMF.

Vietnam To Enter 100 Million Club
Vietnam – Population



Source: UN World Population Prospects, 2006 Revision

BMI's long-term macroeconomic forecasts are based on a variety of quantitative and qualitative factors. Our 10-year forecasts assume in most cases that growth eventually converges to a long-term trend, with economic potential being determined by factors such as capital investment, demographics and productivity growth. Because quantitative frameworks often fail to capture key dynamics behind long-term growth determinants, our forecasts also reflect analysts' in-depth knowledge of subjective factors such as institutional strength and political stability. We assess trends in the composition of the economy on a GDP by expenditure basis in order to determine the degree to which private and government consumption, fixed investment and the export sector will drive growth in the future. Taken together, these factors feed into our projections for exchange rates, external account balances and interest rates.

The continued ascent of the manufacturing sector will bolster export growth over the coming 10-year forecast period, although at a slower pace than the 23.8% average annual expansion recorded between 2003-2007. We foresee export growth stabilising at around 15% annually in 2013-2017 as growing manufacturing exports offset the decline of the commodities sector, where opportunities for growth are constrained by dwindling oil reserves and limitations to expanding coffee and rice production.

Import growth, on the other hand, is likely to abate past 2010 as public infrastructure investment peaks and Vietnam sources a greater share of steel and other investment goods internally. Moreover, a larger proportion of imports will be of consumer goods and it will be vital for Vietnam to prove that it can cost-efficiently produce automobiles, mobile phones and other more capital-intensive consumer goods increasingly demanded by the population.

We see annual import growth falling to around 10% beyond 2010, below the expansion of the export sector, which will be conducive to a turnaround in the trade account. We are currently forecasting Vietnam's trade deficit to peak at US\$24.3bn in 2011 before gradually diminishing and flipping to a surplus towards the end of our 10-year forecasting period. Meanwhile, we see remittances from Vietnamese expatriates, estimated at US\$8bn in 2008 by the **State Bank of Vietnam**, stabilising at US\$10-15bn annually over 2010-2017, meaning that the Vietnamese dong will be under considerable pressure to appreciate towards 2015-2017.

We believe the Vietnamese authorities will have taken heed of the dangers of shackling monetary policy to managing the value of the dong and deliver on its pledges to move towards full convertibility of the dong. The Vietnamese government will, nevertheless, keep a close eye on the dong and only allow a gradual appreciation of the currency in order to balance the twin priorities of growth and inflation. We see the dong moving to VND14,000/US\$ by 2012 and further to VND11,000/US\$ by 2017. Central bank intervention to stem further dong appreciation will see Vietnam's foreign-exchange reserves rising from the present US\$20bn to US\$65bn by 2017.

Key Risks: Inflation, Infrastructure And Education

An appreciating currency will dampen inflationary pressures and we foresee consumer price inflation stabilising at around 5% annually from 2011 onwards, although this will be conditional on the government resolving bottlenecks in infrastructure and power supply. Vietnam's limited road, rail and port capacity is still putting it at a disadvantage compared to China when it comes to foreign investment in export-focused manufacturing. Moreover, the rising divide between demand and supply of energy and resulting power cuts, is a key threat to both growth and inflation. Energy policy is an area that will have to be addressed with more resolve than at present, as the government has impaired investment in power generation by its reluctance to expose state-owned EVN to competition.

Continued reform of the economy through the ongoing 'equitisation' process of raising efficiency at state-owned enterprises and transferring ownership to private hands will also be required to maintain annual GDP growth at 8%, as well as a concerted effort to improve standards at all levels of the education system. Skilled staff are become increasingly difficult

to find, resulting in upward pressure on wages and increased costs for firms, particularly in the fledgling financial sector. Vietnam will need to increase the number of high-standard university graduates in areas such as finance and science if it wants to avoid becoming trapped in low-value manufacturing.

Mega-Urban Regions

Investment Opportunities And Risks

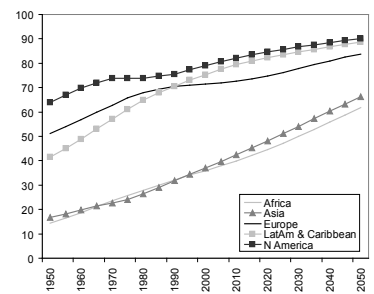
- As the world's urbanisation gathers pace, megacities and 'mega-urban regions' will become increasingly important drivers of the global and national economies.
- Significantly, most of the megacities will be in emerging market states, with the bulk of urban population growth between now and 2050 coming in Asia (1.8bn) and Africa (900mn).
- Urbanisation offers major opportunities, in terms of raising economic productivity, creating demand for new infrastructure, goods and services, and generating wealth.
- However, rapid urbanisation can also bring dramatic change, posing considerable dangers to social and political stability. A failure to address inequalities could lead megacities to become giant slums.
- Urbanisation is not irreversible. Some cities can and will go into decline, either in absolute or in relative terms.

Urbanisation is one of the major mega-trends of the 20th and early 21st centuries, and will continue to be a major driver of economic growth for decades to come, especially in emerging nations. According to the UN, the year 2008 will mark the first time in human history that more of the world's population will live in urban areas than in the countryside.

Equally significantly, over the next 42 years to 2050, the world's urban population will increase by 3.1bn people, with the majority of this growth in Asia (1.8bn) and Africa (900mn). By contrast, urban populations in the rest of the world will remain stable in percentage terms, albeit increasing only marginally in absolute terms. (The definition of urban areas varies from country to country, but in the UK census of 2001, these were defined as settlements with more than 1,500 people in England and Wales. In Nigeria, the definition is towns with more than 20,000 people, engaged mostly in non-agricultural work. Regardless of definitions, it is clear that urbanisation is progressing.)

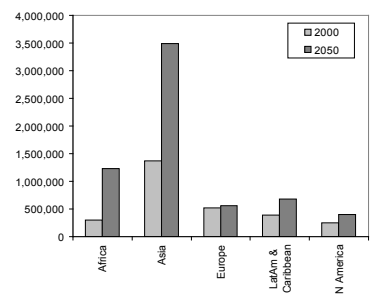
With cities becoming ever larger, through physical expansion into the surrounding countryside, absorption of hitherto satellite towns and mergers with neighbouring settlements, it is increasingly common nowadays to speak of 'megacities' – cities with more than 10mn people – or indeed mega-urban regions – urban corridors that contain tens of millions of people. These mega-regions are now more populous than many countries and have assertive political leaders – some of whom are increasingly conducting their own foreign policies. Furthermore, rivalry between cities is becoming more intense, forcing them to improve

Coming To Town
Urbanisation Rates By Region (%)



Source: UN World Urbanization Prospects: The 2007 Revision

Asia And Africa Are The Main Drivers
Urban Population By Region ('000s)



Source: UN World Urbanization Prospects: The 2007 Revision

their competitiveness. For example, Tokyo, Shanghai, Beijing, Hong Kong, Seoul and Mumbai are all aspiring to be the dominant Asian financial centre of the 21st century, and a similar rivalry is underway in the Gulf between Dubai, Abu Dhabi, Qatar, Bahrain and King Abdullah Economic City.

The Historical Context

Cities have historically been major economic drivers, regardless of changes of governments, national borders, or in some cases even the disintegration of empires. Many cities have existed for longer than most countries. For example, present-day Istanbul has existed for around two thousand years, first as Byzantium, and later Constantinople, before adopting its present name in 1930. Similarly, Rome and Baghdad have survived many incarnations of their national polity, while Mexico City previously existed as the Aztec capital Teno-

TABLE: THE WORLD'S 30 LARGEST URBAN AGGLOMERATIONS

2005			2025		
Rank	Urban Agglomeration	Popn (mn)	Rank	Urban Agglomeration	Popn (mn)
1	Tokyo	35.327	1	Tokyo	36.400
2	Mexico City	18.735	2	Mumbai	26.385
3	New York-Newark	18.732	3	Delhi	22.498
4	Sao Paulo	18.333	4	Dhaka	22.015
5	Mumbai	18.202	5	Sao Paulo	21.428
6	Delhi	15.053	6	Mexico City	21.009
7	Shanghai	14.503	7	New York-Newark	20.628
8	Kolkata	14.282	8	Kolkata	20.560
9	Dhaka	12.576	9	Shanghai	19.412
10	Buenos Aires	12.553	10	Karachi	19.095
11	Los Angeles-Long Beach	12.307	11	Kinshasa	16.762
12	Karachi	11.553	12	Lagos	15.796
13	Cairo	11.487	13	Cairo	15.561
14	Rio de Janeiro	11.469	14	Manila	14.808
15	Osaka-Kobe	11.258	15	Beijing	14.545
16	Manila	10.761	16	Buenos Aires	13.768
17	Beijing	10.717	17	Los Angeles-Long Beach	13.672
18	Moscow	10.416	18	Rio de Janeiro	13.413
19	Paris	9.852	19	Jakarta	12.363
20	Seoul	9.825	20	Istanbul	12.102
21	Istanbul	9.709	21	Guangzhou	11.835
22	Jakarta	8.843	22	Osaka-Kobe	11.368
23	Chicago	8.820	23	Moscow	10.526
24	Lagos	8.767	24	Lahore	10.512
25	London	8.505	25	Shenzhen	10.196
26	Guangzhou	8.425	26	Chennai	10.129
27	Lima	7.747	27	Paris	10.036
28	Tehran	7.653	28	Chicago	9.932
29	Bogota	7.353	29	Tehran	9.814
30	Shenzhen	7.233	30	Seoul	9.738

Source: UN World Urbanization Prospects: The 2007 Revision

chtitlan. In fact, at various times the world has seen many city-states emerge, principally as trading hubs. Some of these, such as the Venetian Republic, became major political powers in their own right.

While the role of cities as economic engines is nothing new, the present mass-urbanisation drive, which began in Britain in the 19th century, has been on a scale never seen before. For example, at its height in the first century AD, Rome's population was about 1mn, but the world's largest urban agglomeration today, Tokyo-Kawasaki-Yokohama, houses 35.7mn people.

In addition, urbanisation has primarily become a developing world phenomenon. In 1950, the world's biggest cities were all in the developed world, but now the bulk of them are in emerging nations. This is hardly surprising, since emerging markets are the ones playing catch-up.

Are Megacities Sustainable?

All this begs the question of whether today's mega-urban regions are sustainable. In our view, the answer is not a question of size but of management. Although Tokyo has 35.7mn people, its citizens generally have a high standard of living. However, large South Asian megalopolises such as Mumbai and Dhaka have such vast slum populations and extreme congestion that the sustainability of their expansion must be called into doubt.

On the other hand, if governments successfully build the necessary infrastructure and reduce poverty, then cities such as Dhaka could eventually become more prosperous. Overall, let us just say that few people living in London or Tokyo 200 years ago could have imagined that in the early 21st century, the cities would respectively have 8mn and 35.7mn people.

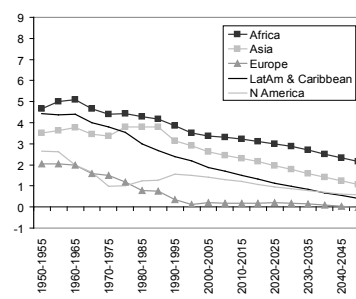
That said, we also emphasise that urbanisation may not necessarily be inevitable, and many countries will remain predominantly rural for some decades yet. Indeed, even in highly urbanised countries, the trend is not irreversible. The UN's projections show Europe's annual rate of urban population growth slowing to virtually zero in the next few decades, before shrinking in 2045-2050.

The Economic Implications Of Urbanisation

Structural economic changes: Urbanisation typically results in a shift from agrarian dominance of the economy to industrial activities and services. The latter two tend to be significantly higher-productivity activities, meaning that the overall productivity level in the economy increases sharply. Meanwhile, as farmers move to cities, and as cities encroach upon farmland, the contribution of agriculture to GDP inevitably shrinks. This is a key reason why many emerging markets are currently experiencing food supply problems, and why soft commodities have surged recently. Furthermore, agriculture is often forced to shift from subsistence farming to mechanisation, as fewer workers are available to toil the land.

Massive demand for new housing: The most obvious consequence of migration from the countryside to cities is a demand for new homes, and this initially leads to the creation

Still Rapid, But Slowing Down
Urban Population Annual Growth Rate (%)



Source: UN World Urbanization Prospects: The 2007 Revision

of shanty towns, as newcomers are forced to build *ad hoc* houses on the urban periphery. Over many years, as shanty residents become richer, they can upgrade their homes (perhaps even building a second storey), or move to wealthier areas. Either way, the demand for new homes often leads to a property bubble, and this is being seen in many emerging market cities worldwide.

Massive demand for new infrastructure: The emergence of new settlements inevitably creates demand for power generation, and ideally sewage treatment facilities (although in practice, many third world governments fail to provide this). In addition, the arrival of new workers will necessitate the construction of new roads and railways, both within the city and between the city and the countryside. Despite living in poor accommodation, new urban residents often initially have high birth rates, creating demand for new schools. Obvious sectors to benefit from all this include cement, steel, copper (for wiring), construction machinery and vehicles (trains, buses, etc.). Thus, infrastructure presents major opportunities for the world's leading engineering and construction firms.

Creation of mass markets for goods and services: The concentration of millions (or tens of millions) of people makes it much easier for companies to distribute goods and services. Thus, urbanisation leads to the creation of mass markets, and allows for economies of scale, as goods are transported in bulk to consumers. Retailers setting up new outlets typically need to determine catchment areas, and the more concentrated the population, the more viable a new store becomes. Mass distribution is much more difficult in the countryside, where the population is scattered far and wide, and infrastructure may be poor.

Changing spending patterns: Urbanisation typically leads to a change in spending patterns, as people move away from subsistence farming and have to buy their own food. A move to the cities also usually means that people no longer work on their land or in their homes, and may have to commute long distances to their workplaces. Consequently, in many emerging market cities, spending on transportation takes up a good chunk of monthly wages, often not far behind food. In addition, urban consumers are often wealthier and more sophisticated, presenting major opportunities for global brand manufacturers. Furthermore, there is also typically a major expansion of banking services, as the economy and society become more sophisticated.

Specialisation of functions: The coming together of millions of people of different skills sets allows for the specialisation of economic activities. Despite the telecommunications revolution, business people still like to be close to other business people, for face-to-face meetings and exchanges of ideas. Thus, some cities will develop a core industry and become renowned for this. For example, the US city of Detroit became a major car manufacturing centre, while more recently, India's Bangalore has emerged as a key IT hub. However, overdependence on a dominant industry can also cause a city to slide into long-term decline, if the industry collapses and new enterprises fail to fill the void. The US cities of Pittsburgh, Cleveland and St Louis have all fallen in national significance, while newer cities like Phoenix and Austin have risen in importance thanks to new industries and services.

Social mobility: The concentration of economic activities leads to greater competition, and more scope for upward social mobility. Certainly, there are more opportunities for

personal economic improvement in cities than in the countryside, where the main activity is farming. However, there is also downward mobility or stasis, as people struggle to progress from the slums. There is a risk that some slum dwellers will be caught in a poverty trap for years.

Suburbanisation: Rising urban income levels in the more advanced emerging markets and the desire to escape congestion typically lead to suburbanisation, as happened in the UK in the 1930s and the US in the 1950s. In fact, suburbanisation is typically the next stage after urbanisation, although the two can go hand in hand. At present, suburbanisation is a major trend in China, as newly rich Chinese move out of over-crowded cities to bigger, more spacious accommodation with green space. In fact, many new Chinese suburbs are consciously modelled on their counterparts in affluent parts of southern California, even adopting US-style names (e.g. 'Emerald Riverside', outside Shanghai). This is creating a culture of new shopping malls and driving, thus leading to a higher demand for cars – and thus oil.

TABLE: THE WORLD'S RICHEST CITIES IN 2020 BY GDP

Rank	City/Urban area	Country	Estimated GDP in 2020 in US\$bn	Estimated annual growth 2006-2020
1	Tokyo	Japan	1,602	2.0%
2	New York	US	1,561	2.2%
3	Los Angeles	US	886	2.2%
4	London	UK	708	3.0%
5	Chicago	US	645	2.3%
6	Paris	France	611	1.9%
7	Mexico City	Mexico	608	4.5%
8	Philadelphia	US	440	2.3%
9	Osaka/Kobe	Japan	430	1.6%
10	Washington DC	US	426	2.4%
11	Buenos Aires	Argentina	416	3.6%
12	Boston	US	413	2.4%
13	Sao Paulo	Brazil	411	4.1%
14	Hong Kong	China	407	3.5%
15	Dallas/Fort Worth	US	384	2.4%
16	Shanghai	China	360	6.5%
17	Seoul	South Korea	349	3.2%
18	Atlanta	US	347	2.6%
19	San Francisco/Oakland	US	346	2.4%
20	Houston	US	339	2.5%
21	Miami	US	331	2.4%
22	Toronto	Canada	327	3.0%
23	Moscow	Russia	325	4.0%
24	Mumbai	India	300	6.0%
25	Madrid	Spain	299	3.2%
26	Detroit	US	287	2.3%
27	Istanbul	Turkey	287	5.2%
28	Seattle	US	269	2.5%
29	Beijing	China	259	6.6%
30	Metro Manila	Philippines	257	5.9%

Source: PricewaterhouseCoopers

Counter-suburbanisation: Also noteworthy – at least in cities in some developed states – is that suburbanites are moving back to inner-city areas, leading to their revival via means of gentrification. Although this has been happening for many years, anecdotal evidence suggests that the subprime debacle is accelerating this trend in the US. At the same time, with suburban houses being sold at knock-down prices, and with poor inner-city folk moving out to the suburbs, the classic rich suburbs-poor inner city divide is becoming reversed.

The Main Political And Social Implications Of Urbanisation

Dramatic social transformation: Rural areas tend to reflect more traditional, conservative values, whereas cities tend to be more progressive and liberal. Urbanisation thus creates dramatic social change – and not always smoothly – as rural migrants adjust to their new settings. One of the most significant changes is typically a fall in birth rates, partly because congestion limits the space for extra children, but also because couples do not need so many children to farm the land. The variety of entertainment and leisure activities available in cities also triggers a lifestyle change. Furthermore, because cities are the main centres of foreign influences in any country, they can come to be viewed negatively by new migrants. This may lead to serious tensions between long-time urban residents and the newcomers.

Political destabilisation: A swift transformation from a rural society to an urban one can often cause major upheaval. (Readers should bear in mind that in some emerging market countries, rural dwellers are decades, if not centuries behind urban dwellers in their lifestyles and habits.) In fact, some historians attribute the Iranian revolution (1979) to excessively rapid urbanisation. Essentially, rural dwellers brought traditional values to cities, found themselves appalled by the decadence of urban life, and the gap between haves and have-nots (e.g. the construction workers building lavish houses that they could never aspire to live in), and then reacted by overthrowing the regime. Iran may be an extreme case, but it is worth keeping in mind.

Significant political divide between the town and country: Most countries, in both the developed world and emerging markets, have significant urban-rural divides in national politics. For example, in the US in 2004, John Kerry won more votes in urban areas (the so-called ‘blue’ states), whereas George W. Bush won more rural support (‘red’ states). Similar patterns exist in the UK. In Japan, the ruling Liberal Democratic Party tends to be more popular in the countryside, whereas the opposition Democratic Party draws more support from the cities. In Thailand, ex-premier Thaksin Shinawatra was mainly popular in rural areas, but disliked in Bangkok. As emerging nations urbanise, their political landscapes will change. Political parties whose main base is in the countryside will find themselves adapting to the new realities or risking obsolescence.

Greater scope for mass movements: Because cities bring people together, this allows movements to congregate and potentially rebel against the government. The sheer density of people makes it much easier to organise mass protests. By contrast, people are often too spread out in the countryside to cause serious unrest. Ultimately, because cities are the centres of power and wealth, what happens there typically sets the course for the nation. (One notable exception is Cambodia’s Khmer Rouge. This rural movement took over the cities, then forced everyone back to the countryside to work the land.)

What Are The Main Drawbacks Of Urbanisation?

Creation of slums: This has become inevitable, as the authorities seldom have the resources to build new homes quickly enough to absorb new migrants from the countryside. Excessive congestion can quickly become a major health hazard, due to lack of sanitation, etc. Some slums have more than 2mn people congested in a small space, leading to serious social tensions.

Easier spread of disease: Nineteenth century London saw widespread disease, while more recently, SARS spread through several Chinese cities and Asian countries in 2003. The close proximity of animals and humans even in urban areas (as a result of many city-dwellers keeping chickens and other animals in their yards) was blamed for the existence of the disease.

Severe pollution: Aside from pollution caused within the city (e.g. smog, dust particles, acid rain), urban economies also put a greater demand for resources on the rest of the country, and ultimately the world. China's reliance on coal power and the proximity of some power stations to cities have led to severe air pollution, and thus respiratory disease. Meanwhile, the lack of sanitation means that rivers become dumping grounds for sewage. Furthermore, in China the sheer demands on water mean that many cities are experiencing a lowering of their water tables, and in some cases land subsidence.

Increased risk from floods and earthquakes: Slums are often built on the most dangerous and least desirable portions of land, where no-one else wants to live or build new properties. This, combined with high population densities, means that slum dwellers are often disproportionately affected by natural disasters. As the recent earthquake in China showed, facilities for low-income people may also be built without stringent safety standards.

Juxtaposition of very poor and very rich: The limited amount of land means that it is common for elite housing to be located surprisingly close to shanty towns. This makes social divisions ever clearer, and creates tension. Thus, crime rates can soar, or politics can become radicalised.

Swelling populations in war time: It is common for urbanisation to be accelerated by wars, when refugees flock to the cities from the countryside to avoid fighting. For example, US military operations in rural South Vietnam caused millions to move to the cities. More recently, although the Kosovan capital of Pristina saw many of its 250,000 residents flee in the 1999 conflict, the population subsequently swelled to more than 600,000, when the province's refugees returned after their temporary expulsion. Elsewhere, the confluence of different ethnic groups in cities can lead to urban strife, essentially making neighbourhoods no-go areas for various parts of the population. The fact that the US military is increasingly preparing itself for urban warfare is an indication that future conflicts may not necessarily be waged in sparsely populated areas.

How Do Policymakers Respond To These Problems?

Avoidance strategies: Rather than deal with urban problems, the political and business elite may migrate to the periphery and build 'edge cities'. These are essentially suburban downtowns, which have all the functions of central business districts, such as offices,

residential and retail space, schools, and even their own power generation facilities so that blackouts in the national grid do not cause inconvenience. In the least pleasant cities, edge cities are thus a retreat. However, in more prosperous emerging nation cities, edge cities often function as growth poles for new businesses. These are often reasonably close to international airports, and typically include hotel and conference facilities, thus allowing international business visitors to skip the congested main city altogether.

A common feature in emerging market cities (and increasingly in some developed states) is the phenomenon of gated communities with private security guards. This, combined with edge cities and use of private transport, allows the elite to essentially live in a parallel world to the mainstream urban fabric.

Policymakers can and do resort to slum clearance. There are several possible motives for this. The first is to free up land for new upmarket housing, new shopping centres or new railway systems. The second is to clear out an eyesore and move everyone to newer housing elsewhere. In such cases, developers would typically be expected to pay compensation to the evictees and find them new places to live. The third is politically motivated and designed to expel potentially rebellious populations from the city. Regardless of the motives, slum clearance can significantly increase political tensions.

Proactive management: As regards housing, investing in major public housing projects is one possible solution to the problem of slums. However, if the new buildings are shoddily constructed or residents fail to maintain them, then the result is that they merely become vertical slums. An alternative to public housing would be more loans for home purchases or improvements. This requires the development of a more sophisticated financial system where bank lending is geared towards consumers rather than state-owned industries and big companies.

Many emerging market governments are investing in major infrastructure projects. For example, Beijing plans to increase the size of its metro system to 561km by 2020 from 142km at present (by contrast, it took 100 years to build the vast majority of London's 400km underground system). However, for many emerging market countries, the costs can be prohibitive. Thus, financing must come from multilateral agencies, or through international bond issues. Conventional heavy-rail metro systems typically provide the highest capacity solutions, but the construction costs, construction times (usually at least a few years) and the disruption caused (by digging up existing roads) can be problematic. Thus, many emerging market cities are building light rail networks. These are cheaper, but have a much lower capacity. A cheaper alternative to both is guided busways, which have been introduced in some Brazilian cities.

A further option is to place restrictions on internal migration (as practised by China in the past) – although this would be considered unacceptable in democratic societies. A more palatable option would be to promote the development of new cities away from the mega-urban regions. In fact, the fastest growing cities are not mega-regions, but medium-sized cities.

How Does Urbanisation Assist National Development?

Although it often seems that urbanisation drains the countryside of labour and talent, cities can also serve as growth poles in underdeveloped regions. For example, in the late

19th and early 20th centuries, the rise of Chicago opened up the US mid-west to further development. In the early 21st century, China is consciously using Chongqing (and to a lesser extent Chengdu) to develop the inner western provinces and shift businesses away from the southern and eastern coastal regions.

Some countries have gone so far as to move their capital cities to remote regions to promote national development. Brazil constructed Brasilia to develop the centre and Nigeria did this with Abuja. Kazakhstan's capital moved to Astana in the north, and Myanmar shifted its capital to Naypyidaw, which is located right in the centre of the country. The latter move was motivated by a desire to improve control of the country from the centre rather than from the old coastal capital of Yangon.

Often, governments use tax breaks or special incentives to attract talent and investment to these new growth centres. One problem is that initially, the new cities seem dull and boring in comparison to existing dominant cities. However, in time these shortfalls are reduced

TABLE: THE WORLD'S FASTEST GROWING URBAN AREAS BY POPULATION

Rank	City/Urban area	Country	Average annual growth, 2006-2020 (%)
1	Beihai	China	10.58
2	Ghaziabad	India	5.20
3	Sana'a	Yemen	5.00
4	Surat	India	4.99
5	Kabul	Afghanistan	4.74
6	Bamako	Mali	4.45
7	Lagos	Nigeria	4.44
8	Faridabad	India	4.44
9	Dar es Salaam	Tanzania	4.39
10	Chittagong	Bangladesh	4.29
11	Toluca	Mexico	4.25
12	Lubumbashi	Congo	4.10
13	Kampala	Uganda	4.03
14	Santa Cruz	Bolivia	3.98
15	Luanda	Angola	3.96
16	Nashik	India	3.90
17	Kinshasa	Congo	3.89
18	Nairobi	Kenya	3.87
19	Dhaka	Bangladesh	3.79
20	Antananarivo	Madagascar	3.73
21	Patna	India	3.72
22	Rajkot	India	3.63
23	Conakry	Guinea	3.61
24	Jaipur	India	3.60
25	Maputo	Mozambique	3.54
26	Mogadishu	Somalia	3.52
27	Gujranwala	Pakistan	3.49
28	Delhi	India	3.48
29	Pune (Poona)	India	3.46
30	Las Vegas	US	3.45

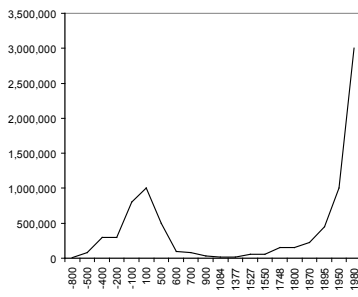
Source: www.citymayors.com.

as the new cities expand. Indeed, as mentioned above, it is smaller second-tier cities that are growing the fastest, at least in percentage terms, if not absolute terms.

Furthermore, leaders of major cities can often use their posts as springboards to high national office. Taiwanese President Ma Ying-jeou and his two predecessors all served as mayor of Taipei, while South Korean President Lee Myung-bak was formerly mayor of Seoul. Iranian President Mahmoud Ahmadinejad, former French president Jacques Chirac, and Turkish Premier Recep Tayyip Erdoğan all served as mayors of their capital cities before becoming national leaders. Elsewhere, former Mexico City mayor Andrés Manuel López Obrador, former New York mayor Rudolph Giuliani, current Moscow Mayor Yuri Luzhkov, and current Tokyo Governor Shintaro Ishihara were all serious candidates for their countries' top leaderships at some stage in their careers.

As megacities or mega-regions become more prominent, we would expect their leaders to become increasingly prominent internationally, at least in business circles, as they strike to make their cities increasingly important in the global economic landscape.

The Eternal City... To A Point
Population Of Rome, 800 BC-1980 AD



Source: Thomas Homer-Dixon, 'The Upside Of Down'

Is Urbanisation Reversible?

Urbanisation is certainly reversible. Many cities in the developed world have stopped growing, and some are shrinking. As mentioned earlier, cities can go into severe decline, if a dominant industry shuts down and no new activities compensate for this. Even if cities do not shrink in absolute terms, their relative importance can fall, as more dynamic entities surpass them. The process of urban decline is most prominent in the old 'rust belt' of the US and in de-industrialised areas of Europe and the former Soviet Union. However, it can also take place in emerging nations where industries have been shut down as part of economic restructuring. This has affected several cities in China's northeast.

Extreme events can substantially reduce urban populations. For example, when the Khmer Rouge took over Cambodia, they forced the bulk of the urban population back to the countryside. More recently, several cities in the former Yugoslavia saw mass expulsion or evacuations. Natural disasters can also become city-busters. In 2005, Hurricane Katrina caused a major exodus from New Orleans. If some of the more alarmist reports about global climate change are true, then many major cities (which are often in coastal regions) will experience serious floods, with concomitant costs in terms of lives and economic activity.

By way of conclusion, Rome's history offers some interesting warnings. At the height of its power in the first century AD, Rome peaked with a population of 1mn. It declined continuously to a nadir of 15,000 in the 11th century, and did not return to 1mn until the 1950s. Given that the general tempo of world history is accelerating, today's mega-regions could eventually decline with surprising speed.

chapter 5 Business Environment

SWOT Analysis

Strengths

- Vietnam has a large, skilled and low-cost workforce, that has made the country attractive to foreign investors.
- Vietnam's location – its proximity to China and South East Asia, and its good sea links – makes it a good base for foreign companies to export to the rest of Asia, and beyond.

Weaknesses

- Vietnam's infrastructure is still weak. Roads, railways and ports are inadequate to cope with the country's economic growth and links with the outside world.
- Vietnam remains one of the world's most corrupt countries. Its score in Transparency International's 2007 Corruption Perceptions Index was 2.6, lower than the regional average of 4.6.

Opportunities

- Vietnam is increasingly attracting investment from key Asian economies, such as Japan, South Korea and Taiwan. This offers the possibility of the transfer of high-tech skills and knowhow.
- Vietnam is pressing ahead with the privatisation of state-owned enterprises and the liberalisation of the banking sector. This should offer foreign investors new entry points.

Threats

- Ongoing trade disputes with the US and the general threat of US protectionism remain a concern.
- Labour unrest remains a lingering threat. A failure by the authorities to boost skills levels could leave Vietnam a second-rate economy for an indefinite period.

BMI Business Environment Risk Ratings

The Ministry of Planning and Investment estimated on July 29 that FDI in January-July 2008 would be US\$45.2bn, compared with commitments of US\$20.3bn in the whole of 2007. Taiwan has emerged as Vietnam's biggest investor in 2008, with US\$8.42bn committed so far. While there is usually a gap between pledged FDI and actual FDI, the Ministry's figures show that foreign investors are still very interested in Vietnam, despite the country's current economic woes. However, we caution that should Vietnam fail to rein in inflation or witnesses a currency crisis, then investor sentiment could quickly turn sour, at least temporarily.

	Business Environment	Rank	Trend
Singapore	83.8	1	=
Hong Kong	82.2	3	=
New Zealand	79.0	6	=
South Korea	73.4	9	=
Japan	72.6	11	=
Australia	71.8	14	=
Taiwan	65.2	24	=
Malaysia	61.5	33	=
Thailand	59.5	38	=
China	52.5	55	=
Philippines	45.0	75	=
Vietnam	42.0	85	=
Sri Lanka	40.6	89	=
Indonesia	40.2	90	=
India	39.8	92	=
Pakistan	37.7	100	=
Cambodia	36.7	103	=
Bangladesh	36.2	106	=
Laos	35.2	110	=
Myanmar	16.0	132	=
North Korea	11.5	133	=
Regional Average: 51.5	Emerging Market Average: 45.5	Global Market Average: 48.6	

Business Environment Outlook

Introduction

Vietnam's large and inexpensive workforce remains its largest attraction for foreign investors, although there is an increasing occurrence of foreign direct investment (FDI) projects aimed at tapping the country's growing consumer market. There is still a large degree of state intervention in the economy, but the government has been gradually moving towards a market economy since 1986, with World Trade Organization (WTO) accession in 2007 being the greatest achievement so far. The country's decrepit infrastructure continues to be an impediment for many foreign investors, but we see this as a diminishing problem because the government is investing heavily in new roads, railways and ports.

Latest Developments

- State-owned **Vietnam National Petroleum Corporation** (Petrolimex) has announced plans to build an oil refinery in the country's central Khan Hoa province. The US\$4.5bn facility will have the capacity to process 10mn tonnes per annum (tpa), equal to some 200,900 barrels per day (b/d). Petrolimex's chair Vu Ngoc Hai has said that his company is planning to start surveying the project's site shortly, alongside partner **China Petroleum and Chemical Corporation** (Sinopec). Crude oil for the facility will be imported from either Singapore or the Middle East. Vietnam currently does not have any refineries, but is hoping to reduce its costly refined products import bill by building new facilities. The announcement of the newly planned refinery follows several other refinery projects, illustrating the country's efforts to achieve self-sufficiency in petrol.
- State oil company **PetroVietnam** has announced plans for the construction of a coal-fired power plant in northern Vietnam. PetroVietnam has been involved in power generation before but has raised complaints about the arduous bureaucracy in Vietnam's power sector, which is hampering investment initiatives. Tight supply in the Asian coal market has compounded the problems of the state-owned utilities company **EVN**, which is struggling to meet domestic demand.
- The development of the Cai Mep Gemadept Terminal Link port complex in Ba Ria-Vung Tau province has fallen behind schedule due to delays in road construction, bringing risks to the expansion of Vietnam's port capacity. Provincial officials plan to inject US\$60mn from its budget into progressing road construction, but we believe this plan could also be hit by delays due to the difficulty in finding contractors. The construction of ports in Ba Rai-Vung Tau is part of a development initiative to offer better port facilities for freight transport in Vietnam and give the heavily congested ports of Ho Chi Minh City (HCMC), which currently handle 70% the country's container volume, some respite. It is hoped that with the development of the five US\$1.7bn ports in Ba Ria-Vung, more of a balance can be struck that will reduce congestion. These ports, which are scheduled to be operational in 2009 and 2010, will be able to handle 40% of goods imported and exported to and from Vietnam's southern region. The **State Bank of Vietnam** imposed a temporary halt on licensing new banks on August 8 in order to adjust the regulatory framework for domestic banks. Many of the partially

private joint-stock commercial banks (JSCBs) established in recent years are in financial distress due to irresponsible lending practices and the central bank's monetary tightening. The central bank is reportedly considering raising capital requirement levels in order to improve the stability of the banking sector. We see these as conducive to macroeconomic stability, but caution that the banking sector as a whole needs to improve lending and risk management practices.

- The Vietnamese government has moved to stem the growing tendency of state-owned enterprises (SOEs) branching out beyond their core areas of business. This comes after reports that SOEs have used their strong capital bases to invest VND7.4trn (US\$450mn) into banking, insurance, real estate and securities, thus abetting speculative bubbles and bringing risks to the SOEs' balance sheets. In a draft decree issued by Ministry of Planning and Investment, SOEs wanting to get involved in businesses considered risky or beyond their core area will need permission by the prime minister or officials authorised by the prime minister.

TABLE: BMI BUSINESS AND OPERATIONAL RISK RATINGS

	Infrastructure	Institutions	Market Orientation	Overall
Afghanistan	20.73	29.85	40.59	30.39
Bangladesh	35.05	25.89	47.74	36.23
Bhutan	20.29	58.26	35.63	38.06
Cambodia	19.69	26.83	63.69	36.74
China	68.01	42.73	46.75	52.50
East Timor	32.47	30.62	59.50	40.86
Hong Kong	75.06	80.76	90.72	82.18
India	50.37	40.21	28.77	39.79
Indonesia	32.65	22.48	65.53	40.22
Japan	88.03	81.02	48.74	72.59
Laos	23.90	31.49	50.17	35.18
Malaysia	65.71	59.42	59.29	61.47
Maldives	40.42	54.31	67.17	53.97
Myanmar	21.44	3.06	23.43	15.98
Nepal	42.67	36.69	54.09	44.49
North Korea	23.63	8.98	1.97	11.53
Pakistan	36.08	29.57	47.50	37.72
Philippines	40.12	37.12	57.64	44.96
Singapore	83.09	88.18	80.16	83.81
South Korea	82.92	67.88	69.35	73.39
Sri Lanka	35.57	48.85	37.49	40.64
Taiwan	69.49	61.38	64.61	65.16
Thailand	59.54	60.06	59.00	59.53
Vietnam	37.23	39.11	49.71	42.01
Australia	86.43	81.44	47.57	71.81
New Zealand	83.41	90.25	63.21	78.96
Global ave.	47.39	47.46	48.65	47.73
Region ave.	49.00	47.56	52.31	49.62

Source: BMI. Scores out of 100, with 100 representing the best score available for each indicator.

Institutions

Legal Framework

Vietnam has a two-tier courts system, with courts of first instances and courts of appeal. The court system consists of the Supreme Court, the provincial People's Courts and the district People's Courts. The Vietnamese legal code is currently in a state of flux and the authorities are drafting a unified legal framework for the conduct of business.

Most of the legal documents in force relating to business were issued in the early 1990s under market-led reform programmes. However, Vietnam rewrote almost all of its laws and regulations affecting commercial activity and judicial procedures between 2002-2006. Despite some progress in protecting intellectual property rights, the overall legal system in Vietnam is regarded as excessively cumbersome.

Vietnam's judicial system lacks transparency and there are widespread concerns about the independence of the judiciary. Both local and foreign firms prefer to resort to arbitration or other non-judicial means as a result of weaknesses in the judicial system – there is a general lack of confidence that the judiciary is capable of interpreting and enforcing the law.

Vietnam's legal system remains underdeveloped and, largely, biased against foreign entities. The court system provides inadequate redress for commercial disputes while contracts are difficult to enforce, particularly if a party is non-Vietnamese. Foreigners also see the commercial arbitration system as weak. When disputes arise, foreign investors tend to try to negotiate or include dispute resolution procedures in their contracts – however, even these are far from failsafe.

Foreign and domestic arbitral awards are legally enforceable in Vietnam since it acceded to the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards in 1995. Local courts must respect awards rendered by a recognised international arbitration institution. However, this provides no assurance that contracts will be honoured. Non-judicial means are therefore frequently used to enforce debt obligations.

Firms generally avoid the judicial system because the process is lengthy and expensive, decisions are considered arbitrary and enforcement mechanisms are ineffective. Smaller companies rely on personal relationships while larger foreign companies may make use of their access to government to ensure contract enforcement.

Property Rights

The 2006 Uniform Enterprise Law has allowed foreign investors to form any type of company instead of only limited liability companies. In general, foreign companies and the private sector are at a disadvantage compared to state-owned companies in terms of access to land, which is still viewed as the property of the 'the people'. Legislation has, however, progressively enhanced the status of private investors in recent years. The 1992 constitution granted stronger land rights to individuals, including rights over commercial and personal property. Private land use rights (LURs) may now be granted for up to 50 years. Since July 1 2004, the Land Law has allowed local private companies with long-term LURs to lease land to foreign investors.

Intellectual Property Rights

The enforcement of intellectual property rights (IPRs) is wholly inadequate, with widespread pirating of products, particularly software, music and videos. The requirements of WTO accession mean that the government will have to substantially beef up IPR protection. Consequently, in July 2006, a new Intellectual Property Law came into effect, designed to clarify the responsibility of government agencies charged with protecting IPRs, though doubts remain over the effectiveness of its implementation. The police service is generally slow to act on administrative orders where trademarks have been infringed. Often violators will seek to extract a payoff in compensation for ceasing the infringement. The US State Department has, therefore, despite significant improvements in the protection of IPR in 2006, kept Vietnam on its 2007 'Special 301 Report' watch-list of countries with inadequate protection of IPR.

Corruption/Red Tape

Investors see official corruption as one of the biggest hindrances to running a business in Vietnam. Joint ventures with state-owned enterprises are particularly prone to corruption

TABLE: BMI LEGAL FRAMEWORK RATINGS

	Investors Protection	Rule of Law	Contract Enforcibility	Corruption
Afghanistan	34.8	0.6	17.4	23.3
Bangladesh	61.1	25.1	8.0	3.3
Bhutan	25.6	75.4	57.0	82.0
Cambodia	51.2	13.8	38.9	6.0
China	7.8	50.3	54.7	54.7
East Timor	11.8	12.6	36.3	na
Hong Kong	62.5	89.8	87.5	92.7
India	38.0	62.9	8.9	54.7
Indonesia	22.3	25.7	26.5	18.0
Japan	58.3	89.2	90.5	91.3
Laos	44.8	19.8	28.7	28.7
Malaysia	53.8	72.5	47.8	75.3
Maldives	91.8	64.1	46.5	23.7
Myanmar	na	4.8	na	1.3
Nepal	44.3	31.7	43.0	23.3
North Korea	na	9.0	na	na
Pakistan	56.2	26.9	17.5	8.7
Philippines	56.4	46.1	54.4	23.3
Singapore	64.5	94.6	75.9	98.7
South Korea	31.7	79.0	81.8	76.0
Sri Lanka	57.6	59.9	47.7	48.0
Taiwan	19.7	81.4	53.1	80.7
Thailand	19.5	60.5	60.1	62.0
Vietnam	22.8	49.7	45.6	28.7
Australia	27.9	94.0	89.2	95.3
New Zealand	66.9	97.0	82.4	100.0
Global ave.	36.8	48.8	49.9	40.2
Region ave.	43.0	51.4	50.0	50.0

Source: BMI. Scores out of 100, with 100 representing the best score available for each indicator.

and abuse, though surveys indicate that while corruption affecting businesses is quite prevalent, the amounts involved are usually quite small. However, rapid economic growth provides opportunities for graft to grow more quickly than government systems evolve. Vietnam scored 2.6 out of 10 in Transparency International's 2007 Corruption Perceptions Index, placing it in 123rd place among the 180 countries surveyed.

One of the best tools in restricting opportunities for corruption has been the expansion of the 'One-Stop Shop' (OSS) network – single agencies that deal with applications for a range of activities, including construction permits, LUR certificates, business registrations and approvals for local and foreign investments.

The Law on Corruption Prevention and Control was passed by the National Assembly in November 2005. A central anti-corruption steering committee was established in 2006, comprising representatives from the government, the National Assembly, state procurator, court and police. The committee is headed by the prime minister and has the authority to temporarily suspend ministers and chairs of people's committees and people's councils if suspected of wrongdoing. The committee discovered 584 cases of alleged corruption, involving close to 1,300 people, in 2007. Among the most noteworthy convictions of corrupt officials was that of former deputy trade minister Mai Van Dau, who was handed a 14-year prison term in March 2007 for accepting bribes in return for export licenses.

The burden of red tape is amplified by the overlapping of government approvals. Vietnam ranks poorly in the length of time it takes to close a business. It can take about five years to close a business, compared to an average of 3.4 years in East Asia & Pacific, and 1.5 years in OECD states.

Infrastructure

Physical Infrastructure

Vietnam's physical infrastructure rating is **59.1**, placing the country in 78th place in our rankings. The country's inadequate infrastructure has become a major grievance for foreign investors and may thus impair future FDI. Our communications ratings for Vietnam stands at **59.9**, but is set to improve as the government, thanks to development assistance from international donors, is investing heavily in constructing new roads, railways, ports and power plants. These projects include the US\$33bn 1,600km high-speed railway currently being constructed, thanks to Japanese funding, between Hanoi and Ho Chi Minh City, which will cut travel time to less than 10 hours when completed.

As an example of progress already made, more than 90% of rural households now have electricity compared to just over 50% 10 years ago. Rapid industrialisation of the economy has, however, seen power demand increase by 15-17% per year and Vietnam is now struggling to expand its electricity production, which produced 59bn KWH in 2006, according to the **Asian Development Bank**. It has been estimated that Vietnam needs to build 124 new power plants between 2006-2010, adding a total capacity of roughly 36,000MW, to satisfy demand. Several ongoing construction projects of power plants have been hit by delays – due to slow land clearance, delayed equipment supplies and poor contractor performance – and

power blackouts and brownouts are therefore likely to remain a problem. Our electricity access rating for Vietnam stands at **58.3**, placing Vietnam in 49th place in our rankings.

Foreign direct investment has also helped to improve Vietnam's telecommunications system, with foreign groups investing heavily in fanning out 3G telecom and broadband networks over the most populous parts of the country.

Labour Force

Vietnam's large, well-educated and inexpensive labour force remains one of the country's chief attractions to foreign investors. The labour pool is increasing by up to 1.5mn a year, while wage costs are still low compared to other countries in the region, although wage growth has picked up pace in recent years. The Vietnamese General Statistics Office estimated the number of employed at 44mn in 2005, equivalent to 81.4% of people aged 15-64. The unemployment rate is expected to remain between 4-6% in 2008.

Vietnam's reform-driven economic growth has resulted in a restructuring of the labour market, with a shift away from agricultural employment to non-farm employment. The General Statistics Office estimated that farmers constituted 52% of the workforce in 2006 with close to 19% working in industry and construction, and just over 25% working in the service sector.

Managerial talent and skilled workers are generally in short supply, which has the effect of raising costs. The expanding financial sector is particularly plagued by labour shortages and is said to be in need of tens of thousands of skilled personnel by 2010. Foreign companies are becoming increasingly troubled by an excessive turnover of qualified workers, which is driving up salaries for skilled personnel. Foreign companies have previously been the prime choice of Vietnamese professionals as they pay 14% more than domestic firms on average, according to a 2007 survey by human resources consultancy **Navigos Group**. Working for domestic firms is, however, becoming increasingly popular as they are currently closing the salary gap with foreign firms.

Labour shortages and a sharply progressive income tax system have pushed up the costs for skilled personnel. Vietnam has, on the other hand, maintained its cost advantage in manufacturing wages. The Japan External Trade Organisation (JETRO) found in a survey in November 2006 that monthly salaries for ordinary workers ranged from US\$87-198 around Hanoi in northern Vietnam and from US\$122-216 in Ho Chi Minh City in the southern Mekong delta region. This can be compared with an average salary for workers in Thailand of US\$164 per month and between US\$134-446 in China's Guangzhou province, the source of much of Chinese manufacturing output. Although wages are rising, we believe Vietnamese labour is still very competitively priced, in particular after the imposition of the Chinese Labour Contract Law on January 1 2008, which is estimated to have raised labour costs in China by between 5- 40% and which has prompted many South Korean and Taiwanese firms to consider moving factories to Vietnam.

The regulatory burden in Vietnam's labour market has traditionally been high, but is easing over time. In 2003, legislation was introduced that allowed foreign companies to recruit staff directly, as long as they provide government agencies with a list of recruited work-

ers. However, the requirement to use employment service agencies continues to apply to branches and representative offices of foreign companies.

One of the main regulatory burdens is the social protection system, which imposes a compulsory social insurance contribution scheme in which employers must pay in 15% of the salary, with employees proving 5%. Regulations for hiring workers are significantly more onerous than the East Asia & Pacific average. Whereas the hiring cost is 17% of the salary in Vietnam, it is only 5% in Thailand, for example. The imposition of the Chinese Labour Contract Law on January 1 2008 has, however, made many foreign companies view Vietnamese labour market regulation more favourably. Employers are required by law to establish labour unions within six months of setting up, and these must be members of the Vietnam General Confederation of Labour. While most factories have trade unions, many of these do not operate in practice. Trade unions are more active in the public sector and only one-third of foreign companies have collective agreements with their workforces.

Vietnam does not have a bad industrial relations record. There were about 400 strikes in 2006, most of them at foreign-invested firms in the textiles and apparel sector, despite working condition often being better at these firms than at 400 SOEs. Most strikes have resulted from legal or contractual breaches, including failure to pay wages and benefits, failure to pay social insurance contributions, and failure to pay severance pay at termination.

The sharp uptrend in consumer price inflation, especially of essential goods such as food, fuel and housing prompted increased labour unrest in late 2007 and early 2008 as workers demanded higher wages. The increasingly pressed economic conditions for labourers prompted tens of thousands of workers to go on strike in Ho Chi Minh City and Dong Nai province in January 2008.

Market Orientation

Foreign Investment Policy

Increased FDI is an integral part of Vietnam's ambitious economic expansion plans, and with ratings agencies pushing their grades higher, the country looks like a solid investment destination, especially for manufacturing. FDI amounted to US\$20.3bn in 2007 and we believe it will remain at roughly the same level in 2008, in spite of the growing imbalances in the economy.

The rising levels of official development assistance (ODA), which hit a record of US\$5.4bn for 2008, pledged by multilateral donors are also important, but have been outpaced by inflows from foreign private sources over the last five years. But, as the country tries to transform from centralised to more market-oriented economy, the investment framework is still poorly developed in many areas, with bureaucracy and a lack of transparency cited among major problems.

Despite ambitious targets for foreign investment as an important source of fuel for economic expansion plans, a number of barriers to investment remain. An opaque legal system, an inflexible financial system, corruption, a lack of regulatory transparency and consistency,

a ponderous bureaucracy and complex land purchase rules are among areas criticised by foreign investors.

The government has been introducing and amending legislation in an effort to remedy these perceived shortcomings.

Key legislation includes:

- The Law on Foreign Investment (1989), which has been amended several times to make FDI more attractive.
- Government decree 24 of 2000, which carries a pledge to avoid expropriation and guarantees the right to repatriate profits. It also outlines the government's intention to treat private and state sectors equally.
- A revised bankruptcy law and a Law on Competition, both passed by the National Assembly in 2004, in a bid to improve the FDI climate. Fully-owned foreign banks are now allowed to compete on an equal footing with domestic banks.
- The Vietnamese legal code is currently in a state of flux and the authorities are drafting a unified legal framework for the conduct of business. A new Common Investment Law and a Unified Enterprise Law came into effect in July 2006, as did a new Intellectual Property Law designed to clarify the responsibility of government agencies charged with protecting IPRs, but doubts remain over the effectiveness of its implementation.

The main forms of foreign investment are:

- Joint venture (JV) agreements, under which foreign and domestic firms share capital and profits.

TABLE: ASIA, FDI INFLOWS

	2005		2006	
	US\$bn	Per capita	US\$bn	Per capita
Australia	-34.62	-1,717.10	24.02	1,179.28
China	72.41	55.04	69.47	52.48
Hong Kong	33.62	4,802.60	42.89	6,041.13
India	6.68	6.1	16.88	15.24
Indonesia	8.34	36.9	5.56	24.29
Malaysia	3.97	156.4	6.06	234.88
Pakistan	2.2	14.4	4.27	27.49
Philippines	1.85	22.3	2.35	27.76
Singapore	15.0	3,465.10	24.21	5,526.71
South Korea	7.05	147.4	4.95	103.17
Sri Lanka	0.27	13.8	0.48	24
Taiwan	1.63	71.3	7.42	324.05
Thailand	8.96	139.5	9.75	150.57
Vietnam	2.02	24.0	2.32	27.11

Source: UNCTAD, BMI.

- Business Cooperation Contracts (BCC), which allow a foreign company to carry out business in cooperation with a Vietnamese firm through capital investment and revenue sharing, but without gaining right of establishment or ownership.
- Wholly Foreign-Owned Enterprises, are becoming more common, especially those involving industrial production for export.
- Build-operate-transfer (BOT) agreements is the least common form of foreign direct investment, and has a reputation among foreign investors of providing regulatory and financing problems.

Foreign portfolio investment is only permitted in small quantities, with aggregate foreign ownership of listed companies capped at 49%. Foreign ownership of banks is capped at 10% per investor, and 30% in aggregate. Moreover, many of the shares listed on the Ho Chi Minh City Stock Exchange (HSCE) are too illiquid to attract foreign investors. Investments in export processing zones (EPZs), industrial zones (IZ) and high-technology zones

TABLE: BMI TRADE RATINGS

	Protectionism	Bureaucracy
Afghanistan	na	21.6
Bangladesh	0.7	22.9
Bhutan	4.2	18.3
Cambodia	7.5	25.4
China	51.7	52.9
East Timor	na	40.5
Hong Kong	100.0	98.6
India	12.9	23.0
Indonesia	54.4	44.3
Japan	76.9	81.5
Laos	19.7	6.7
Malaysia	64.6	50.9
Maldives	na	55.3
Myanmar	1.4	na
Nepal	13.6	34.1
North Korea	4.2	2.3
Pakistan	16.3	42.9
Philippines	76.2	66.9
Singapore	100.0	88.9
South Korea	42.2	69.1
Sri Lanka	48.3	35.6
Taiwan	95.9	64.1
Thailand	55.8	37.6
Vietnam	11.6	44.0
Australia	70.7	80.3
New Zealand	72.1	76.3
Global ave.	47.1	45.2
Region ave.	43.5	47.4

Source: BMI. Scores out of 100, with 100 representing the best score available for each indicator.

(HTZs) attract tax and other incentives, and offer a ready made operational infrastructure, which may be difficult to arrange outside.

EPZ investments carry 10-12% profit tax. The first established was the Tan Thuan zone near Ho Chi Minh City in 1991, where over a hundred manufacturers currently operate. A number of others have since been built, though they have not been as successful as hoped, partly because all produce from EPZs must be exported.

IZs are for use by firms in construction, manufacturing, processing or assembly of industrial products, often food processing and textiles production. IZ firms pay a 10% profit tax and get refunds if profits are reinvested. IZ firms may produce for the domestic market as well as the export market. Most FDI into Vietnam comes from North East Asia, notably Taiwan, South Korea, Japan and China/Hong Kong. Canada and the US are the largest non-Asian FDI sources. Leading sectors for FDI are manufacturing, other industry and oil and gas.

Foreign Trade Regime

Although high tariffs, customs bureaucracy and legal inadequacies have provided significant trade barriers, the opening up of Vietnam's economy has been accompanied by concrete measures to meet the requirements of the WTO and other international trade organisations. Vietnam has committed to bound tariff rates (or legal ceilings) on most products ranging from zero to 35%. Reductions in most bound rates from 17.4% on average in 2007 to 13.6% are to be phased in gradually.

Vietnam became a member of the WTO in January 2007. A bilateral trade agreement with the US in effect since December 2001 has substantially lowered tariffs on US industrial and agricultural products, removed non-tariff barriers on US service providers and eliminated barriers to US exports in key areas such as pharmaceuticals and petroleum products.

Vietnam is a member of the Association of South East Asian Nations (ASEAN) – with Brunei, Philippines, Indonesia, Laos, Myanmar, Malaysia, Singapore, Thailand, and Cambodia – as well as the linked ASEAN Free Trade Area (AFTA). Vietnam is thus party to negotiations on free trade agreements (FTAs) being conducted by ASEAN, such as talks with the European Union, China, Australia and New Zealand.

Vietnam is, in addition, in, or preparing for, talks over FTAs with Chile and Japan. Import tariffs are high by regional standards, averaging 16.8% in 2006 according to the WTO.

TABLE: TOP EXPORT DESTINATIONS

	2001	2002	2003	2004	2005	2006	2007
United States	1,066	2,350	4,463	5,206	6,551	8,423	10,387
Japan	2,510	2,299	2,808	3,507	4,122	4,871	5,331
Australia	1,042	1,172	1,476	1,798	2,593	3,728	3,447
China	1,417	1,013	1,323	2,322	2,318	2,260	2,859
Germany	722	1,007	1,181	1,522	1,563	1,790	2,342
Total exports	15,014	15,713	20,516	25,779	30,957	39,514	40,615
Top 5, % of total	45.0	49.9	54.8	55.7	55.4	53.3	54.5

Source: IMF

Vietnam will continue to dismantle tariffs in a bid to meet its WTO accession goals, although some key sectors remain protected.

Vietnam has agreed to comply with ASEAN's Common Effective Preferential Tariff (CEPT) scheme on manufactured goods within the ASEAN region, which calls for rates to be brought down to the 0%-5% range.

The legislation providing the framework for the trade regime is 1998's Law to Amend the Import and Export Tariffs Law. However, given the ASEAN and WTO requirements the tariff structure is in a constant state of flux at present. To reduce the rising costs of a range of products, Vietnam in October 2007 cut import tariffs by between 30% and 60% on many food and dairy products.

Tax Regime

Since 2003, corporate tax has been charged at a unified rate for both domestic firms and foreign investors. From the start of 2005, a self-assessment regime has been in effect. The previous tax audit system has been superseded by a tax investigation system.

- **Corporate tax:** Main rate is 28% for domestic firms and those involving foreign investment, but the National Assembly was in May 2008 reviewing a proposal from the Ministry of Finance to slash this rate to 25% in order to boost competitiveness (see latest developments). Resident firms are taxed on global income. Non-resident firms are taxed only on Vietnamese-sourced income. A surtax of 10- 25% is charged progressively on income from land use rights.
- **Individual tax:** Levied progressively up to 40%. Different regimes apply to domestic employees and resident expatriates. The income threshold above which tax is paid is higher for expatriates than for local employees. Resident individuals are taxed on global income. Non-residents are taxed on Vietnamese-sourced income only, at a flat rate 25%.
- **Indirect tax:** Main VAT rate is 10%. A 5% rate is charged on some goods, including computers and accessories, construction, machinery, chemicals, coal and metallurgy products. The following attract a zero VAT rate: exported goods and software and services exported to firms in export processing zones. Registration is obligatory for businesses. VAT taxation is also subject to an ongoing revision by the National Assembly (see latest developments).
- **Capital gains:** Usually taxed as income at corporate rate. Gains by foreign investors on the transfer of an interest in a foreign or Vietnamese enterprise attract a 25% tax. Gains by individuals on the transfer of a home or on land-use rights are taxed progressively up to 60%.

Operational Risk

Security Risk

Vietnam is generally a very safe country for foreign residents and travellers. Petty street crime is rising in the major cities, but there have been very few serious offences against foreigners reported. Unexploded mines and ordnance are a continuing hazard, particularly in central Vietnam and along the Laos border.

The poor standard of roads and other public infrastructure is also a safety risk, as is the poor level of driving which makes traffic accidents one of the most prominent health risks for both foreigners and nationals.

Tourism

Executive Summary

Figures released by the Vietnam National Administration of Tourism (VNAT) show that tourist arrivals increased dramatically in the first quarter of 2008. In total, visitors in Q108 reached 1.29mn, representing a 15.7 y-o-y increase. Visitors in March 2008 totalled 424,954. While this represented a month-on-month decline from February 2008, we attribute this more to a statistical decline following a high number of tourist arrivals during the Lunar New Year in February rather than to a slowdown in the booming tourism industry.

Indeed, a mark of Vietnam's success in attracting visitors specifically during the Lunar New Year was the unusually high proportion of visitors from within the Asia-Pacific region. In Q108 arrivals from China comprised by far the greatest amount of tourists entering Vietnam, totalling 216,857 over the quarter, an impressive 60.2% y-o-y increase. By way of comparison, visitors from South Korea comprised the next largest group, with 141,431 visitors in Q108, actually a slight y-o-y decline. Other visits from within the region also increased; arrivals from Hong Kong increased 32.5% y-o-y to 1,658, while visitors from Thailand rose 34.5% y-o-y to 52,543. Of particular note were arrivals from the US, which increased 7.9% y-o-y to 133,019, the third most important source of tourists. Given that the US economy continued to slow in Q108, we view it as a positive signal that tourism flows remained relatively strong. While this may indicate that Vietnam's tourism industry may not be as significantly impacted by the US slowdown as we had feared, we would caution that the time-lag between booking holidays and arrival may mean that the impact is felt more towards the middle of the year.

Domestic Tourism Boost – As well as the industry's early resilience to the US downturn, we expect domestic tourism to act as a mitigating factor in any potential slowdown of US arrivals. As such, the traditional two-day holiday at the end of April, this year falling on 30 April and 1 May, should have boosted domestic tourism statistics for both months, boding well for Q208 figures. Early indications suggest that domestic travel on these dates was well above normal figures, with bus companies in the south estimating that departures were twice the normal level at this period. As usual, movement was particularly marked from north to south, with the majority of domestic tourists either heading to the Mekong Delta or to the central cities of Hue and Da Nang. Domestic tourism was boosted by regional efforts to attract tourists, particularly in the form of locally-organised festivals.

Hotel Rates Rise – Despite the government's long-standing aim to increase room capacity in the country, room supply still remains well below demand, notwithstanding the flood of private hotel investment. In particular, room rates rose by an estimated 40% y-o-y in 2007, with particular increases seen in high-profile tourist destinations such as the southern island of Phu Quoc. The government estimates that Hanoi in particular requires an extra

13,000 rooms by 2011 in order to meet demand. As yet rising room prices do not appear to have dented the market's attractiveness. However, with the industry increasingly reliant on domestic arrivals to fuel growth, higher rates could have a drag effect on industry growth in the medium term.

Hospitality Overview

With visitor arrivals expected to reach nearly 6mn a year by 2012, and the government signalling the prioritisation of the tourism industry as a key foreign exchange earner, it is little surprise that activity in the hotel segment is booming accordingly. The number of hotels is increasing across the board. By end-2007, the total number of hotels (inclusive of guest houses) had risen to approximately 4,700, from 3,800 in mid-2004. The capacity of Vietnam's hotel industry has risen from 57,000 available rooms in 1998 to 130,000 rooms currently.

In terms of high quality multinational operators, **Intercontinental**, **Accor**, **Best Western**, **Hilton Group** and **Sheraton** are all active (or in the process of setting up operations) in Vietnam. With visitor numbers set to increase by around 9% y-o-y in the coming years, the occupancy rate should climb considerably, notwithstanding an anticipated increase in the number of hotels.

Accor hopes to open two new properties in Vietnam, La Residence Hotel and Spa in Hue, Vietnam's ancient imperial capital, and a Novotel in the southern coastal resort of Nha Trang. The company also opened a Novotel in Halong Bay in 2007, the World Heritage area northeast of Hanoi. In a further indication of Accor's interest in the market, the company announced in April 2008 that it would open three Pullman and two Mercure brand hotels in Vietnam between 2010 and 2012. This supports Accor's aim to increase its hotel chain from eight to 20 in Vietnam by the end of 2010.

In June 2006, the national tourism authority stated that Vietnam needs 50,000 more hotel rooms in the next five years to cater for the 31mn tourists expected in 2010. Under the plan presented by the Vietnam National Administration of Tourism (VNAT), in 2010 the tourism industry is expected to cater for 31mn tourists, comprising 6mn international arrivals and 25mn local tourists.

Consequently, the government is planning a spate of tourism investment conferences to introduce potential projects to investors, and conduct investment survey trips for investors.

TABLE: VIETNAM'S TRAVEL INDUSTRY — HISTORICAL DATA AND FORECASTS ('000 UNLESS OTHERWISE STATED)

	2004	2005	2006e	2007e	2008f	2009f	2010f	2011f	2012f
Tourist arrivals	2,928	3,470	3,783	4,124	4,412	4,677	4,982	5,405	5,864
Tourist departures	203e	221	241	262	286	303	323	350	380
Airline passenger arrivals	1,710e	2,052	2,246	2,438	2,633	2,791	2,972	3,225	3,499
Cruise arrivals	302e	347	379	414	445	471	502	545	591
Land arrivals	966e	1,056	1,157	1,271	1,333	1,415	1,507	1,635	1,774
Total airline passenger numbers	8,214e	8,953e	9,759	10,637	11,595	12,290	13,088	14,201	15,408
Foreign exchange receipts (US\$m)	1,750e	2,100e	2,352	2,611	2,859	3,087	3,287	3,567	3,870

e/f = BMI estimate/forecast. Source: World Tourism Organization, Vietnam National Administration of Tourism

The authority is also looking to coordinate its promotional activities with the Ministry of Planning and Investment to bring out special preferential investment policies. VNAT expects total revenue of the tourism industry in 2010 to reach US\$4-5bn, or double the 2005 figure.

Local companies are also tapping into the tourism boom, with news in June 2006 that the Thanh-Long Tourism Company and the Viet-Thang Jean Company are planning to invest US\$900mn to build a luxury tourist resort in the Dat Do district of Ba Ria-Vung Tau province. Construction of the resort — to be known as Seadragon Hill — commenced in early 2007 and will take five years to complete. This will represent the largest domestic tourism project ever undertaken in Vietnam, and will include five-star hotels, restaurants, a casino (subject to government approval) and other facilities.

Major recent investments include the beginning of construction on a US\$100 million Hyatt Hotels complex in early 2008. The complex in Danang will have 226 rooms and is scheduled for completion in 2010. In addition, French operator Accor plans to expand its hotels chain in Vietnam from eight in 2007 to 20 by 2010, via construction of its three main brand chains: Pullman, Mercure and Novotel.

Despite the government's long-standing aim to increase room capacity in the country, room supply still remains well below demand, notwithstanding the flood of private hotel investment. In particular, room rates rose by an estimated 40% y-o-y in 2007, with particular increases seen in high-profile tourist destinations such as the southern island of Phu Quoc. The government estimates that Hanoi in particular requires an extra 13,000 rooms by 2011 in order to meet demand. As yet rising room prices do not appear to have dented the market's attractiveness. However, with the industry increasingly reliant on domestic arrivals to fuel growth, higher rates could have a drag effect on industry growth in the medium term.

Industry Forecast Scenario

Vietnam's visitor arrivals totalled 354,000 in December 2007, bringing full-year 2007 arrivals to 4.17 million. While month-on-month growth totalled a relatively sedate 4.0%, full-year growth totalled an impressive 16.0%. This was above our more conservative forecast of 13.0%, and is a strong testament to the positive underlying trends within the industry.

Full-year growth was driven particularly by air arrivals, which totalled 3.3bn, representing y-o-y growth of 20.7%. Less impressive were arrivals by sea and land, which grew only 0.1% and 4.3%, respectively, to total 224,389 and 685,234. Visitor numbers from Europe continued to increase strongly, with visitors from France, Italy, the Netherlands and Belgium growing 37.9%, 39.2%, 37.9% and 26.6%, respectively. Arrivals from the US were less strong, up 6.9% y-o-y, reflecting the economic slowdown in the US. Regional arrivals more than compensated for this slowdown, with arrivals from Hong Kong, Malaysia, Australia and New Zealand up 39.6%, 37.8%, 31.7% and 42.4%, respectively. Particularly impressive was outstanding growth in arrivals from Russia, which surged by 54.8% y-o-y to 44,544, reflecting both the success of Vietnam's marketing policy and the growing affluence of Russian consumers.

Figures released by the Vietnam National Administration of Tourism (VNAT) show that tourist arrivals increased dramatically in Q108. In total, visitors in Q108 reached 1.29mn, representing a 15.7 y-o-y increase. Visitors in March 2008 totalled 424,954. While this represented a month-on-month decline from February 2008, we attribute this more to a statistical decline following a high number of tourist arrivals during the Lunar New Year in February than to a slowdown in the booming tourism industry. A mark of Vietnam's success in attracting visitors specifically during the Lunar New Year was the unusually high proportion of visitors from the Asia Pacific region. In Q108 arrivals from China comprised by far the greatest amount of tourists entering Vietnam, 216,857, a 60.2% y-o-y increase. Visitors from South Korea were the next largest group, with 141,431 visitors in Q108, actually a slight y-o-y decline. Other visits from within the region also increased; arrivals from Hong Kong increased 32.5% y-o-y to 1,658, while visitors from Thailand rose 34.5% y-o-y to 52,543. Of particular note were arrivals from the US, which increased 7.9% y-o-y to 133,019, the third most important source of tourists. Given that the US economy continued to slow in Q108, we view it as a positive signal that tourism flows remained relatively strong. While this may indicate that Vietnam's tourism industry may not be as significantly affected by the US slowdown as we had feared, we would caution that the time-lag between booking holidays and arrival may mean that the impact is felt more towards the middle of the year.

Given the strength of the performance in 2007, we are optimistic about the potential for growth in 2008, despite growing indications that the US may enter recession in H108. While this will continue to impact negatively on US visitors to Vietnam, we feel that continued strength in arrivals from Europe and the region will go a large way towards compensating for this slowdown. In addition, we expect the 2008 Olympics in Beijing in August 2008 to have some positive spillover effects for the rest of the region, with some visitors choosing to spend time in nearby countries either before or after the games. As such, we are predicting visitor arrivals to reach 4.5 million in 2008, representing growth of 10.0%. As in 2007, the ability to withstand the US slowdown means that risks to this forecast are to the upside.

Defence

Executive Summary

Vietnam is in the process of re-integrating into the international community, and as such much of its internal political and social structures have undergone change. Vietnam is also forging a role for itself in regional strategic and security developments, particularly with traditional allies. Vietnam is also developing stronger ties with other regional powers. In Q108 India sought to strengthen military and diplomatic ties with Vietnam as part of its 'Look East' strategy, which is an attempt by India to usher in a period of closer relations with key states in South East Asia. Vietnam will have to manage its bilateral ties with India carefully as the former's decisions will no doubt be closely watch by China. Despite Vietnam consolidating its regional and international security identity, it can ill afford to alienate such an important ally as China.

In 2007, the Vietnamese government announced plans to reform the financial dealings of the Vietnam People's Army (VPA). The move towards a professionalised force focusing on conventional armed force duties is the result of it strengthening ties with other regional armed forces. The move is part of the government's larger policy to consolidate all state-owned enterprises. In Q108 Vietnam decreed that all military-owned defence industries will be managed by the government by the end of 2012. The change in ownership is part of the Defence Industry Ordinance, which dictates that the role of the indigenous defence industry is to support economic and social development as well as the defence of Vietnam.

Vietnam's local defence industry is smaller than that of its neighbours, including Thailand and Singapore, and thus the local defence industry faces stiff regional competition. Encouragingly, in Q207 the International Traffic in Armed Regulations amendment enabled the US to embark on examining two-way trade with Vietnam on non-lethal defence systems. In the long run this may provide Vietnam with additional export opportunities in the sale of small arms and light weapons.

Market Overview

A former Soviet proxy, Vietnam has failed to develop its own domestic defence industry adequately. Hindering its development has been its long history of conflict, meagre resources, lack of domestic know-how and military doctrine of guerrilla and defensive warfare strategies, which are still being overcome. Most Vietnamese arms were purchased from the Soviets, except for a few newly-acquired platforms from North Korea, Russia and a small number from India.

Perhaps the largest inhibiting factor preventing the industry's development is capital. With Vietnam so economically far behind regional leaders, it lacks the required industrial and scientific base necessary for any credible defence industry. However, future purchases, expected to come in the next decade, may include technology transfers, allowing Vietnam to jump ahead generations and providing the foundation for a domestic industry.

Vietnam maintains a small domestic defence industry capable of supplying small arms, minor weaponry, and ammunition. For more technologically-advanced production, Vietnam relies on reverse engineering; this technique has been employed to keep the nation's fleet of ageing Soviet aircraft in use prior to an agreement with India. All defence production is facilitated

by state enterprises, and there is little if any R&D done within the country aimed at creating new platforms. However, through a focused procurement programme, the Vietnamese defence industry will benefit from exposure to new technology. The Vietnamese government continued to boost its surveillance capabilities through the acquisition of electro-optic sensor systems in late March 2005. The systems, produced by **Israel Aircraft Industries/Tamam Division**, will equip the Vietnamese coast guard. The Plug-in Optronics Payload 200 (POP 200) will significantly boost the coastguard's day/night surveillance capabilities, and the identification of the target's location and acquisition. Israel Aircraft Industries/Tamam Division originally designed the POP 200 system for aerial vehicles, but it has been since modified to fit light aircraft and to be applied for both ground and sea operations.

Like most other sectors of the economy, Vietnam's defence industry is looking for technological transfers. Opportunities seem possible with companies from India, the UK, Russia, and France. However, the larger issue remains funding. With few resources directed towards the massive military, and just a small percentage of the total budget allocated to new purchases, Vietnam remains temporarily handcuffed until the economy expands to such a point that significant money is allocated to the defence budget.

Industry Trends & Developments

Vietnam's defence industry is largely underdeveloped compared to other neighbouring states, especially Singapore and Australia. Due to the weak indigenous defence industry, Vietnam imports most of its defence systems, with Russia, Poland and Israel providing the bulk of Vietnam's arms acquisitions. French defence company **Thales** is set to penetrate the Vietnamese defence and security market, especially in the area of light arms. Specifically, Thales is seeking to provide technology that can integrate with the Russian designed AK-630 naval Gatling Gun. Thales has already successfully integrated its technology with Poland's **Orkan** naval missile craft. However, there are a number of obstacles hindering the development of a robust defence and security industry in Vietnam.

In 2008 Vietnam's defence industry continued to mature. In Q108 the government directed that all military-owned defence industries will be managed by the government by the end of 2012. At present there are some 140 defence firms managed by the military. The change in ownership is framed in the Defence Industry Ordinance, which states that the role of the indigenous defence industry is to support economic and social development in addition to the defence of Vietnam. The government stated that the military's management of the defence firms and military issues were overloading the armed forces. However, it is likely that the move was also driven by the need for Vietnam's defence industry to mature more rapidly.

Arms Trade Overview – Vietnam's ageing platforms require replacement if the military is to have any operational capacity within the next decade. The almost total absence of any large-scale defence industry translates into the nation's need for foreign purchases. Historical suppliers Russia and India will likely remain the primary sources of new purchases, as both countries offer technologically-advanced systems for a relatively low price in comparison to Western goods. However, there is the opportunity for UK and US firms provided that they can offer incentives to Hanoi.

In Q207, Vietnam's defence export structure received a boost when the US announced that it intended to lift the arms trade sanctions placed on the country, after the International Traffic in Armed Regulations amendment enabled the US to embark on examining two-way trade with Vietnam on non-lethal defence systems. Items that are not included in the new agreement range from non-lethal crowd defence articles to night-vision systems used by security forces. It is likely that in the initial stages of the arms trade relationship will be asymmetrical, with Vietnam most probably importing most of the arms from the US. However, as the Vietnamese defence industry matures the country could boost its arms exports, particularly in the area of small arms and light weapons (SALW). Here Vietnam holds a comparative advantage in the labour-intensive SALW industry. Another issue to consider is that Vietnam's defence systems are old and need spare parts from older systems, which the US is unlikely to produce. As such, Russia is likely to remain Vietnam's main arms trading partner in the foreseeable future.

Industry Forecast Scenario

Army And Military Enlargement – In terms of civilian and possible dual use areas, Vietnam's aerospace industry presents the most easily realised opportunities. The industry has been growing by 10-15% annually and has made several recent purchases from non-traditional suppliers. As air traveller numbers continue to increase, new planes and infrastructure will be needed to accommodate demand.

The state-owned **Civil Aviation Administration of Vietnam** handles civilian air purchases. The administration is scheduled to receive US\$4.5bn for infrastructure and US\$5bn for new aircraft by 2010. Money for purchases will come from the state budget, development assistance and joint partnerships. Japan, Europe and especially the US are the largest players in the industry, and the US market share is expected to grow as the two nations continue to normalise relations. Recent activity in the sector has included **Vietnam Airlines** adding to its fleet of 25 aircraft, which includes five **Boeing 767-300s**, 10 **Airbus A-320s** and two **Airbus A-321s**, by signing a contract to buy four **Boeing 777-200ERs**. However, the best opportunity for contracts is located in the spares market, and aiding the nation in its multi-billion infrastructure development plans.

Although Vietnam continues to have little or no indigenous defence industry, change could be just a decade away. The military needs to add new platforms to all services to maintain training programmes and operational capacity. This need could be met by defence agreements

TABLE: VIETNAM DEFENCE SECTOR — HISTORICAL DATA & FORECASTS

	2004	2005	2006	2007e	2008f	2009f	2010f	2011f	2012f
Army personnel, '000s	420	418	416	413	413	413	413	413	413
Conscripted army personnel, '000s	0	0	0	0	0	0	0	0	0
Navy personnel, '000s	37.4	38	38.5	39.2	39.2	39.2	39.2	39.2	39.2
Conscripted navy personnel, '000s	0	0	0	0	0	0	0	0	0
Air force personnel, '000s	30	30.3	30.6	31	31	31	31	31	31
Total military personnel, '000s	487.4	486.3	485.1	483.2	483.2	483.2	483.2	483.2	483.2
Paramilitary force personnel, '000s	40	40	40	40	40	40	40	40	41
Total armed forces, '000s	527.4	526.3	525.1	523.2	523.2	523.2	523.2	523.2	524.2

*In 2000 the Air Defence Force was amalgamated with the Air Force to create the People's Air Force. na=not available; f=forecast. Sources: 1 BICC, 2 SIPRI, 3 IISS, 4 State Department, 5 BMI research. SIPRI data available from <http://projects.sipri.se/armstrade/>

with Russia, India and possibly the UK or South Korea. New large-scale contracts could form the backbone of a defence industry that would be well positioned to sell arms to questionable states such as Cuba and Burma. However, for this to happen, foreign partners must be willing to transfer technology or sell licensing agreements to Hanoi. More importantly, the CPV will have to find funding or pursue non-traditional payment options. Whether the CPV will make the development of this industry a national priority remains in question.

Government Expenditure On Defence Industry – Vietnam’s economy has been one of the region’s fastest growing. (It is important to note that Hanoi’s purchase of foreign goods, especially for the military, has been contingent on its economic growth.) With new and possibly sustained growth, Vietnam could be entering a potential spending phase similar to the one recorded in the pre-financial crisis years.

Hanoi announced plans in Q107 to reform many state owned enterprises (SOEs) throughout the country. Although the pace of reform is behind schedule, something that should come as no surprise, the banking sector, utilities, post, telecommunications, chemicals, insurance, and manufacturing sectors have been identified as profitable locations for foreign direct investment (FDI) and possible partnerships. In many of these sectors, foreign investors will be offered the opportunity to buy shares in SOEs; however, corruption and the opaque nature of business suggest that they would be high-risk plays, especially without a proven, workable legal framework to define business practices.

In the meantime, Vietnam remains a predominately agrarian society, with some 65% of the labour force employed in the sector, which includes forestry, fisheries, and agriculture. The sector accounts for 23% of GDP. Vietnam’s staple crops include coffee, rice and pepper, along with aquaculture exports; it continues to be a world production leader in the above goods. In relation to regional economies, Vietnam’s per capita GDP, net export values, and net GDP lag far behind regional competitors the Philippines, Thailand, and Indonesia.

Much like China, Vietnam has a glut of SOEs. Though accounting for 40% of industrial output, SOEs do not receive foreign investment and hence are languishing in terms of technological upgrades. It is likely that in the next decade Hanoi will sell many SOEs to raise foreign capital or, in the case of mining operations and other capital intensive industries, form partnerships between SOEs and foreign investors, who will need to offer expertise and R&D monies.

Meanwhile, private enterprises in the country account for roughly 25% of GDP, but for obvious reasons they are one of the fastest growth sectors and employ 400% more people than the state sector. One sector in particular to watch is tourism. With Thailand facing insurgency in the south, China becoming more expensive along its rapidly evolving coast, Indonesia and the Philippines stigmatised by their association to terrorism, and the cost of living increases in Malaysia, Vietnam has the potential to emerge as a safe, cheap tourist destination. Its lengthy coastline, numerous parks, wartime legacy, central location and cheap living costs will likely transform the nation into a tourist mecca in the decade to come.

This report is abstracted from our latest Vietnam Tourism and Defence reports, which include in depth research on the sectors, full five-year forecasts and thorough analyses of the competitive landscapes. BMI currently covers 16 industries across 60 countries. For further information, or to order a report, please contact: subs@businessmonitor.com

chapter 7 BMI Global Assumptions

Here, BMI analysts give their view of the state of the world economy and the main challenges faced. In this context, they outline their forecasts for growth, inflation, interest rates and the exchange rate in the US, the eurozone, Japan and China over the forecast period of the report (2008-2012). There are also separate sections on the oil price and commodities markets. The forecasts contained in these sections represent the basic assumptions that underpin the analysis in BMI's country reports.

Global Outlook

A More Uncertain World

Our new global assumptions reflect our updated views on the trajectory of the US dollar and commodities in the second half of 2008 and beyond. In a nutshell: the US dollar comeback that we have been awaiting will have to wait a bit longer. We see the **European Central Bank** (ECB) remaining hawkish, commodities remaining fundamentally supported, inflation continuing to plague emerging market (EM) central bankers, and the financial sector falling further. Key changes to our global assumptions include:

- A downward revision in our year-end forecast of the US dollar versus the euro, from US\$1.45/EUR to US\$1.49/EUR. We are still forecasting a rebound in the US dollar

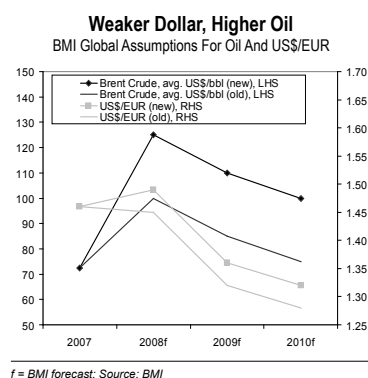


TABLE: GLOBAL ASSUMPTIONS

		2005	2006	2007	2008f	2009f	2010f	2011f	2012f
Real GDP growth (%)	US	3.5	3.3	2.2	0.9	1.9	3.1	3.0	2.8
	Eurozone	1.4	2.7	2.6	1.6	1.4	1.8	1.9	1.9
	Japan	2.7	2.4	2.1	1.1	1.5	2.1	2.1	2.1
	China	10.4	11.1	11.5	10.7	9.5	9.5	9.5	9.5
	World	4.8	5.1	4.9	3.9	4.1	4.3	4.2	4.2
Consumer inflation (year-end)	US	3.4	2.5	4.1	3.2	2.1	2.3	2.1	2.1
	Eurozone	2.1	2.2	2.9	3.1	2.0	1.7	2.0	2.0
	Japan*	-0.1	0.3	0.1	1.0	0.7	0.8	0.9	1.0
Interest rates (year-end)	Fed funds rate	4.25	5.25	4.25	1.50	3.00	3.25	4.25	4.25
	ECB refinancing rate	2.25	3.50	4.00	4.50	4.50	4.00	4.00	4.00
	Japan overnight call rate	0.00	0.25	0.50	0.50	0.50	0.75	1.00	1.25
Exchange rates (year-end)	US\$/EUR	1.18	1.32	1.46	1.49	1.36	1.32	1.32	1.29
	EUR/US\$	0.85	0.76	0.68	0.67	0.74	0.76	0.76	0.78
	JPY/US\$	118	119	112	105	110	110	110	110
Goldman Sachs Commodity Index	Metals (GSIN)	294	446	400	420	370	400	420	420
	Agriculture (GSAL)	210	272	320	360	320	300	300	300
Oil prices (average)	Oil – Opec basket US\$/bbl	50.64	60.87	69.00	121.50	106.50	96.50	91.50	81.50
	Brent Crude US\$/bbl	54.70	66.80	72.50	125.00	110.00	100.00	95.00	85.00

* Calendar-year basis. Source: BMI

by the end of 2009, but to a more moderate US\$1.36/EUR (compared with US\$1.32/EUR previously).

- An upward revision of our ECB refi rate forecast to 4.50% by end-2008, from 4.00% previously. This revision, in tandem with our view that a US rate cut is in the offing by year-end (with Fed funds at 1.50% versus its current 2.00% level), possibly due to the failure of another major US financial institution at some point in H208, helps explain our slightly less constructive view on the US dollar.
- A downward revision in our 2009 eurozone growth forecast, from 2.0% to 1.4%. This is due in part to our revised view on ECB tightening. Our US growth forecasts remain more or less the same, with a slight revision in the 2009 forecast from 2.0% to 1.9%. US growth should, therefore, comfortably outpace that of the eurozone in 2009 (at 1.9% versus 1.4%).
- A substantial upward revision in our oil price forecasts. We now see Brent crude averaging US\$125.00/bbl in 2008, falling to US\$110.00/bbl in 2009 (previous forecasts: US\$100.00/bbl and US\$85.00/bbl, respectively). We have maintained our metals and agriculture price forecasts, as we believe that despite near-term downside risks, the commodities complex should remain high on a historic basis over the forecast period.
- A revision in our year-end **Bank of Japan (BoJ)** overnight call rate forecast, from a 25bps cut to 0.25%, to no change, at 0.50%. This reflects our expectations for higher inflation in Japan. We have also slightly bumped up our yen forecasts to JPY110.00/US\$ from JPY112.00/US\$ over the period from 2009-2012 (the end-2008 projection remains unchanged at JPY105.00/US\$).

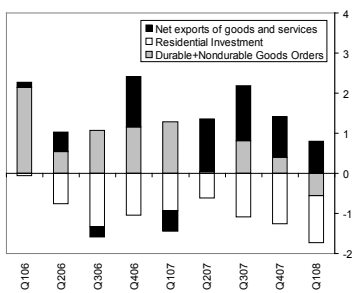
United States

An Unsteady Ship

The US economy is in poor shape, but we think the preconditions exist for a recovery next year. In the meantime, the dollar may test all-time lows versus the euro in H208, propelled by a weak domestic economic outlook and diverging interest rate expectations with the eurozone. By the end of 2008, however, we believe that US economic growth will begin to recover, and we are forecasting a 1.9% growth rate in 2009. We believe that the US will hit recession in 2008, but we nonetheless expect the US economy will begin to outperform the eurozone's by the end of the year, or at the very latest, by early 2009. Our US growth forecast for 2008 as a whole is 0.9%, which includes a negative outturn for a portion of the year, with a resurgence by year-end. We see growth rising to 3.1% by 2010, reflecting a return to above-trend expansion.

The **Federal Reserve's** response to the credit crunch, which has included unorthodox lending measures and 325bps of rate cuts so far, has been timely enough for us to anticipate an economic rebound. Furthermore, the weak US dollar has propped up the external sector, with net exports having contributed to overall GDP growth in seven of the past nine quarters. There are signs that private fixed investment may not be as big a drag as we had thought, with capital

The Consumer And Homeowner Roll Over
US – Contribution To Overall GDP Growth (percentage points)



Source: BEA

goods orders showing signs of life despite weak headline Institute for Supply Management survey results. Although the decline of the US consumer is the biggest risk to our outlook, and will in any case weigh on growth, it will also force a readjustment of the exchange rate. Our 'rebalancing act' thesis suggests that the US current account deficit will narrow as consumer demand for imported goods falls. If we are right about these macroeconomic factors, we believe that the downward pressures on the dollar will begin to abate.

Rest Of The World Saves The Day

The upward revision to Q108 US GDP in June was in line with expectations, with the 0.9% q-o-q annualised figure representing a bump up from the originally reported 0.6%. Several of the underlying figures caught our eye, and help underline our fundamental 'rebalancing act' view that demand from a robust global economy should help cushion the US from too large a downturn in 2008 and help the dollar recover. The first chart shows that key components of the domestic economy – durable and nondurable goods demand, and residential investment – dragged down the headline Q108 real GDP figure, a further indication that the US consumer is under pressure. Combined, they pulled down GDP by 1.73 percentage points (pp), including a 0.56pp contraction in goods orders, both figures that are consistent with a major slowdown and possible recession. In contrast, net exports added 0.8pp, nearly the entire headline growth figure. The chart to the right tells the tale.

Indeed, net exports' contribution to GDP growth were revised up, helping to ensure that GDP did not enter negative territory in Q109. The last time growth excluding-net exports reached this territory was the 2000-2001 economic downturn, and before that, in the 1990-1991 recession. Important to note is that imports were far lower in Q108 than originally expected, presumably reflecting the weakness of the US consumer and tighter credit markets. That is having more of an effect on aggregate than the rise in exports. These trends should continue.

Financial Sector Poses Risks

We are not yet convinced that the banking sector is back on its feet, or that the US consumer will return to form any time soon, in the face of rising grocery and fuel bills. As the US economy weakens, and defaults rise, writedowns are likely to continue to mount, continuing to put the banking sector under pressure. This could put the Fed on the defensive, at the very least holding rates at 2.00%, or as we believe, cutting further.

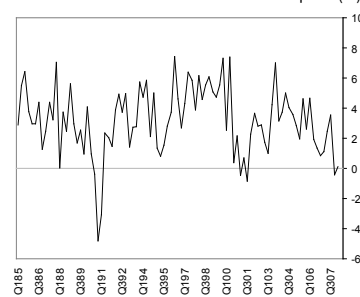
Eurozone

Tighter Monetary Policy Threatens Growth

We have revised down our 2009 eurozone real GDP growth forecast to 1.4% from 2.0% (with 2008's projection unchanged at 1.6%), as we believe that the knock-on from the US slowdown will become evident toward the end of 2008. Worryingly, amid deteriorating external conditions, the individual economies of the eurozone are running at different speeds. With monetary policy tightening, rather than loosening – we are now forecasting that the ECB will raise its refi rate to 4.50% by year-end – the dangers of a eurozone recession by the end of 2009 are mounting. While the ECB is just doing its job, the biggest risk to the

Flat Or Negative Growth Without The Help Of Net Exports

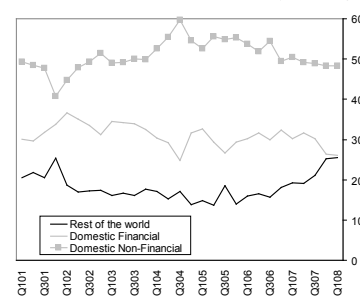
US – Headline GDP Growth Minus Net Exports (%)



Source: BEA

Relying Less On Banks And More On The Rest Of The World

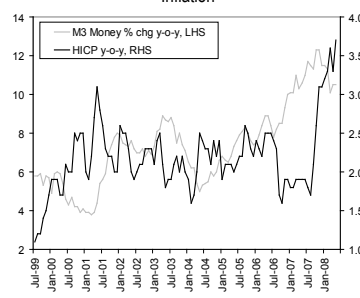
US – Breakdown Of Corporate Profits By Source (%)



Source: BEA

Twinned Headache For The ECB

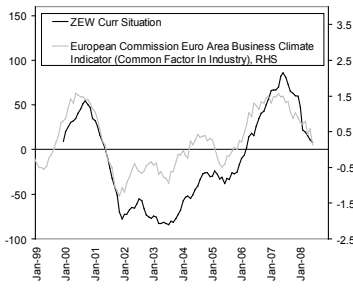
Eurozone – M3 Broad Money Supply And Headline Inflation



Source: Eurostat

Not So Cheery

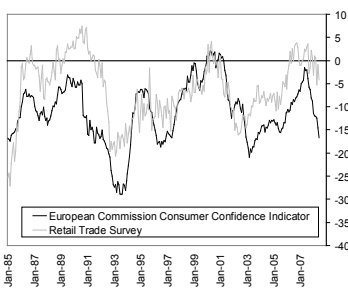
Eurozone – Business Confidence Indicators



Source: ZEW, Eurostat

Unhappy Consumers

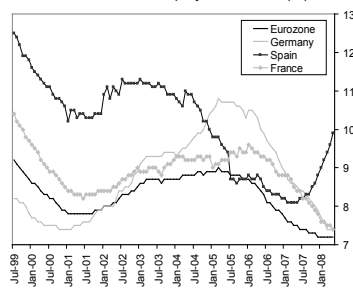
Eurozone – Retail Trade Survey And Consumer Confidence



Source: Eurostat

Unemployment Putting The 'Pain' In Spain

Eurozone – Unemployment Rates (%)



Source: Eurostat

eurozone in our view is not the inflationary risks posed by high commodity prices, but the increasing likelihood of a sharp economic downturn.

The ECB's hawkish stance on inflation is understandable. Prices remain stubbornly above the 2.0% target, producer price inflation is through the roof, and M3 money supply growth, which is seen by policymakers as a key leading indicator of prices, has been ascending sharply since mid-2004, from around 5.0% y-o-y at that time to 10.5% y-o-y in May.

High imported commodity prices are taking their toll, despite the strong euro, and the biggest headache for the ECB is the potential for a wage-price spiral. The ECB's June bulletin highlighted the 'risk that recent increases in food and energy prices might feed through to consumers' inflation perceptions and expectations', which would then feed into higher wages via tight labour markets, the bargaining position of unions, and contractually obligated price-wage indexation. Unemployment rates are low in several eurozone states, and the overall eurozone jobless rate is at 7.2%, the lowest since the bloc was formed in 1999. Furthermore, labour costs have been on the rise since Q406, rising by a 4½-year high of 3.3% y-o-y in Q108 (Q2 figures are not yet available). With day-to-day costs rising, it seems unlikely that wage negotiators are going to remain quiet.

Signs Point To Lower Growth And Inflation... Eventually

So, the stage is set for even higher eurozone interest rates. Ultimately, however, the ECB risks over-tightening just as the eurozone economy reaches an inflection point. The ECB may be making the classic mistake of setting monetary policy while staring into the rear-view mirror, ignoring the potentially disinflationary or even deflationary risks presented by a eurozone downturn in H208 and 2009.

We believe that growth has peaked, and so too, apparently, do consumers and corporations. The combination of waning growth, higher oil prices and the sapping of external competitiveness due to the euro's rise against the US dollar have led to clear inflection points in major business sentiment surveys, including the ZEW. The picture on the consumer side of the equation is equally negative. Again, there was a pretty clear inflection point in June/July 2007, after which successive surveys of both consumers and retailers have painted an increasingly dour picture. All of these surveys indicate that the pricing power of retailers and manufacturers is unlikely to be sustained, which should eventually keep the lid on inflation.

It appears that as the economy weakens, so too will the labour market. All else being equal, the eventual reduction of labour market pressures should keep a lid on inflation, and help prevent a descent into a wage-price spiral.

Complicating the ECB's position is that there is a mounting divergence between eurozone states' economies. German growth has remained fairly strong, in spite of the headwinds posed by higher interest rates and a stronger euro. But in Italy, Spain and Ireland, where growth is slowing or contracting, tighter monetary policy is potentially disastrous. Denmark's economy contracted in the first quarter. Unemployment is shooting up in Spain, and Italian and Irish growth is, respectively, flatlining and plunging. If there is further divergence between the growth of eurozone member states, the political pressure from weaker nations is likely to mount, only complicating the ECB's task.

Adding to the ECB's headaches is that as in the US, European banking institutions are being stung by the credit crunch, with more writedowns on asset-backed securities likely to come.

A Pyrrhic Victory?

One sign that the ECB's fears may be misplaced is the stability of the eurozone core inflation measure, which indicates that greater spending on food and energy items is crowding out spending on other items – a classic symptom that the problem is not money supply growth, but a change in relative prices. In other words, a move higher in global commodity prices, and not domestic monetary policy, has ultimately been responsible for the rise in the headline HICP inflation figure. Were oil and food prices to drop sharply from their current levels, at this time next year, headline inflation would likely fall significantly in the coming months, in the absence of an increase in the money supply. This analysis will be little consolation for labour unions, though, which is why ECB President Jean-Claude Trichet has been so acute in warning against wage hikes.

Given these factors, the danger is that in order to bring the headline inflation number down, the ECB will have to bring the eurozone economy to its knees. Indeed, some countries are already on the verge of recession. We believe that the ECB is merely meeting its mandate to maintain price stability, but at the cost of future growth – hence our decision to sharply reduce our 2009 eurozone real GDP growth forecast to 1.4% from 2.0%.

Japan

Inflation Risks, Despite Weak Growth

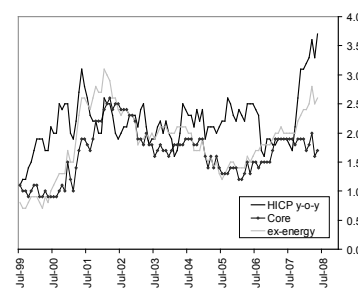
Amid a weakening global economy, we are forecasting Japanese real GDP growth of only 1.1% in 2008 and 1.5% in 2009, compared with 2.1% in 2007. Although Japan's economy expanded at an annualised rate of 4.0% in Q108, this pace is clearly unsustainable, given that the US is probably already in recession. While Japan's exports – which are the main driver of its economy – will be cushioned by demand from China, a significant proportion of these shipments ultimately depend on demand from the US. This is because many Japanese firms have shifted assembly to China over the past decade.

In early July, the BoJ stated that economic conditions had worsened in eight of the country's nine regions since April, owing to rising energy and commodity prices. At the same time, the BoJ's quarterly Tankan business survey showed that businesses are also gloomy, with the manufacturing index falling to +5, its lowest level since September 2003.

In addition, domestic demand will remain subdued, with consumer confidence at its lowest level in six years. The structural reason for this is that major companies have increasingly relied on 'temporary' workers (i.e., those on part-time, fixed-term, or temp-agency contracts) on much lower pay to replace their higher-salaried 'permanent' employees who had been retired or laid off. More recently, though, rising energy prices have hurt sentiment. Furthermore, Japan's unemployment rate rose to a seven-month high of 4.0% in April and May 2008.

Headline High... But Core Not A Problem

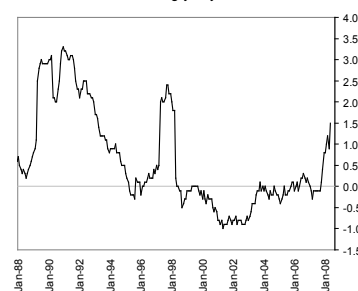
Eurozone – Inflation Indicators



Source: Eurostat

Finally Out Of Deflation

Japan – Core CPI (Excl. Fresh Food Prices), %
chg y-o-y



Source: Statistics Office

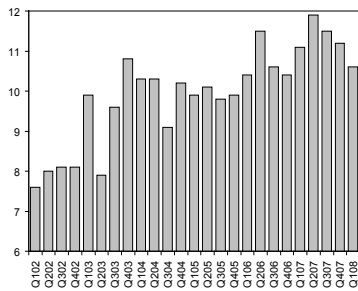
Meanwhile, core CPI rose to a 10-year high of 1.5% y-o-y in May 2008, and Japan appears finally to have extricated itself from a decade of deflation. This mainly reflects energy prices, which are likely to remain high for the foreseeable future. While the likelihood of an economic slowdown would appear to point towards an interest rate cut by the BoJ, we believe that the inflationary outlook would make this risky. We thus believe that the BoJ will keep the overnight call rate (currently 0.50%) on hold for the rest of 2008 – although we cannot preclude a rate cut, given the current macroeconomic outlook.

A key unknown is whether Prime Minister Yasuo Fukuda will be replaced, either through an intra-party move against him, or by an early general election. Both scenarios would produce a shaky government, ill-positioned to enact major reforms needed to reinvigorate the economy.

Japan’s Medium-Term Prospects

Over the long term, Japan could raise its potential growth rate to above 2.0% by deregulating its economy, introducing greater competition, and allowing more immigration. Nonetheless, Japan’s outlook is clouded by two main factors. One is the rising public debt-to-GDP ratio, which is now around 150%, the highest in the developed world. The government aims to attain a primary surplus by FY11/12, or even before then, but the higher consumption taxes and other levies necessary to achieve this could hurt growth. The second and bigger problem is Japan’s rapidly ageing and slowly declining population, which could fall below 90mn by 2055, according to the health ministry. Although the government is planning incentives to boost birth rates, the decline will be difficult to reverse, meaning that Japan will have to import millions of workers from abroad to keep its workforce young. However, immigration is politically unpopular, limiting this as a viable solution. Japan will therefore have to maximise automation and technological innovation to maintain productivity amid a greying population.

All Things In Moderation
China – Real GDP Growth, % chg y-o-y



Source: BMI

China

Inflation The Major Risk

Economic momentum decelerated for the third consecutive quarter in Q108, as real GDP growth cooled to 10.6% y-o-y. However, there is evidence to suggest that the sharp slowdown from Q407’s 11.2% expansion was in part a result of the winter snow storms and the lunar new year celebrations. Indeed, despite February’s severe winter weather costing the Chinese economy more than US\$15bn, according to government estimates, economic activity remained robust throughout the period. Furthermore, import growth remains strong. This indicates that domestic investment – a crucial driver of the economy, contributing an estimated 11.5pps to growth in 2007 – is set to continue expanding at a rapid pace. Fixed investment accounts for almost 60% of overall real GDP growth in China, far outpacing the contribution made by net exports, meaning that while a stronger yuan and softening external demand will continue to put pressure on the country’s export sector, economic growth is unlikely to fall sharply as a result. However, while we see scope for economic growth to rebound in Q208 (much as it did in 2007, 2006 and 2005), our core scenario remains that economic momentum will continue to moderate in 2008 and 2009 as monetary tightening takes grip and softening external demand takes its toll.

Meanwhile, despite the yuan gaining against the US dollar in H108, China's trade surplus continued to mount and foreign reserves carried on accumulating at a rapid pace. The country's trade surplus almost doubled in Q108 compared to the equivalent period a year ago, rising from US\$6.75bn in Q107 to US\$13.41bn, while China's foreign reserve pile surged 40.0% y-o-y in March to US\$1.682trn. While we expect growth in the trade surplus to moderate as export growth cools and imports maintain their robust momentum, and for foreign reserve growth to similarly slow, it appears that the anticipated slowdown will not take place as swiftly as originally thought. This too will ensure that economic growth remains well-supported.

Inflation Remains The Key Issue

With monetary policy still too lax, inflation will continue to prove problematic to the Chinese authorities. Yet, we maintain our view that policymakers have little room to manoeuvre with respect to further monetary tightening. Interest rate hikes will have a limited effect while inflation persists at such elevated levels, since real rates will remain in deeply negative territory, and will likely only exacerbate the growing problem of speculative money entering the economy. Indeed, in a signal of Beijing's growing concern over the situation, the State Administration of Foreign Exchange (SAFE) issued new, tighter quotas for banks' short-term foreign currency debt in April, having ordered last year that both foreign and local banks slash their burden of short-term foreign debt by 60% and 30%, respectively, of 2006 levels.

Faster yuan appreciation also carries a similar risk. Accelerated currency gains and the widening yield differential between **People's Bank of China** bills and US LIBOR make the carry trade even more attractive, while at the same time threatening to hit the country's exporters – and, perhaps more importantly, jobs in this key sector – sharply. Thus, we continue to expect further reserve ratio hikes and direct curbs on bank lending, although we caution as to how effective such a policy approach will be; so far, it has yielded only minimal results.

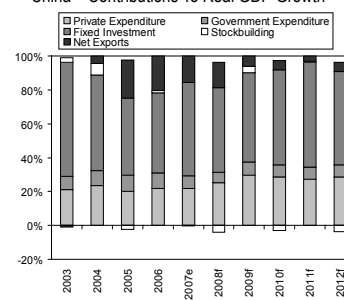
Commodities

Oil: Bubble Forming

Although the weaker dollar and increased investment in the commodities complex by the fund management community are being blamed in many quarters for higher oil prices, the reality is that high prices are being underpinned by the strength of demand from EM. As Nobuo Tanaka, the executive director of the International Energy Agency (IEA), recently stated, with OPEC production at record highs and non-OPEC production high too, there has been no unusual build in stocks, implying that supply and demand fundamentals are underpinning prices. Furthermore he pointed out the increasing shift in demand from OECD countries to developing states, with total consumption in EM equalling that of mature economies by 2015.

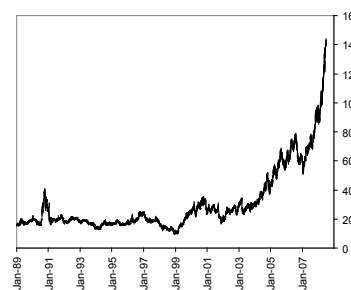
Against this backdrop of strong demand, the potential for a weaker US dollar – which also means higher global inflation – will exert further upside pressure on oil prices. Indeed, although we think the dollar is in the latter stages of its multi-year bear trend, we could yet see one more significant move to the downside, perhaps towards the US\$1.6000-1.7000/EUR area. In turn, oil prices would spike higher, comfortably through US\$150.00/bbl.

Fixed Investment The One To Watch
China – Contributions To Real GDP Growth



e/f = BMI estimate/forecast; Source: BMI

Still Spiking... For Now
Front Month Brent Crude – US\$/bbl



Source: BMI

However, given the severe inflationary pressures pervading EM, we expect the ongoing monetary tightening to continue, and in several cases to be quite aggressive over the coming months. The significant increase in the cost of borrowing across EM in general will weigh on economic activity, causing a reduction in levels of real GDP growth. This together with a gradual reduction of energy price subsidies in EM, and the ongoing economic slowdown in the US, will see demand for oil cool in the latter part of H208.

We would not be surprised to see the market fall swiftly to the US\$85.00/bbl-US\$100.00/bbl area in H208/H109. This, of course, would still represent a high price of oil. Given that we are not forecasting a collapse in EM growth levels, merely a small moderation, we see demand for oil remaining solid in the medium-to-long term, especially in light of ongoing refinery limitations and the ever-present threat of rising geopolitical tensions in the Middle East. With this in mind, we have upped our 2008 average price forecast for Brent crude to US\$125.00/bbl, from US\$100.00/bbl previously, and the 2009 forecast to US\$110.00/bbl, from US\$85.00/bbl.

Metals: A Higher Equilibrium

In line with our view, continued rampant emerging market growth has put upside pressure on the base metal complex even as developed world growth has slowed. Supply constraints resulting from strikes and power shortages have also kept inventory levels low. We stick with the view that base metal prices will remain elevated thanks to strong EM growth, and maintain our end-2008 Goldman Sachs Industrial Metals (GSIN) index forecast of 420.00, noting the upside risks resulting from potential supply disruptions.

This forecast prices in a moderate correction from the current highs as we believe the potential for aggressive inflation fighting by central banks worldwide will dampen global demand, leading to cooling in the demand for base metals towards the latter part of the year. Together with a rebound for the dollar, this cooling in demand should take the GSIN index towards 370.00 in 2009. Any further moderation beyond this is likely to be prevented by the rising costs of production, meaning prices will remain high on a historical basis. Beyond this, we see scope for further gains over the long term as infrastructure growth in EM, and in particular China and India, support the demand side, and worsening supply constraints raise production costs.

Softs: Moderate Correction, But Remaining Elevated

We expect to see the agricultural complex remaining close to historic highs throughout the remainder of 2008, with our end-2008 Goldman Sachs Agricultural Index (GSAG) target remaining at 360.00. We note though that record demand and disruptions in supply provide potential for the index to mount another charge to its all-time high. Against a backdrop of low inventories, poor weather conditions in the US, rising demand for ethanol production and a growing Chinese appetite, as well as a massive spike in the price of oil, have all been ideal conditions for higher agricultural prices. Corn and soybeans have benefited greatly, with the latter boosted by supply uncertainties caused by farmers' protests in Argentina.

We expect grains prices to remain buoyed by the ongoing supply issues, but acknowledge that given the impressive run, they are susceptible to a pull-back over the medium term as production

responds to the historically high prices. Also, a sharp correction in oil prices, which would reduce the demand for ethanol, and take the wind out of the sales of speculative commodity investors, presents a major downside threat for the price of agricultural commodities over the medium term. Notwithstanding the downside risks, we set an end-2009 GSAG target of 320.00.

We expect agricultural prices to remain elevated on the back of growing demand from EM. The key to the outlook of soft commodities, though, will be China. Our core view is that Chinese economic growth will continue to impress and changing dietary habits will keep upside pressure on the agriculture complex. Perhaps the biggest threat comes from the potential for China to emerge as a major softs producer, which could alleviate much of the demand pressure.