

Executive Summary

Recovery Not Secure Despite Stimulus

- The 3.1% y-o-y expansion in Q109 was the lowest on record, but more recent macroeconomic data suggest that the government and central bank's stimulus measures are now gaining traction. We thus acknowledge upside risks to our 2.9% growth forecast for 2009, but refrain from an upward revision due to the still precarious state of the global economy. On the political front, the economic downturn has not yet seen any material repercussions, but we have nevertheless decided to lower our short-term political risk ratings on the back of high inflation and rising unemployment undermining public acceptance of one-party rule. Meanwhile, regional tensions have risen due to China's more assertive claims of sovereignty in the South China Sea.
- The crackdown on trade union activists, bloggers and other political dissidents has left little doubt that the Communist Party of Vietnam has no intention of moving towards greater political freedom. Nonetheless, the widening cracks in the government's monopoly on information remain a long-term threat to one-party rule. This has been particularly evident in Hanoi's efforts to silence domestic criticism of China, which has risen due to a controversial Chinese investment in bauxite mining in the central highlands. However, while Chinese investment into the extractive sector is likely to remain a contentious issue in the short term, we believe that economic integration carries the key to improved Sino-Vietnamese relations over the longer term.
- We maintain our below-consensus 2.9% GDP growth forecast for 2009, but are now acknowledging upside risks to this forecast. This is due to strong fiscal and monetary stimulus bolstering domestic demand, and a weaker dong softening the contraction in external demand. With global economic conditions expected to improve slightly in 2010, we maintain our 5.0% growth forecast for next year. We also maintain our expectation that the government will stepwise depreciate the dong towards VND19,000/US\$ by the end of the year. However, this carries risks to macroeconomic stability as public confidence in the dong has been impaired by expectations of higher inflation and speculation surrounding a devaluation.
- The sharp deterioration in economic conditions both domestically and globally has prompted the Vietnamese government to shift its attention from economic reforms to devising measures to support growth in the short term in the face of slumping global demand. Only 73 out of a planned 262 state-owned enterprises (SOEs) were equitised (transformed into shareholder-owned companies) in 2008, and initial public offerings of SOEs like **Bao Viet** have been unsuccessful, largely due to the high pricing of shares. While continued delays in the equitisation process are expected, we are not expecting any shift in the government's economic reform agenda, which will continue to support economic activity.

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

- The sharp slowdown in growth expected in 2009 is likely to weigh on public acceptance of the one-party system, and street demonstrations to protest economic conditions could easily develop into a full-on challenge of undemocratic rule.
- 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.
- Relations with China have deteriorated over the past year due to Beijing's more assertive stance over disputed islands in the South China Sea and domestic criticism of a large Chinese investment into a bauxite mining project in the central highlands, which could potentially cause widescale environmental damage.

BMI Political Risk Ratings

Vietnam's short-term political risk (STPR) rating of 79.8 reflects a largely stable political system, mainly kept in place by the ruling Communist Party of Vietnam (CPV)'s monopoly on power. While public expressions of discontent have so far been limited, slower growth and high inflation pose a threat to stability in the near term, with the social stability component having dropped to 62.5 from previous scores of 70 and above. However, we see one-party rule as inherently unsustainable in the longer term, and thus accord Vietnam a rating of 52.8 in our long-term political risk (LTPR) ratings, mainly due to a score of 27.6 in the characteristics of polity rating.

	S-T Political	Rank	Trend
Singapore	97.3	1	=
Hong Kong	86.7	2	=
Australia	86.5	3	=
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New Zealand	82.1	5	=
Malaysia	81.9	6	=
Japan	80.2	7	=
Vietnam	79.8	8	+
Laos	79.6	9	+
Taiwan	79.0	10	=
South Korea	77.1	11	=
North Korea	76.9	12	=
Seychelles	73.8	13	=
Sri Lanka	69.6	14	=
Indonesia	69.0	15	=
Bangladesh	67.7	16	=
Cambodia	67.3	17	=
Philippines	66.0	18	=
Thailand	65.4	19	+
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Domestic Politics

Political Repression To Continue

Vietnam has yet again come under criticism for its poor human rights record after the regime boosted its efforts to repress political dissent by curbing internet use and jailing bloggers. The damning report entitled *Not Yet a Workers' Paradise* was published by non-governmental organisation (NGO) Human Rights Watch (HRW) on May 4, and paints a picture of an increasingly repressive reaction from the Vietnamese authorities to the formation of trade unions independent of the ruling Communist Party of Vietnam (CPV).

The report gives a detailed account of how Vietnam underwent what HRW calls a 'false opening' of a greater official tolerance of rights of organisation ahead of Hanoi's hosting of the Asia Pacific Economic Cooperation (APEC) summit in November 2006 and Vietnam's accession to the World Trade Organisation in January 2007. This was, according to HRW, followed by a crackdown in 2007 and 2008 as an increasing number of workers, mainly employed in foreign-owned factories, joined 'wildcat' strikes, i.e. without the approval of CPV officials, for better wage and working conditions.

The report underlines our view that political conditions in Vietnam are, and will most likely remain, repressive in spite of the continued liberalisation of the economy. Indeed, the jailing of a number of political activists in 2007 and 2008, among them the Roman

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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 Kiem, 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 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	79.8
BMI Structural Political Risk Rating	52.8

Source: BMI

Catholic priest Nguyen Van Ly, has made it clear that the CPV regime in Hanoi has no intention of coupling economic reform with concessions in the field of politics.

However, the increased penetration of internet services – Vietnam's Ministry of Information and Communication estimated the number of internet users at more than 20 million, or 24% of the population, in November 2008 – has been a political evolution of its own. While outright assaults on one-party rule remain rare, bloggers have become increasingly vocal in their criticism of government policy.

The CPV regime has become increasingly wary of the threat to its information monopoly, and by extension one-party rule, posed by this elusive army of bloggers and, consequently, in October 2008 set up a new government body called the Administration Agency for Radio, Television and Electronics Information with the objective of monitoring internet usage. Moreover, a law was passed in December last year prohibiting the creation of internet posts deemed to undermine national security, contain inaccurate information that could damage the reputation of individuals and organisations, or disclose state secrets.

We expect the government to continue its efforts to control internet usage, with government corruption and foreign policy (especially Vietnam's tense relationship with neighbouring China) remaining the main no-go areas for internet bloggers. However, this will be an uphill struggle as savvy internet users will find ways to circumvent the government's efforts to restrict free speech on the internet.

While monitoring, and penalising, trade union activists and bloggers will remain as stop-gap measure to contain political dissent, the main challenge for the regime in the near term will be to prop up economic growth so as to avoid widespread public discontent with one-party rule. We thus maintain that political risk will remain heightened over 2009 and 2010 as economic growth comes in below trend.

Foreign Policy

Hanoi To Keep A Wary Eye On Beijing

Vietnam's ever-tense relations with China have taken a turn for the worse over the past year as Beijing has raised its claims for the disputed Paracel and Spratly islands in the South China Sea, and a multibillion dollar Chinese investment in bauxite mining in the central Vietnamese highlands have raised criticism of China in Vietnam.

Vietnam's relations with China have always been one of apprehension of the intentions of its 'big brother' north of the border. Indeed, more than a thousand years of Chinese rule (between 203BC and 905AD and a brief period in the 15th century) have made the Vietnamese extremely wary of any encroachment on their autonomy and territory by their larger neighbour. Although the two have been ideological allies since the Communist Party of Vietnam's victory, with Chinese assistance, over the French in 1954 and the unification of Vietnam under Communist rule in 1975, territorial disputes have frequently put Hanoi and Beijing at loggerheads.

BMI VIEW

We expect Hanoi's relations with its northern neighbour to remain tense in the short-to-medium term as Vietnam and China stand by their conflicting claims on the Paracel and Spratly islands. However, while Chinese investment into the extractive sector is likely to remain a contentious issue in the short term, we believe that economic integration carries the key to improved Sino-Vietnamese relations over the longer term.

Disagreements over the demarcation of the land border between the two, and the Vietnamese ousting of the Chinese-backed Khmer Rouge regime in neighbouring Cambodia, brought China and Vietnam to a brief but bloody war in February-March 1979, with an estimated 50,000 killed. Border skirmishes continued throughout the 1980s until Beijing and Hanoi normalised diplomatic relations in 1991. A land border agreement between the two was signed in 1999 and the demarcation of the 1,350km land border was finalised on January 1 2009.

Maritime Disputes Linger

However, progress on land border demarcation has not been coupled with any progress in settling the long-running dispute over the Paracel and the Spratly Islands in the South China Sea. The conflicting claims for the Paracel Islands date back, at the least, to the colonial era when France annexed the islets into French Indochina. China later exploited the political vacuum resulting from the collapse of French Indochina and South Vietnam to occupy parts of the Paracel Islands in 1956 and 1974 respectively.

The tension surrounding the disputed islands has steadily increased in recent years as the May 13 2009 deadline set by the UN in 2004 for countries to submit claims for the legal extension of their continental shelves has now closed. The deadline was a bid for a final resolution of maritime borders to put an end to territorial disputes over areas of the seabed believed to contain oil and natural gas resources, which is a prime factor for both the Chinese and Vietnamese claims for the disputed islands.

Existing international law stipulates that nations can exploit the seabed if their continental shelves extend beyond territorial seas stretching 200 miles from the coast, but this does not solve the problem of conflicting claims. The Paracel and Spratly islands have thus become subject to a regional power play, frequently involving the flexing of military muscle. Beijing has upped its claims for the islands over the past year, making a submission to the United Nations on May 12 that 'China possesses indisputable sovereignty and jurisdiction over the South China Sea islands and their near seas'.

Vietnam has sought to defend its claims over the disputed islands, and has submitted a competing petition together with Malaysia to the UN questioning China's claims in the South China Sea. The declaration follows a more aggressive stance by China over the past year, with the Chinese navy becoming increasingly hostile in its activities, among other things squaring off with surveillance ships from the US navy in March 2009.

Of particular significance for Vietnam has been the construction of a major submarine base on the Chinese island of Hainan, capable of hiding up to 20 submarines, which will significantly boost the Chinese navy's operative capabilities in the South China Sea. In an effort to counter the Chinese build-up, Vietnam purchased six kilo-class Russian submarines for US\$1.8bn in April, a massive outlay for a country with an annual military budget of just US\$3.6bn. However, given that China has a population 15 times bigger and an economy roughly 100 times the size of Vietnam's, there is little Hanoi can do to check the Chinese military expansion on its own. With the Chinese threat growing, we find it likely that Hanoi will continue to seek closer military and political ties with the US in order to fulfil the joint aim of countering the expansion of China's military might.

UN Attempts To Solve Island Dispute
Map – South China Sea



Source: BMI

Mining Project Exacerbating Tensions

The rivalry in the South China Sea has fed into growing public discontent over a decision by the Vietnamese government to allow a Chinese-financed investment in bauxite mining in Bao Lam in the Lam Dong province in the central highlands. The project has sparked a spiral of nationalistic sentiment, which has unnerved both Beijing and Hanoi. Vietnamese authorities have sought to defuse the public uproar by closing down newspapers and websites who have criticised the investment on the grounds that it will bring severe environmental damage to the region.

The mining project's critics have been boosted by the intervention of General Vo Nguyen Giap, a 97-year-old hero from the wars of independence against the French and the Americans, who has spoken out against the investment project in what he calls a strategically important location in terms of security and defence. Nonetheless, opposition from Giap and the public failed to prevent the Politburo, Vietnam's highest executive body, from approving the project on April 28. We see this as reflective of the sharp slowdown in foreign direct investment (FDI) pledges in the first four months of 2009, which means that the Vietnamese government is welcoming virtually any foreign direct investment regardless of origin. That said, Chinese investment into the natural resources sector is likely to remain a contentious issue and we expect the Politburo to take a more apprehensive stance once global economic conditions and FDI inflows have recovered.

Mekong River And Trade Gap Also Problematic

While the government may succeed in quelling opposition to the project in the short term, we believe that the fear of Chinese dominance will remain as an underlying current in Vietnamese society. Relations between China and Vietnam are thus likely to remain volatile with intermittent periods of heightened tension. However, there is a risk of a further deterioration in the years ahead. One potential area of conflict is the flow of the Mekong river, which is vital for supplying a significant part of the Vietnamese agricultural sector with water. China has been damming up the upper tributaries of the river in order to boost energy production in the western hinterlands of China, which has had repercussions on the flow downstream.

Beijing's moves to arrest the flow of the Mekong proper with the completion of the Manwan dam in 1996 caused concerns among downstream nations, which have still been hesitant to criticise China's dam-building outright. However, this could be set to change as China's economic exploitation of the Mekong increases.

Another potential spoiler of Sino-Vietnamese relations is the increasingly skewed trade relationship between the two. Vietnamese exports to China increased by 35% to US\$4.5bn in 2008 while imports from China grew by 25.2% to US\$15.6bn, making China its largest import source and trade partner. This has brought about an US\$11.1bn trade deficit on Vietnam's part, equal to 13% of 2008 GDP. The unbalanced trade relationship has caused concern in Hanoi, which is wary of becoming dependent on imports from its northern neighbour, which is already seen as the main competitor in a number of sectors, such as textiles and other forms of low value-added manufacturing.

However, there are a few encouraging developments such as the planned economic corridor between Kunming in the landlocked Chinese province of Yunnan to Hanoi and its port city Haiphong, which could create a more benign relationship of mutual economic dependence rather than the present atmosphere of economic competition. While the historically fraught relationship between France and Germany might appear a far-fetched allegory, we believe that increased economic integration is the best way to reduce tension between the historic foes in the longer term.

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Source: BMI

Mining Project Exacerbating Tensions

The rivalry in the South China Sea has fed into growing public discontent over a decision by the Vietnamese government to allow a Chinese-financed investment in bauxite mining in Bao Lam in the Lam Dong province in the central highlands. The project has sparked a spiral of nationalistic sentiment, which has unnerved both Beijing and Hanoi. Vietnamese authorities have sought to defuse the public uproar by closing down newspapers and websites who have criticised the investment on the grounds that it will bring severe environmental damage to the region.

The mining project's critics have been boosted by the intervention of General Vo Nguyen Giap, a 97-year-old hero from the wars of independence against the French and the Americans, who has spoken out against the investment project in what he calls a strategically important location in terms of security and defence. Nonetheless, opposition from Giap and the public failed to prevent the Politburo, Vietnam's highest executive body, from approving the project on April 28. We see this as reflective of the sharp slowdown in foreign direct investment (FDI) pledges in the first four months of 2009, which means that the Vietnamese government is welcoming virtually any foreign direct investment regardless of origin. That said, Chinese investment into the natural resources sector is likely to remain a contentious issue and we expect the Politburo to take a more apprehensive stance once global economic conditions and FDI inflows have recovered.

Mekong River And Trade Gap Also Problematic

While the government may succeed in quelling opposition to the project in the short term, we believe that the fear of Chinese dominance will remain as an underlying current in Vietnamese society. Relations between China and Vietnam are thus likely to remain volatile with intermittent periods of heightened tension. However, there is a risk of a further deterioration in the years ahead. One potential area of conflict is the flow of the Mekong river, which is vital for supplying a significant part of the Vietnamese agricultural sector with water. China has been damming up the upper tributaries of the river in order to boost energy production in the western hinterlands of China, which has had repercussions on the flow downstream.

Beijing's moves to arrest the flow of the Mekong proper with the completion of the Manwan dam in 1996 caused concerns among downstream nations, which have still been hesitant to criticise China's dam-building outright. However, this could be set to change as China's economic exploitation of the Mekong increases.

Another potential spoiler of Sino-Vietnamese relations is the increasingly skewed trade relationship between the two. Vietnamese exports to China increased by 35% to US\$4.5bn in 2008 while imports from China grew by 25.2% to US\$15.6bn, making China its largest import source and trade partner. This has brought about an US\$11.1bn trade deficit on Vietnam's part, equal to 13% of 2008 GDP. The unbalanced trade relationship has caused concern in Hanoi, which is wary of becoming dependent on imports from its northern neighbour, which is already seen as the main competitor in a number of sectors, such as textiles and other forms of low value-added manufacturing.

However, there are a few encouraging developments such as the planned economic corridor between Kunming in the landlocked Chinese province of Yunnan to Hanoi and its port city Haiphong, which could create a more benign relationship of mutual economic dependence rather than the present atmosphere of economic competition. While the historically fraught relationship between France and Germany might appear a far-fetched allegory, we believe that increased economic integration is the best way to reduce tension between the historic foes in the longer term.

chapter 2 Economic Outlook

SWOT Analysis

Strengths

- Vietnam has been one of the fastest-growing economies in Asia in recent years, with GDP growth averaging 7.6% annually between 2000 and 2007.
- 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 still suffers from substantial trade, current account and fiscal deficits, leaving the economy vulnerable as the global economy enters into recession in 2009. 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

- World Trade Organisation membership has given Vietnam access to both foreign markets and capital, while making Vietnamese enterprises stronger through increased competition.
- The government will, in spite of the current macroeconomic woes, continue to move forward with market reforms, including privatisation of the State-Owned Enterprises sector, and liberalisation of 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 focuses too much on stimulating growth and fails to root out inflationary pressure, 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 short-term economic risk (STER) rating of 55.4 mainly reflects a deterioration of external conditions and the fiscal situation as the government has attempted to supplant a sharp reduction in external demand with fiscal stimulus. Vietnam's chronic fiscal and current account deficits also weigh down our long-term economic risk (LTER) ratings, where the fiscal and external components score 25.0 and 33.3 (out of 100), respectively. However, this is partly offset by a robust score of 75.0 in the growth component, reflecting a strong potential for rapid economic expansion, bringing the overall LTER to 52.5.

	S-T Economy	Rank	Trend
China	91.3	1	=
Hong Kong	79.6	2	=
Singapore	75.0	3	-
Thailand	74.4	4	=
New Zealand	70.6	5	=
Malaysia	70.4	6	=
India	66.9	7	=
Taiwan	66.7	8	-
Australia	65.8	9	+
Philippines	64.0	10	-
Japan	62.5	11	=
South Korea	59.2	12	+
Laos	56.3	13	+
Vietnam	55.4	14	-
Indonesia	54.4	15	-
Bangladesh	54.2	16	=
Cambodia	54.0	17	=
Sri Lanka	47.5	18	+
Pakistan	43.1	19	-
Seychelles	18.5	20	=
North Korea	-	21	=
Myanmar	-	22	=
<i>Regional average 61.5</i>	<i>Global average 53.7</i>	<i>Emerging Markets average 51.6</i>	

	L-T Economy	Rank	Trend
Singapore	76.1	1	=
Hong Kong	75.2	2	=
Australia	74.0	3	+
Malaysia	72.9	4	=
Taiwan	72.8	5	-
China	72.0	6	=
South Korea	69.1	7	+
New Zealand	68.0	8	=
Thailand	65.2	9	=
Japan	63.2	10	=
India	58.9	11	=
Indonesia	54.2	12	-
Bangladesh	53.5	13	-
Vietnam	52.5	14	-
Philippines	52.4	15	=
Cambodia	49.3	16	=
Sri Lanka	49.2	17	-
Laos	46.2	18	+
Pakistan	43.8	19	-
Seychelles	24.7	20	=
North Korea	-	21	=
Myanmar	-	22	=
<i>Regional average 59.7</i>	<i>Global average 54.0</i>	<i>Emerging Markets average 51.4</i>	

Economic Activity

Growth Bottoming Out, But Risks To Recovery Remain

We revised down our 2009 growth forecast for Vietnam from 5.0% to 2.9% in January as regional and global macroeconomic data revealed the severity of global demand destruction, which will undoubtedly have an effect on the export-dependent Vietnamese economy. We now note that both the Vietnamese government and the IMF have followed our lead. The Vietnamese government lowered its 2009 growth target from the 6.5% set in December to 5.0% in May, while the IMF reduced its 2009 growth forecast for Vietnam from 4.75% to 3.3% in early May, to reflect a deterioration in the global macroeconomic environment.

However, we are now acknowledging upside risks to our 2009 forecast as domestic and global economic data indicate that the 3.1% y-o-y growth posted by Vietnam in Q109 may have marked the bottom of the ongoing downturn. However, there are a number of potential obstacles in the way of a sustained economic recovery, and we do not believe Vietnam is out of the woods quite yet.

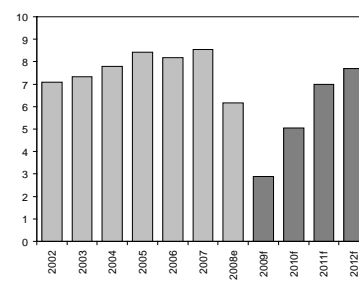
The 3.1% y-o-y outturn in Q109 was the slowest on record, with manufacturing growth dropping to 0.45% y-o-y from 6.3% in the preceding quarter, a sharp contrast from the double-digit growth rates registered between Q106 and Q308. The state-run National Centre for Socio-Economic Information and Forecast stated in a report released in early May that growth would pick up to 3.5-3.8% in Q209, and we find this estimate reasonable given the solid performance of exports and the boost given to economic activity from the expansion of the government's loan subsidisation programme. Indeed, the government's decision to include medium-and-long-term loans in the programme saw overall lending jump by 4.86% m-o-m in April from growth rates of 0.52%, 0.23% and 1.92% in January, February and March respectively.

In addition, industrial production grew by 4.2% m-o-m in April after having contracted by 8.6% in February. This pushed cumulative industrial production output for January-April up by 3.3% compared to the equivalent period a year ago. We expect industrial production growth to rise to 8.0% by the end of 2009, bringing the average for the year to 6.0%. Moreover, retail sales increased by an impressive 21.5% y-o-y in January-April as Vietnamese consumers remained considerably more optimistic than their counterparts in other Asian economies. The semi-annual Nielsen global consumer confidence index for

BMI VIEW

We maintain our below-consensus 2.9% GDP growth forecast for 2009, but are now acknowledging upside risks to this forecast. This is due to strong fiscal and monetary stimulus bolstering domestic demand, and a weaker dong softening the contraction in external demand. With global conditions expected to improve in 2010, we maintain our 5.0% growth forecast for next year.

Long Road To Recovery
Annual Real GDP (% chg)



Source: General Statistics Office, f= BMI forecast

TABLE: ECONOMIC ACTIVITY

	2006	2007	2008e	2009f	2010f	2011f	2012f	2013f
Nominal GDP, VNDbn [1]	974,266.2	1,144,014.6	1,478,695.0	1,711,359.8	1,899,304.4	2,111,892.7	2,362,409.8	2,652,282.9
Nominal GDP, US\$bn [1]	61.00	70.94	84.59	90.07	94.97	111.15	131.25	147.35
Real GDP growth, % change y-o-y [1]	8.2	8.5	6.2	2.9	5.0	7.0	7.7	7.9
GDP per capita, US\$ [1]	723	829	975	1,024	1,065	1,229	1,432	1,587
Population, mn [2]	84.40	85.60	86.80	88.00	89.20	90.40	91.60	92.80
Industrial production index, % y-o-y, ave [3]	17.7	16.3	14.6	6.0	10.0	12.0	14.0	14.0
Unemployment, % of labour force, eop [3]	4.8	4.6	5.0	5.5	5.5	5.0	4.5	4.0

Notes: e BMI estimates. f BMI forecasts. Sources: 1 IMF (General Statistics Office). 2 IMF; 3 General Statistics Office.

H109, published in April, showed that Vietnamese consumers were the most optimistic in the world when it came to believing that the domestic economy would exit the current downturn by the end of 2009.

Private consumption should also be boosted by a planned US\$1.6bn of tax breaks for companies and individuals in a US\$8-9bn stimulus package being debated in the National Assembly as we went to print. While the National Assembly has increased its scope to criticise suggested government policies, effective political power still lies with the Politburo. Hence, we see no risk that the government's stimulus package will fail to gain parliamentary approval.

Further Dong Devaluation Likely

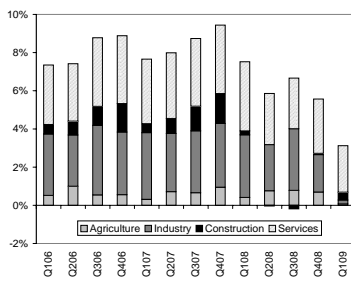
The Vietnamese export sector has done relatively well so far this year, with exports declining by 0.1% y-o-y in January-April, which can be compared to double-digit declines in other regional economies. Having said this, subtracting the US\$2.5bn export rush in gold bullion in Q109 (see our online service, May 7 2009, 'BoP Improving But Still Shaky') the y-o-y export growth figure for the period drops to -13.7%, which we believe is a more representative figure. We are currently expecting exports to drop by 19.5% to US\$50.9 for 2009 as a whole.

While this is considerably better than our forecasts for other Asian economies, Vietnam's high reliance on external demand – exports amounted to 74.8% of GDP in 2008 – means the country's export contraction will be harder felt. Further dong devaluation may thus prove to be an easy way for the authorities to soften the blow of contracting external demand. Indeed, we adjusted our end-09 dong target from VND18,000/US\$ to VND19,000/US\$ in January and were partly vindicated in doing so when the **State Bank of Vietnam** (SBV) widened the trading band around the dong from 3% to 5% on March 24, which was effectively a devaluation of 2%.

After a brief period of stabilisation, downside pressure on the dong has quickly re-emerged. This was mainly due to the SBV's expansive monetary policy and declining dollar inflows from exports, foreign direct investment and remittances. With the US dollar trading at a premium of VND200-500 to the ceiling price of the SBV's trading band on the black market in mid-May, we expect it to be only a matter of time until conditions on the ground will yet again force the central bank's hand. The extent of the devaluation is to a large extent a guessing game. We find an adjustment of 2-3% to VND18,200-300/US\$ most likely at the initial stage to bring the official exchange rate in line with supply and demand conditions, but do not rule out a larger adjustment to quell expectations of a further devaluation.

A dong devaluation would naturally add to the inflationary pressures already evident in the economy from the interest rate subsidy programme. Nonetheless, the present trend is still one of disinflation with consumer price inflation dropping to 9.2% y-o-y in April 2009, the first single-digit figure since October 2007. We expect inflation to bottom out in the low single digits in Q309 and start rising again towards the end of the year (our end-09 inflation forecast stands at 7.7%). However, we are already seeing signs that inflation expectations are rising, with fears of a new inflationary bubble weakening public confidence in the dong, which could bring a further dollarisation of the economy. This would, in turn, decrease the

Services Holding Up Growth
Contribution To GDP Growth By Sector (pp)



Source: General Statistics Office

traction of monetary policy and most likely result in further macroeconomic instability.

An orderly depreciation of the dong towards VND19,000/US\$ would, on the other hand, aid the export sector and an economic recovery, especially as the pressure is now on other Asian currencies to appreciate against the dollar as risk appetite has returned, further improving Vietnam's price competitiveness. Also adding to a more positive external demand picture is the effect on domestic demand expected from the strong fiscal stimulus package currently being implemented by the government to counter the slowdown. However, while the government's efforts to counter the slowdown through increasing public infrastructure projects are commendable, we believe that the slow disbursement of the funds will, to a great extent, spill over into 2010. With this in mind, we are forecasting a fiscal deficit of 8.2% of GDP in 2009 to be followed by a 7.7% shortfall in 2010.

This has raised the need to increase government borrowing to finance the burgeoning fiscal deficit. However, the state treasury has held a number of unsuccessful bond auction in H109 as it has been averse to pay the higher yields demanded by the market. As a consequence, the treasury had, in mid-May, only been able to raise US\$236mn out of the government's fund-raising target of US\$3.11bn. Yet, with government revenue falling by 20% y-o-y in Q109, the treasury will inevitably have to accept higher yields in future bond auctions. We do not see this as a greater threat to public finances, as total public debt is still less than 50% of GDP, according to IMF estimates. We raised our sovereign risk rating for Vietnam from D- to D in May, but this was solely due to an improvement in the ability-to-pay component from 22 to 26 (out of 45) on the back of greater macroeconomic stability, with the willingness-to-pay component actually falling from 30 to 28 (out of 55).

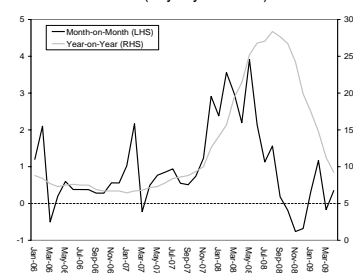
Risks To Outlook

We have decided to maintain our below consensus GDP forecast of 2.9% in spite of the emergence of tentative green shoots of economic revival in recent macroeconomic data. There are a few factors that are keeping us from revising up our growth forecast. Firstly, we suspect that part of the increased lending through the loan subsidisation programme has been invested in the stock and real estate markets, and may not actually bolster real economic activity. Secondly, the sharp credit growth rate in April has made the SBV apprehensive of a possible resurgence in inflation with the 0.35% m-o-m increase in April being the highest monthly inflation rate recorded since August last year (with the exception of the 1.17% Tet-induced price increase in January).

We see a risk that stimulative fiscal and monetary policy will lead to inflationary conditions down the road, and possibly a repeat of the severe macroeconomic imbalances of 2008, when inflation rocketed to 28.4% y-o-y in August and the ballooning trade deficit threatened a balance-of-payments crisis. Also, bearing in mind the weak public confidence in the dong, we see a possibility that the SBV and the government may thus opt to scale down their stimulus efforts for the benefit of macroeconomic stability and longer-term growth.

Thirdly, external demand will be key for an economic recovery. With this in mind we highlight that our growth forecasts of -3.1%, -3.6% and -6.1% for key export destinations the US, Europe and Japan respectively, are still considerably below consensus. Indeed, we do not expect these economies to post a marked recovery until well into 2010. With

Inflation Decelerating, But Still A Risk
CPI (% y-o-y & m-o-m)



Source: General Statistics Office

BMI VIEW

With growth slowing to the slowest in a decade and consumer price inflation dropping back into single digits, we see room for the SBV to lower rates further in 2009. However, with lending growth surging in April and public confidence in the dong still fragile, we find it likely that the SBV will keep the base rate on hold in the short term, instead potentially opting to lower the refinancing rate further.

global growth forecast to improve to 1.7% in 2010, after a 2.3% contraction in 2009, we maintain our 5.0% GDP growth forecast for Vietnam next year, with GDP forecast to expand by 7.0% in 2011.

Monetary Policy

Rates On Hold Short Term, Further Cuts Expected

We maintain our forecast of an additional 200bps in cuts in the base rate from the SBV as economic growth remains sluggish and consumer price inflation continues to trend downwards. However, the present weak public confidence in the value of the dong will constrain the central bank in its efforts to stimulate consumption in the near term, as further interest rate cuts risk increasing the dollarisation of the economy.

The SBV kept the benchmark Vietnam base rate unchanged at 7.0% at its latest meeting on April 29, but central bank governor Nguyen Van Giau stated in an interview published on the government's website on May 4 that the bank would keep easing monetary policy in order to support the government's stimulus efforts to boost the economy.

Indeed, with GDP growth dropping to 3.1% y-o-y in Q109, the lowest quarterly growth estimate on record, and consumer price inflation dropping to 9.2% y-o-y in April after having touched 28.4% in September 2008, we foresee further monetary easing in order to stimulate domestic demand over the remainder of the year. The SBV has held off from cutting the base rate, which it uses to set reference rates for commercial bank deposit and lending rates, since lowering it from 8.5% to 7.0% on January 23, opting instead on April 10 to lower the refinancing rate, at which it lends to commercial banks, from 8.0% to 7.0%, and the discount rate, at which it buys back bank debt securities, from 6.0% to 5.0%.

The heaviest load in easing credit conditions has instead been pulled by the government, which has spent more than VND17trn (US\$1bn) on its interest-rate subsidy programme, in which it has paid the interest costs in excess of 4% of loans to small-and medium-sized enterprises (SMEs). The programme has proved highly effective in boosting commercial

TABLE: MONETARY POLICY

	2005	2006	2007	2008	2009f	2010f	2011f	2012f	2013f
Lending rate, %, eop [3]	11.40	11.18	12.00	15.00	9.00	12.00	12.00	12.00	12.00
Real Lending Rate, %, eop [1,4]	2.60	4.58	-0.60	-4.90	1.70	5.00	6.00	6.00	6.00
Consumer prices, % y-o-y, eop [2,5]	8.8	6.6	12.6	19.9	7.3	7.0	6.0	6.0	6.0
Consumer prices, % y-o-y, ave [2,5]	8.2	7.5	8.3	23.0	7.0	9.0	6.5	6.0	6.0
Exchange rate VND/US\$, eop [6]	15,913.00	16,051.00	16,018.00	17,480.00	19,000.00	20,000.00	19,000.00	18,000.00	17,000.00
Exchange rate VND/US\$, ave [6]	15,851.56	15,987.37	16,075.77	16,432.78	18,240.00	19,500.00	19,500.00	18,500.00	17,500.00
M2, VNDbn [7]	690,652.0	922,672.0	1,153,340.0	1,441,675.0	1,730,010.0	2,076,012.0	2,491,214.0	2,989,457.0	3,587,349.0
M2, % y-o-y [7]	29.7	33.6	25.0	25.0	20.0	20.0	20.0	20.0	20.0
Central Bank policy rate, % [8]	7.80	8.25	8.25	8.50	5.00	6.50	8.00	8.00	8.00
Exchange rate VND/EUR, eop [6]	18,840.99	21,180.90	23,368.66	24,472.00	24,700.00	26,400.00	26,220.00	23,220.00	21,250.00

Notes: f BMI forecasts. 1 Real rate strips out the effects of inflation; 2 Base year 2000; Sources: 3 IMF. 4 IMF/BMI; 5 General Statistics Office; 6 BMI; 7 IMF, State Bank of Vietnam; 8 State Bank of Vietnam.

lending, helping to push up year-to-date (YTD) credit growth to 11.16% at the end of April, from a mere 2.67% YTD a month earlier.

However, the effectiveness of the programme is now under threat as commercial banks are struggling to raise funds to extend loans. The deposit interest rates offered by banks are already approaching the 10.5% cap on lending rates (150% of policy rate), squeezing the net interest margin and overall profitability of banks. A reduction of the base rate with the aim of stimulating the economy would thus be counterproductive if not coupled with measures aimed at facilitating capital conditions for banks. With the reserve requirement ratio for short- and long-term dong deposits already as low as 3% and 1% respectively, we believe the next move is likely to be another cut in the refinancing rate in order to keep cheap credit flowing to the corporate sector.

However, it is not inconceivable that the SBV could hold off on pulling the trigger in order to save rate-cutting ammunition in the event of further negative sentiment buffeting the economy. Moreover, the current monetary easing, combined with an expansive fiscal policy and base effects from a period of deflation in the last four months of 2008, have raised the spectre of inflation returning to double digits towards the end of the year. This could de-anchor inflation expectations and further undermine public confidence in the dong, endangering an expected economic recovery.

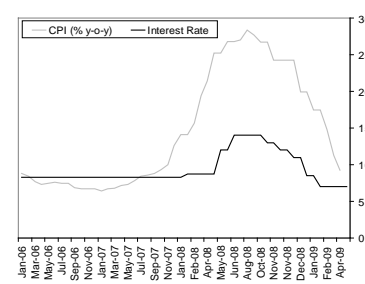
Meanwhile, the government is currently working on a bill to give the SBV more autonomy on its monetary policymaking. The first draft of the State Bank Law bill is expected to be presented to the National Assembly at the end of this year, with ratification scheduled for early 2010. If the bill is passed, which we expect to be a mere formality, it will be a positive for macroeconomic stability by clarifying the mandate for the central bank and strengthening its autonomy vis-à-vis the government.

The current state bank law does not determine what the SBV's priority should be in policymaking, with the bank being commissioned to run a monetary policy of both controlling prices and depreciating the dong at a pace of 1% annually against the US dollar to boost the competitiveness of Vietnamese exports. With high growth rates being vital to uphold the public acceptance of one-party rule by the Communist Party of Vietnam, depreciating the exchange-rate has been the *de facto* mandate for the SBV.

The macroeconomic risks inherent in the absence of a strong inflation-targeting mandate for the SBV have become increasingly apparent in the past five-to-10 years as the SBV's exchange-rate mandates has resulted in a very lax monetary policy regime as the central bank has been unable, or unwilling, to fully sterilise large capital inflows from foreign direct investment and remittances.

Having taken stock of the real estate and stock market booms, which both ended in a severe slump in 2007 and 2008, and skyrocketing inflation which hit 28.4% y-o-y in August last year, the Vietnamese government is now seeking to clarify the SBV's mandate of controlling both the exchange-rate and inflation, as well as strengthening its role in bank supervision, in the new State Bank Law bill. The new legislation follows a plan adopted in 2006 to make the SBV fully independent in setting policies on monetary, interest rate and exchange rate management by 2020.

Real Interest Rate Returning To Positive Territory
Consumer Price Inflation & Policy Rate (%)



Source: GSO, SBV

BMI VIEW

Vietnam's balance of payments look in considerably better shape in Q209 than at the same time last year, but remains at risk from a further slowdown in exports and weaker remittance and foreign direct investment inflows. However, Vietnam's strong macroeconomic fundamentals should ensure that capital inflows remain sufficient to cover the trade deficit over our forecast period.

If the government moves ahead with the State Bank Law bill, we would view this as a significant step towards greater macroeconomic stability and a possible upgrade in our long-term economic risk rating, where Vietnam currently stands at 55.4, with the central bank independence component scoring 1 out of 5.

Balance Of Payments

BoP Improving, But Still Shaky

We emphasise that Vietnam's balance-of-payments position remains at risk in spite of the US\$950mn trade surplus recorded in the first four months of 2009, a marked shift from the US\$11.6bn shortfall recorded in the same period in 2008. This is because the figures are skewed by large anomalies in the foreign trade of gold and, to a lesser extent, rice. Vietnam's large trade deficit in H108 was to a great extent due to rocketing imports of gold and capital goods as rapidly accelerating inflation eroded public confidence in the dong as a storage of value. Anticipating higher prices, businesses brought forward their purchases of machinery and investment goods, and consumers shifted their savings from cash or low-interest paying bank deposits into gold and cars. This brought Vietnam on the verge of a balance-of-payments crisis, which was only averted by the government banning gold imports in May 2008 and imposing curbs on autos imports, while at the same time raising interest rates sharply.

The situation was the reverse in Q109 as banks and other holders of gold exploited a large discrepancy in domestic and international gold prices after the SBV allowed gold traders to export. Vietnam's exports of precious stones and metals soared to US\$2.3bn in Q109, more than 40 times the sum in the same period a year earlier. Subtracting gold exports, the trade account actually posted a deficit of US\$640mn in the quarter. Reportedly, the discrepancy between domestic and international prices was reversed in late March and early April, and the General Statistics Office (GSO) has estimated that gold exports fell to a mere US\$15mn in April, from US\$1.3bn in the preceding month.

While gold exports may take off again if price discrepancies return, our core scenario is for them to return to normal levels as fears of a possible devaluation of the dong and a shortage of US dollars in the market have increased the attractiveness of holding gold bullion. Gold apart, Vietnamese exports have also been bolstered by increased volumes of oil and rice shipments, up 20% and 50% y-o-y respectively in January-April, which have

TABLE: BALANCE OF PAYMENTS

	2004	2005	2006	2007	2008e	2009f	2010f	2011f	2012f	2013f
Exports, US\$bn [1]	26.48	32.45	39.83	48.56	63.25	50.90	55.99	61.59	68.98	77.26
Imports, US\$bn [1]	30.34	34.89	42.60	58.92	81.00	55.00	61.05	67.77	74.54	82.00
Trade balance, US\$bn [1]	-3.85	-2.44	-2.78	-10.36	-17.75	-4.10	-5.06	-6.18	-5.56	-4.74
Current account, US\$bn [1]	-1.59	-0.56	-0.16	-6.99	-11.24	-4.50	-2.80	-5.43	-7.17	-6.65
Current account, % of GDP [1]	-3.49	-1.06	-0.27	-9.86	-13.29	-5.00	-2.95	-4.89	-5.47	-4.51
Foreign reserves ex gold, US\$bn [1]	7.04	9.05	13.38	22.00	22.00	25.00	27.00	31.00	37.00	41.21
Import cover, months g&s [1]	2.6	2.9	3.6	4.3	3.3	5.5	5.3	5.5	6.0	6.0

Notes: e BMI estimates. f BMI forecasts. Sources: 1 Asian Development Bank, State Bank of Vietnam.

partly offset the effect of lower prices compared to H108 (when spiking prices prompted the government to restrict rice exports on concerns about food security).

Textile and garment exports have also held up well, increasing by 1.8% y-o-y to US\$2.6bn in January-April. Vietnam's fledgling manufacturing sector is dominated by labour-intensive, low value-added producers in the garment and textile sector, which has been highlighted as an advantage in the current global economic downturn as consumers tighten their belts and shift to cheaper products. Vietnamese manufacturers should thus do better than producers higher up the value-added ladder in more advanced economies such as South Korea and Singapore, while overseas shipments of commodities such as oil, rice and coffee offer some export diversification. Nonetheless, we still expect Vietnamese exports to fall 12.5% in 2009 to US\$50.9bn, equivalent to 56.5% of expected GDP. With the global economy likely to experience a gradual recovery over 2010 and 2011, and with Vietnam holding a competitive position in an increasing number of sectors, we expect exports to start growing again as of 2010 at a rate of 10-12% annually.

Indeed, Vietnam's trade position has been bolstered by the Vietnam-Japan Economic Partnership Agreement (VJPEA) signed in December 2008. Exports to Japan already amount to 11.6% of total exports (according to the IMF's 2007 Direction of Trade Statistics), but the agreement is likely to provide an additional boost to this figure and make Vietnam less dependent on demand from the EU and the US. Indeed, garment manufacturers are already reporting increased orders from Japan, which is offsetting weaker demand from Western markets.

Weak Domestic Demand Depressing Imports

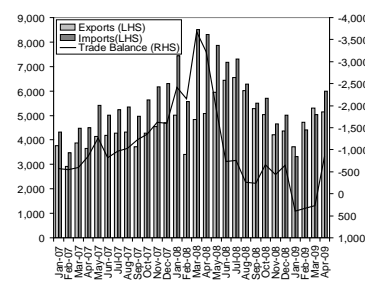
Weak domestic consumption and investment have seen imports fall by 25.7% y-o-y to US\$5.2bn in April with overseas purchases of steel (-60% y-o-y) and machinery (-25% y-o-y) and other investment goods leading the decline. While obviously positive for the trade balance and the overall balance-of-payments position, the sharp slowdown in imports is also a worrying indicator for domestic demand and the economy as a whole. With the government rolling out its stimulus package over the remainder of the year and capital investment needs in the private sector building up, we expect imports to find a floor in mid-2009, although further dong weakness is a risk here, while the export sector is expected to experience further pain, meaning that the trade account is likely to remain in deficit for the remainder of the year.

We are expecting a full-year trade deficit of US\$4.1bn in 2009, which is a considerable improvement from the US\$17.5bn shortfall recorded last year. This will constitute a significantly lighter stress on Vietnam's current account, which posted a deficit of US\$11.2bn, or 13.2% of GDP, in 2008 according to our estimates. We expect the current account deficit to fall to US\$4.5bn in 2009, equivalent to 5.0% of GDP, as remittances inflows from overseas Vietnamese fall.

Weaker Remittance And FDI Inflows Expected In 2009

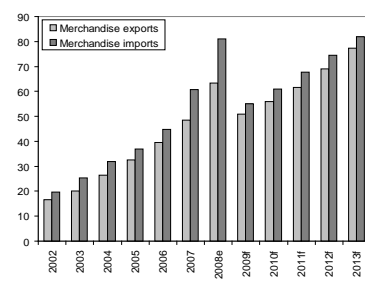
Commercial banks in Vietnam are now reporting sharply weaker remittances as overseas Vietnamese are buffeted by deteriorating economic conditions in the EU and the US. Sa-

Gold Sales Distorting Trade Figures
Exports, Imports & Trade Balance (US\$m)



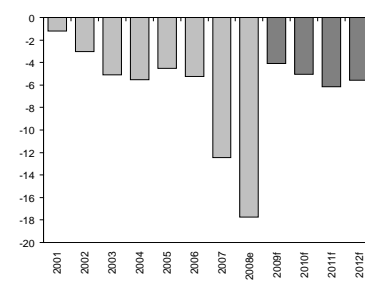
Source: General Statistics Office

Trade Growth Falling Back To Trend
After 2009 Contraction
Exports & Imports (US\$b)



Source: General Statistics Office, f= BMI forecast

Trade Balance Testament To
Turbulent Times
Trade Balance (US\$b)



Source: General Statistics Office, f= BMI forecast

combank, one of the leading commercial banks, has reported that remittances transferred via the bank fell 22% y-o-y in Q109 to US\$120mn, with other banks reporting declines of a similar magnitude. We see both push and pull factors behind the weakening remittance inflow.

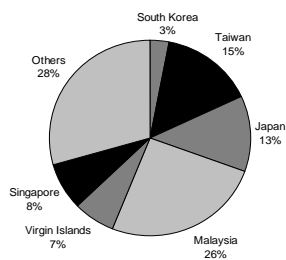
Firstly, employment and overall economic conditions in key overseas destinations are becoming increasingly tight. More than half of the three million overseas Vietnamese (2006 estimate) reside in the US, where the latest available non-farm payroll report saw the US economy shedding 663,000 jobs in the year running up to March 2009. While the 6.4% unemployment rate among Asians in the US in March is below the 8.5% overall unemployment rate, it still constitutes a rapid increase from the 3.6% rate recorded in March 2008. In addition, many Vietnamese-Americans are small business owners and, as such, may need to inject surplus cash into their businesses in order to keep them afloat through the downturn. This limits the cash available to send to family and relatives in Vietnam.

On the pull side, the limited market confidence in the dong is encouraging overseas Vietnamese to keep their funds abroad as further depreciation of the dong is likely to impact negatively also on dollar- and gold-denominated assets. Another factor is the decline of the property and stock market, which pulled in large amounts of money from overseas during the boom years of 2005-2007. With both the property and stock market still looking weak, the investment opportunities for overseas Vietnamese are likely to remain limited for the foreseeable future, weighing on remittance inflows.

On the financial side, we expect FDI disbursements to be weaker in 2009 than the US\$11-12bn estimated in 2008. There is a plethora of reasons behind this outlook. Firstly, investment financing remains hard to come by amid still tight global credit conditions. Secondly, the prospects for both market-based and production-based investment remain unappealing, given the uncertain outlook for the world economy and Vietnam's high dependence on external demand. Thirdly, it should be noted that East Asian economies such as Japan, Singapore and Taiwan are among the biggest foreign investors in Vietnam. With the Japanese, Singaporean and Taiwanese economies expected to be among the worst hit by the global downturn, contracting by 6.1%, 7.2% and 4.5% respectively in 2009, according to **BMI** forecasts, it is highly likely that affected companies will struggle to raise cash and be obliged to rein in their investment plans.

Indeed, FDI pledges fell 17% y-o-y to US\$6.2bn in the first four months of 2009, according to data from the Ministry of Planning and Investment's Foreign Investment Agency, with the service sector taking US\$5.95bn of the total sum. Nonetheless, we believe remittances and FDI inflows will be more than sufficient to cover the trade deficit in 2009. Looking past the current global economic downturn, which we expect to last well into 2010, we maintain that Vietnam remains an attractive alternative for international investors seeking a location for low-cost manufacturing operations as well as an early foothold in an expanding consumer market. As such, we believe that Vietnam's trade deficit, which we are forecasting will widen to US\$5.1bn in 2010 and US\$6.2bn in 2011, will be covered by remittance and FDI inflows.

East Asian Investors Dominate
FDI By Country of Origin (2008)



Source: General Statistics Office

Banking Sector

Banking Sector To Fall Prey To Foreign Competition

The Vietnamese banking sector is yet in its infancy with the majority of the population still relying on family and neighbourhood co-operatives for their borrowing and savings needs. Nevertheless, it exhibits some of the vulnerabilities of other economies where banks have gone bust, such as a history of rapid credit growth over the past five-year period, exposure to a booming real estate market which has now turned sour, primitive risk management systems, and inadequate regulatory supervision.

However, we point to a number of factors that we believe will ensure the Vietnamese banking sector will remain in a decent shape through the current downturn. Firstly, Vietnamese banks are virtually unexposed to US subprime debt and other 'toxic assets', and have only a low degree of foreign-currency lending (roughly 20% of total loans, mainly to exporting firms hedged against exchange-rate risk). Secondly, conservative lending practices with loan-to-value ratios of 35-50% have limited the uptick in non-performing loans due to excessive lending during the real estate bubble, which burst in 2007-2008. Thirdly, capital adequacy ratios are generally healthy among the larger semi-private joint-stock commercial banks (JSCBs), which have increased their capital base through share issues and retained earnings while the four major state-owned commercial banks (SOCBs), which still dominate the market, were never involved in the lending excesses of the real estate booms.

We estimate that the main risks to the banking sector are concentrated among the smaller JSCBs, which used more aggressive lending practices to win market shares during the boom years. The information available about the financial health of these smaller banks is very scarce, making it difficult to adequately assess the risk of bank failures. We estimate that a number of these smaller banks remain at risk of their capital bases falling to critical levels, with a poorly-defined mandate for the SBV to intervene in troubled banks remaining a threat to overall bank stability. However, the systematic risks posed to the stability of the banking system by this cohort of smaller banks is marginal, given that they control less than 5% of total banking assets.

Loan Subsidies And Capital Injections Reducing Risks

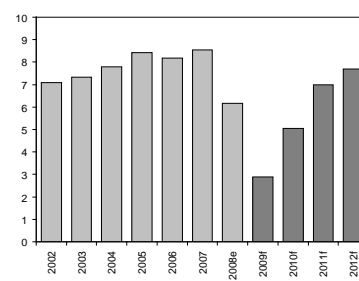
Indeed, the overall risk of loan defaults for Vietnamese banks is now subsiding as the government's VND17trn (US\$1bn) loan subsidisation programme, capping interest rates for short-term loans at 4.0%, has decreased the financial burden on qualifying firms. Nevertheless, bad credit risks from the economic downturn remain and most JSCBs have cut, or cancelled altogether, their dividends in order to boost their capital base in anticipation of 2009 being a tougher year than 2008.

In addition to cutting dividends, a number of JSCBs have announced that they intend to increase their chartered capital in 2009. **Techcombank** has stated that it plans to increase its capital base from VND3.64trn (US\$200mn) to VND5.68trn, while **Habubank** is to increase its capital from VND2.8trn to VND3.0trn, and **Dong A Bank** from VND2.88trn to VND3.4trn. Larger JSCBs have also stated their intention of raising their capital bases, with **Sacombank** announcing on March 17 that it would raise its capital base by 31% in

BMI VIEW

While a sharp slowdown in credit growth and an uptick in non-performing loans will hurt profits in 2009, we maintain our view that risks to the Vietnamese banking sector are limited. However, even the most efficient domestic banks stand virtually defenceless against the onslaught of foreign bank groups having gained permission to set up fully-owned subsidiaries in Vietnam.

Economic Slowdown Bringing Pain To Banks
Annual Real GDP (% chg)



Source: General Statistics Office, f = BMI forecasts

2009 from VND5.1trn to VND6.7trn (US\$384mn). Nonetheless, more capital injections will surely be needed, in particular among the smaller banks, which are required by the SBV to raise their capital base to VND2trn by the end of this year and to VND3trn by the end of 2010.

The strains on the banking sector have been alleviated by the SBV bringing down the benchmark interest rate from 14% in mid-2008 to 7% in January 2009. With economic woes mounting and consumer price inflation (CPI) expected to drop into low single digits in the coming months (from 11.25% y-o-y in March and a 16-year high of 28.4% y-o-y in August 2008), we expect a further rate cut to 6% within short, and envisage the SBV lowering the base rate to 5% by the end of 2009 in spite of the inherent risks of reigniting lingering inflationary pressures. This will give further relief to banks struggling from compressed net interest margins.

However, lower policy rates and the interest rate subsidy programme have had a limited effect on credit growth, which has fallen in tandem with slowing GDP growth, which hit a low of 3.1% y-o-y in Q109. As a consequence, the government has stepped up its measures to support the domestic economy and the interest rate subsidy programme has now been extended to also subsidise medium-to-long-term loans taken between April 2009 and December 2011 for a period of up to two years. The extension of the programme came after central bank figures showed that credit growth amounted to a mere 2.67% in Q109, which can be compared to expansions of 6% and 10% in Q107 and Q108, respectively.

We view this drop in credit growth as primarily a result of a sharp deterioration in business conditions deterring corporate and household lending. We expect credit growth to pick up slightly following the extension of the interest rate subsidy programme in early April, but maintain that most banks will be focused on maintaining their houses in 2009 rather than expanding business. We expect credit growth of roughly 20% in 2009, after an estimated 21% expansion in 2008, which was sharply down from the peak 53.9% credit growth recorded in 2007. However, we note that some of the larger JSCBs have set very ambitious growth targets for the year; Sacombank has stated that it is aiming for its outstanding credit to grow by 50% to VND50trn (US\$2.8bn) in 2009, while **Asia Commercial Bank** has set its credit growth target for the year at 90%.

Foreign Competition Greatest Long-Term Risk For Banks

In spite of these challenges, we expect the Vietnamese banking system to exit 2009 in a reasonable financial shape and with stronger risk management systems in place. Even so, this will still leave them in a poor condition to cope with the expected onslaught of foreign banks, which are still eager to expand into the Vietnamese market in spite of the rising risks to profitability in the short term. We believe that the Vietnamese banking market still offers opportunities for committed long-term investors who are prepared to ride out the current domestic and global economic woes, which could prove prolonged, in order to gain an early foothold in a market set to expand rapidly over the coming years.

As in China, Vietnam has shielded its banking sector from foreign competition throughout its economic reform process. However, the terms of Vietnam's accession to the World Trade Organisation in January 2007 obliged Hanoi to commit to gradually opening up its banking

market to foreign participation. As a consequence, a number of foreign banks have been present in Vietnam through representative offices in order to establish their brand in the market and to set up a base for future expansion, while others have bought stakes in local players, although the foreign ownership cap of 20% has been a deterrent for the transfer of expertise and technology.

Five foreign banks – **HSBC** and **Standard Chartered** of the UK, **ANZ Bank** from Australia and New Zealand, **Shinhan Bank** from South Korea, and **Hong Leong Bank** of Malaysia – were during 2008 finally given permission to set up fully-owned subsidiaries allowing them to compete for market shares in earnest. Domestic banks are well aware of the risks posed by the immensely more experienced, technologically superior and better capitalised foreign banks, but have over the past year been too preoccupied with navigating the stormy macroeconomic conditions to take any adequate precautionary measures to meet this challenge.

They are thus likely to stand virtually defenceless as foreign banks roll out well-tested strategies of functional and easily accessible financial services, such as mobile and internet banking, which are likely to find great appeal with Vietnam's young population. With domestic banks having little else to counter this than vain appeals for economic nationalism, we expect foreign banks to increase their market share rapidly over the coming years.

Indeed, as we pointed out last year, we expect foreign banks to dominate the Vietnamese banking sector within the next 10-15 years, with state-owned banks reduced to supporting the agricultural and SME (small and medium-sized enterprises) sector. We believe some of the larger JSCBs may still play a significant role in the market if they can combine their forces and retain key personnel from better-paying foreign competitors. While a high degree of foreign ownership of the domestic banking sector could be perceived as a risk to economic stability, as experienced at present in the Baltic countries in Europe, we expect the expansion and upgrading of the financial sector to be a key driver of growth throughout and beyond the current downturn.

Credit Growth Taking Off Again In Real Terms
Credit Growth & Inflation (%)



Source: General Statistics Office, World Bank

The Vietnamese Economy To 2018

Growth To Return To 8% Long-Term

Vietnam's emergence as one of the most promising economies in Asia, if not the world, stems largely from the Communist Party of Vietnam's (CPV) 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: a large, and young population eager to work hard to improve their 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 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. We expect the manufacturing sector to take a hit in 2009 and 2010 as global

BMI VIEW

We remain positive about Vietnam's growth prospects over the next 10 years, believing that the macroeconomic woes of 2008 and 2009 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 be able to return to GDP growth rates of approximately 8% annually over the next 10 years.

TABLE: LONG-TERM MACROECONOMIC FORECASTS

	2011f	2012f	2013f	2014f	2015f	2016f	2017f	2018f
Nominal GDP, US\$bn [2]	111.15	131.25	147.35	165.00	184.82	206.99	231.80	259.59
Real GDP growth, % change y-o-y [2]	7.0	7.7	7.9	8.0	8.0	8.0	8.0	8.0
Population, mn [3]	90.40	91.60	92.80	94.10	95.40	96.70	98.00	99.30
GDP per capita, US\$ [2]	1229	1432	1587	1753	1937	2141	2365	2614
Consumer prices, % y-o-y, ave [1,4]	6.5	6.0	6.0	5.5	5.0	5.0	5.0	5.0
Current account, % of GDP [5]	-4.89	-5.47	-4.51	-4.19	-3.70	-2.09	-1.44	-0.69
Exchange rate VND/US\$, ave [6]	19,500.00	18,500.00	17,500.00	16,500.00	15,500.00	14,500.00	13,500.00	12,500.00

Notes: f BMI forecasts. 1 Base year 2000; Sources: 2 IMF (General Statistics Office). 3 IMF; 4 General Statistics Office; 5 Asian Development Bank, State Bank of Vietnam; 6 BMI.

demand slumps, but then pick up speed again as the world economy recovers.

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 and 2007. We foresee export growth stabilising at around 12% annually in 2013-2018 as growing manufacturing exports offset the decline of the commodities sector, where opportunities for growth are constrained by dwindling oil reserves and a 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.

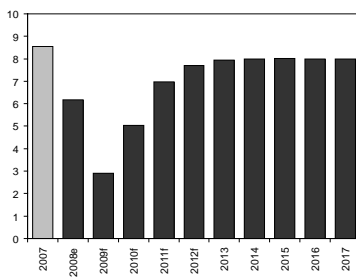
We see annual import growth falling to around 10% beyond 2010, below the expansion of the export sector, which will be conducive to a continued improvement in the trade account. We are expecting the trade deficit to fall from US\$17.5bn in 2008 to US\$4.1bn in 2009. While we expect a brief widening of the trade deficit in 2010-2012 it should start to narrow again as exports increase, 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** (SBV), but falling to around US\$6bn in 2009 as G3 economies contract. However, we foresee remittances continuing to rise over 2010-2018, meaning that the Vietnamese dong will be under considerable pressure to appreciate.

We believe the Vietnamese government will put its pledge to to move towards full convertibility of the dong on hold in the short term in order to support the suffering export sector. However, with the inflation scare of 2008 in mind – which was largely due to the policy of depreciating the dong amide large capital inflows – we see the SBV moving to allow the dong to appreciate once global economic conditions have stabilised. We see the dong moving to VND20,000/US\$ by the end of 2010 before starting to appreciate again, to VND19,000/US\$ by the end of 2011, and further to VND12,500/US\$ by 2018. Central bank intervention to stem further dong appreciation will see Vietnam's foreign exchange reserves rising from the present US\$22bn in February 2009 to US\$71.7bn by 2018.

Key Risks: Inflation, Infrastructure And Education

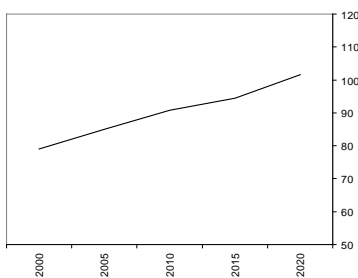
An appreciating currency will dampen inflationary pressures and we foresee consumer price inflation stabilising at around 5% annually from 2011 onwards, although this will be conditional on the government resolving bottlenecks in infrastructure and power supply. Vietnam's limited road, rail and port 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.

Growth To Return To Trend
Annual Real GDP (% chg)



Source: General Statistics Office, f= BMI forecast

Vietnam To Enter 100 Million Club
Population



Source: UN World Population Prospects, 2006 Revision

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 becoming 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.

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 Outlook For Global Banking

Introducing Expanded Banking Coverage

BMI has relaunched its Commercial Banking report series, with expanded analysis and data provision, both in print and on our on-line service, Business Monitor Online. A raft of new reports have also been commissioned, with increased coverage of Islamic banking issues in Middle Eastern and key Asian markets.

The stories below include our outlook for the global banking sector, together with analysis of our Commercial Banking Business Environment Ratings.

If you would like any further information on our commercial banking analysis please see <http://store.businessmonitor.com/industries/banking/>

Global Overview: Changes Are Coming

BMI's view on the future of the global banking sector is evolving quickly, alongside the panoply of rescue plans being introduced by national governments and central banks. As the global financial crisis continues to play out, it is not inconceivable that many major global banks prove technically insolvent, with impaired assets weighing heavily on their balance sheets. However, with the support of official entities including central banks and national treasuries, it is more likely than not that the major banks which have survived the crisis so far will make it to the end. While we would have thought it likely a few months ago that many

TABLE: LOAN-TO-DEPOSIT RATIOS, SELECTED STATES

	2006	2007	2008e	2009f	2010f	2011f	2012f	2013f
Argentina	.57	.61	.65	.64	.62	.61	.63	.63
Brazil	1.60	1.77	1.64	1.54	1.47	1.39	1.33	1.30
China	.68	.69	.73	.76	.79	.77	.75	.73
India	.81	.82	.81	.79	.78	.77	.76	.76
Japan	.77	.76	.77	.74	.73	.73	.74	.74
Mexico	.85	.90	.90	.84	.81	.78	.76	.74
Nigeria	.82	.90	.90	.86	.84	.83	.82	.81
Russia	1.16	1.22	1.34	1.25	1.17	1.12	1.11	1.09
Saudi Arabia	.86	.85	.90	.88	.89	.89	.89	.86
Singapore	.71	.74	.78	.76	.75	.75	.75	.74
South Africa	1.10	1.11	1.12	1.11	1.10	1.09	1.08	1.07
South Korea	1.24	1.32	1.32	1.24	1.23	1.21	1.18	1.16
Turkey	.60	.67	.67	.64	.64	.65	.66	.69
United Kingdom	.88	.92	.95	.88	.87	.87	.87	.86
United States	.92	.94	.87	.81	.81	.81	.80	.80

Source: National Regulators, Central Banks, Statistics Agencies, BMI Forecasts

major banks would be nationalised, we are now increasingly convinced that governments have absolutely no desire to completely wipe out shareholders and subsume megabanks. This is as much about political expediency – few leaders want to be associated with the government takeover of national icons when it can be avoided – as it is about ensuring the banking sector has some scope to get back on its feet in a few years by remaining listed on the stock market and retaining a private-sector influence. Short of nationalisation, we believe that governments and central banks will do whatever it takes to keep banks afloat, whether via capital injections, troubled asset relief plans, or debt guarantees.

The catch is, however, having avoided the total meltdown of the global financial system, monetary and financial authorities will attempt to impose new regulations in order to stave off future crises. The upshot is that deleveraging and risk aversion is likely to be more of a structural than a cyclical phenomenon; and the freewheeling lending practices of the past few years are going to be replaced by tight regulation and greater transparency. This means that for most banking sectors worldwide, loan-to-deposit and loan-to-asset ratios are likely to decline, with lower loan growth over the coming few years. These projected trends are reflected in our forecasts, particularly for the more mature national banking sectors.

Basically, we believe the big banks that have survived the crisis so far will continue to survive, but there are obviously significant concerns over what form they will take in the future. There is major clamouring from the public and national authorities for increased oversight and regulation from the financial sector, given the gravity of the current economic downturn and the perception that it originated from irresponsible lending practices. Several questions over the future regulation of the banking sector have yet to be answered.

- **Transparency:** Financial institutions have been accused of a lack of transparency, which has exacerbated the lack of trust that investors have in banks, in turn making it difficult to raise capital. This is especially the case as some assets, including derivative instruments and illiquid ‘toxic’ securities, are extremely difficult to value fairly, and

TABLE: LOAN GROWTH (% CHG Y-O-Y), SELECTED STATES

	2006	2007	2008e	2009f	2010f	2011f	2012f	2013f
Argentina	19.0	27.8	31.0	8.0	5.0	10.0	17.0	19.0
Brazil	30.6	30.9	27.0	3.0	6.0	7.0	9.0	11.0
China	-	16.6	26.0	15.0	12.0	5.0	5.0	8.0
India	25.9	25.6	22.0	14.0	16.0	18.0	18.0	20.0
Japan	1.9	0.6	4.8	-5.0	1.0	1.5	3.0	3.0
Mexico	20.0	22.7	12.0	-2.0	2.5	3.5	4.0	4.5
Nigeria	27.1	92.2	60.0	5.0	9.0	13.0	15.0	15.0
Russia	48.4	50.3	35.6	7.0	9.0	12.0	16.0	17.0
Saudi Arabia	9.3	20.4	22.0	-6.0	4.0	7.0	10.0	11.0
Singapore	6.3	19.9	16.6	-5.0	4.0	6.0	7.0	7.5
South Africa	28.7	22.0	12.0	6.0	9.0	12.0	12.0	12.0
South Korea	15.5	13.1	15.0	-4.5	3.5	4.0	4.5	5.0
Turkey	40.6	27.5	26.0	-2.0	10.0	11.0	15.0	16.0
United Kingdom	11.6	26.4	26.5	-7.0	1.5	2.0	2.0	2.0
United States	7.7	9.3	-0.4	-3.0	3.0	4.5	5.0	5.5

Source: National Regulators, Central Banks, Statistics Agencies, BMI Forecasts

it is unclear who is holding what.

- **Bank capital:** How much capital is enough? Pro-cyclicality has been at the heart of the problem. When times are good, and asset prices increase, lending is expanded, and capital looks adequate, but the opposite occurs when times are bad, creating a self-perpetuating downward spiral. Meanwhile, off-balance sheet lending in special purpose vehicles has made capital adequacy ratios more difficult to gauge. While a full reworking of the Basel II criteria appears unlikely at this stage, there may well be a move towards greater transparency, closer monitoring of risky positions, and regulatory measures against the pro-cyclical nature of capital positions.
- **Compensation:** Banking compensation will come under increasing scrutiny, particularly for those institutions that accept public financing. Here, regulators and bank boardrooms alike will have to strike a delicate balance between appropriate compensation for long-term (versus short-term) performance on the one hand, and placing artificial limits on compensation that would deter skilled workers from entering the sector on the other.
- **Accounting practices:** The jury is still out on the mark-to-market standard of accounting for assets on banks' balance sheets. Some banks have complained that mark-to-market puts too much pressure on their capital bases at precisely the time when capital is difficult to raise. But the crucial counter-argument is that banks would have reduced their risk exposure in a more responsible manner if they had accurately and assiduously marked-to-market throughout the economic cycle, rather than waiting for markets to sour.
- **Global policing:** While it is clear that domestic regulators have fallen asleep at the switch, we believe that regulation will also take more of a global guise in the future, as banks' international activities increase. Basel II is a good start for standardising capital requirements, but given the increasing levels of country-to-country lending, there is likely to be a call for a stronger and more effective regulatory body to corral the activities of large international financial institutions. This may be difficult to achieve, however, as it would be hard to imagine major banks in developing markets accepting the same standards as those in, say, Western Europe.

Despite all of this, there remains considerable promise for the global banking sector. Although they may now be subject to increased scrutiny and regulation, the majority of commercial banks and depository institutions were not involved in many of the worst practices that have brought the banking world into the current crisis. Many banks that dabbled in exotic products will gravitate back towards bread-and-butter lending practices and maintaining stronger deposit bases. And we believe that emerging markets retain considerable promise, particularly where they have underdeveloped banking sectors and large populations with middle-class potential. This is reflected in our forecasts for continued deposit and loan growth for several emerging states' banking sectors. The global banking sector will almost certainly emerge from the current crisis in a different form, but with continued growth potential over a long-term horizon.

Business Environment Rating Outlook

Commercial Banking Business Environment Rating Analysis

In our commercial banking business environment ratings universe of 46 mainly emerging market states, it is little surprise that the US and UK come in first and second place with scores of 88.0 and 82.0 respectively. Of crucial importance to both scores is the very high rankings in the crucial 'Limits of potential returns, Market structure' sub-category, which accounts for 42% of the overall score. The two countries are ranked first and second in this category as well. This sub-category captures the size of the sector, and the potential for assets and loans to grow in US dollar terms. While both systems have been buffeted by the global credit crunch and will not post stellar growth numbers in percentage terms for the foreseeable future, the sheer size of the US and UK's financial systems means that there is massive potential for deposits, assets and client loans to rise. In addition, the generally solid institutional framework – which looks set to be augmented with new post-credit crunch regulations – will continue to provide a firm basis for the sector.

Asia Rising

Beyond the Anglo-Saxon economies, the highest ranking economies are in Asia, including South Korea (76.7), Singapore (70.0) and Taiwan (72.6). There are, though, countervailing trends in place in these three market leaders. While Singapore leads the world globally in the 'Risks to realisation of returns, Country risk' sub-category, with a score of 84.0, South Korea and Taiwan both have a score of 64.0, ranking them at 17. This is a function of Singapore's high score on key elements of BMI's economic, political and business environment risk ratings, which measure the risks to policy continuity. In contrast, the small size of the Singaporean economy and banking sector is a major factor limiting the potential for expansion, especially in a world of lower liquidity and risk appetite. South

TABLE: COMMERCIAL BANKING BUSINESS ENVIRONMENT RATINGS, SELECTED STATES

State	Commercial Banking BE Rating, %	Global Ranking Out Of 46 States
United States	88.0	1
United Kingdom	82.0	3
South Korea	76.7	4
China	70.8	7
South Africa	70.4	8
Singapore	70.0	10
Saudi Arabia	69.5	11
Brazil	68.9	13
Russia	67.1	14
Mexico	65.5	18
Turkey	60.7	24
India	60.6	25
Japan	56.3	27
Nigeria	55.8	28
Argentina	44.4	40

Source: BMI

Korea and Taiwan, however, have large domestic economies to provide the deposit base necessary to fund credit growth.

Elsewhere in Asia, we note that China (overall score 70.8) ranks seventh overall. As the world's third biggest economy – and still an emerging state at that – China's the scope for asset growth is huge. This has allowed the country to be ranked fourth in the 'Limits of potential returns' category (74.0), and post the highest 'Limits of potential returns, Market structure' sub-category score, at 90.0. What is preventing China from rising any higher is its poor performance in the 'Limits of potential returns, Country structure' sub-category, at 50.0 (37th), and the 'Risk to realisation of returns' category, at 63.4 (23rd). Of particular concern to **BMI** is the potential for a systemic collapse of the local system, where much lending is still state directed and risk management is still embryonic. In addition, despite the size of the whole economy, per capita GDP still remains low. We forecast US\$3,024 for 2009, with significant income inequalities. This severely limits the ability of financial institutions to sell premium products in the local markets, and also means that average deposit levels are still very low.

Emerging Europe, Limited Opportunities

The emerging European states are posting surprisingly mediocre ratings outturns. We have outlined at length in recent months the potential for a systemic crisis in the region transmitted through the major Western European banks removing credit and capital from central and Eastern Europe. These risks are exacerbated by the deep recessions we see in the Baltics, Bulgaria, Russia and Turkey, and the risks of further currency crises that could create even greater economic dislocations, as the massive economic asymmetries that have built up in the region unwind. When taken in tandem with the relatively small size of the local economies and the rapid banking sector expansion seen in recent years, it is little surprise that the highest rated emerging European state is regional heavyweight Russia, at 67.1 (14th globally), and that the top 'new' EU member is the Czech Republic, at 64.5 (18th). Coming close to the bottom of both the regional and global peer groups are Latvia (39.0, 43rd) and Ukraine (43.0, 40th), which have both been forced to tap the IMF and EU for emergency funds.

MENA Below Par

Five of the nine countries in the Middle East and North Africa (MENA) region are in the bottom third of our 46 rated states, with only the UAE truly shining (71.0, 6th). This is a result of the massive decline in oil prices, which has resulted in a slump in liquidity in both oil producing states and those which have benefited from an influx of hydrocarbon revenues seeking higher returns. Of particular concern is that while some progress has been made on putting the region's financial infrastructure on a more sustainable footing in recent years, it is still far too dependant upon oil revenues, and there are few drivers of either economic or commercial banking growth outside the natural resources sector. Indeed, it is particularly worrying that not one MENA state has broken into the top 10 states in the 'Limits of total returns, Market structure' sub-category. The best performers are the UAE and Iran (joint 13th place in this category), and even with the growth of Islamic banking products, the boom years are over. We expect much more moderate growth in the financial space over the forecast period, to 2013.

Opportunities In Africa

While Africa remains one of the most 'under-banked' regions in the world – and hence one of the most insulated from the global credit crunch – the commercial banking business environment ratings still reflect the major problems in operating in even the region's largest economies. Even with South Africa's overall 70.4 rating score putting it in 8th place globally, this masks its stellar performance on the limits of total return (scoring 74.0, ranked 4th), and its poor risks to potential return performance (62.1, 24th). The country's main weaknesses, in common with Kenya and Nigeria, are bureaucracy, external economic risk and financial market risk, all of which deter potential investors from engaging more forcefully in the local market.

Diffuse Latin Performance

Again, in Latin America, the ratings do not tell one particular story, with a diffuse regional picture developing. Perhaps the most interesting story is among the worst performers, which include Argentina (44.4, 40th), Colombia (43.7, 40th) and Venezuela (36.0, 45th). All three economies face difficult times over the coming years, having been fiscally imprudent. The latter two (especially Venezuela) have benefited significantly from the oil boom, which has now come to an end. There is little to be optimistic about in any part of the ratings for these countries, and we anticipate a much weaker performance than in Brazil (68.9, 13th), Chile (66.6, 16th) or even Mexico (65.5, 18th). Of particular note is Brazil's crucial 'Limits of potential return, Market structure' sub-category rating of 80.0 (4th globally) and Chile's reasonably solid 80.0 'Risks to realisation of returns, Market structure' rank of 8th.

Commercial Banking BE Rating Methodology

Since Q108, we have described numerically the banking business environment for each of the countries surveyed. We do this through our Commercial Banking Business Environment Rating (CBBER), a measure that ensures we capture the latest quantitative information available. It also ensures consistency across all countries and between the inputs to the CBBER and the Insurance Business Environment Rating, which is likewise now a feature of our insurance reports. Like the Business Environment Ratings calculated by BMI for all the other industries on which it reports, the CBBER takes into account the limits of potential returns and the risks to the realisation of those returns. It is weighted 70% to the former and 30% to the latter.

The evaluation of the limits of potential returns includes market elements that are specific to the banking industry of the country in question and elements that relate to that country in general. Within the 70% of the CBBER that takes into account the limits of potential returns, the market elements have a 60% weighting and the country elements have a 40% weighting. The evaluation of the risks to the achievement of returns also includes banking elements and country elements (specifically, BMI's assessment of long-term country risk). However, within the 30% of the CBBER that take into account the risks, these elements are weighted 40% and 60% respectively.

Further details on how we calculate the CBBER are provided at the end of this report.

In general, three aspects need to be borne in mind in interpreting the CBBERs. The first is that the market elements of the limits of potential returns are by far the most heavily weighted of the four elements. They account for 60% of 70% (or 42%) of the overall CBBER. Second, if the market elements are significantly higher than the country elements of the limits of potential returns, it usually implies that the banking sector is (very) large and/or developed relative to the general wealth, stability and financial infrastructure in the country. Conversely, if the market elements are significantly lower than the country elements, it usually means that the banking sector is small and/or underdeveloped relative to the general wealth, stability and financial infrastructure in the country. Third, within the risks to the realisation of potential returns, the market elements (i.e. how regulations affect the development of the sector, how regulations affect competition within it, and Moody's Investor Services' ratings for local currency deposits) can be markedly different from BMI's long-term risk rating.

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 2008 Corruption Perceptions Index was 2.7, placing it in 20th place in the Asia-Pacific region.

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 know-how.
- 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 American protectionism, will remain concerns.
- 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

Vietnam's business environment rating of 42.0 is constrained by infrastructure rating of 37.2, with the massive US bombing during the Vietnam war putting the country's road and rail network decades behind peer nations. The institutions score of 39.1 reflects the vestiges of a planned economy still present in many government bodies and state-owned enterprises in spite of the ongoing economic reform process. Indeed, the winds of change are noticeable in the market openness score of 49.7, which reflects an increasing degree of trade and financial market integration with the outside world.

	Business Environment	Rank	Trend
Singapore	83.8	1	=
Hong Kong	82.2	2	=
New Zealand	79.0	3	=
South Korea	73.4	4	=
Japan	72.6	5	=
Australia	71.8	6	=
Taiwan	65.2	7	=
Malaysia	61.5	8	=
Thailand	59.5	9	=
China	52.5	10	=
Philippines	45.0	11	=
Vietnam	42.0	12	=
Sri Lanka	40.6	13	=
Indonesia	40.2	14	=
India	39.8	15	=
Pakistan	37.7	16	=
Cambodia	36.7	17	=
Bangladesh	36.2	18	=
Laos	35.2	19	=
Myanmar	15.9	20	-
North Korea	11.5	21	=
Seychelles	-	22	=
<i>Regional average</i> 50.8	<i>Global average</i> 50.3	<i>Emerging Markets average</i> 46.9	

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

- The Vietnamese government has announced that a body consisting of officials from the Ministry of Planning and Investment's (MPI) Bidding Management Bureau will join the board that appraises bidding documents for projects funded by Official Development Assistance (ODA) by Japan. The move comes after a bribery scandal involving municipal officials from Ho Chi Minh City and a Japanese consulting company prompted Tokyo to freeze all ODA in December 2008. Japanese ODA was resumed again in April 2009 as Tokyo declared that it was content with the Vietnamese efforts to stem government corruption.
- The MPI has proposed a launch of a fund which, if implemented, will offer private investors attractively priced loans when investing in infrastructure projects under the public-private partnership (PPP) scheme. Such schemes are widely used in other developing economies where governments have limited funds to invest in public infrastructure, but has so far not been commonly used in Vietnam. However, the Vietnamese government is currently developing three pilot PPP projects to test the water for increased private sector investment into public infrastructure.
- A delegation consisting of 40 Vietnamese firms and led by Vice President Nguyen Thi Doan attended a forum in the Chilean capital of Santiago in mid-May. According to Chile's export promotion agency, Vietnamese exports to Chile increased by 46.4% to US\$80.6mn in 2008 while imports amounted to US\$96.7mn, lifting the value of two-way trade by 9 percent compared to the previous year. Chilean President Michelle Bachelet said on May 15 that she hoped Vietnam and Chile will soon sign a Free Trade Agreement (FTA) as the two countries have come into concurrence on many important issues during FTA negotiations.
- The State Securities Commission (SSC) has decided to indefinitely delay the introduction of short-selling of stocks, citing technological issues and the risks involved as the economy is still fragile. The SSC set up an objective in 2006 to allow short selling by the end of 2009 to develop the markets and open up the financial industry. Nguyen Son, head of the SSC's market development department, stated that the SSC needed a timeframe for the plan as it depended on available technology, regulations, human

resources and other conditions.

- Haiphong, the port city of the capital of Hanoi, boosted its capacity on May 18 with the inauguration of Dinh Vu Seaport. The new facility includes a modern wharf and berths, which will facilitate petroleum exploration in the Gulf of Tonkin and the Red River Delta. The new port will add 1.2 million tonnes of cargo-handling capacity, which will boost the development of the Dinh Vu Industrial Zone.
- Singapore-based global shipping company **APL** is to launch its first weekly direct container shipping service between Vietnam and the west coast of North America in June. Vietnamese companies have so far been reliant on feeder ships connecting with larger vessels when transporting their products overseas. APL will use the new deepwater terminal in Saigon, with the transit time to the US west coast estimated at about 15 days. However, Saigon ports are notoriously congested, which poses a risk for delays on the new shipping line.

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 fail-safe.

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 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.

TABLE: BMI LEGAL FRAMEWORK RATINGS

	Investor Protection	Rule of Law	Contract Enforceability	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.

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 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 2.7 out of 10 in Transparency International's 2008 Corruption Perceptions Index, placing it in joint 121st 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 planned, 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 more 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 47.4mn in 2008. The unemployment rate is expected to remain between 4-6% in 2009.

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 – by 19.5% between April 2007 and March 2008 according to Navigos – 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 workers. 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 conditions 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.

The Vietnamese government decided on October 10 2008 to raise the minimum wage for basic work from VND1,000,000 to VND1,200,000 per month for workers in foreign-invested enterprises central Hanoi and Ho Chi Minh City. The minimum wage for workers in foreign-invested plants in other parts of Vietnam are arranged in three levels with the lowest lying at VND920,000. The equivalent wage tranches for workers in Vietnamese-owned plants range between VND800,000 and VND650,000. The new minimum wage levels become effective on January 1 2009.

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 invest-

ment destination, especially for manufacturing. FDI pledges in 2008 have been estimated at US\$62bn, more than triple the US\$20.3bn recorded in 2007. However, we believe FDI could fall significantly in 2009, due to the global recession.

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.
- 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 are 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 (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.

TABLE: ASIA, FDI ANNUAL INFLOWS

	2006		2007	
	US\$bn	Per capita	US\$bn	Per capita
Australia	25.74	1,255.4	22.27	1,075.7
Bangladesh	0.79	5.7	0.67	4.7
Cambodia	0.48	34.2	0.87	60.3
China	72.72	55.3	83.52	62.5
Hong Kong	45.05	6,520.6	59.90	8,602.3
India	19.66	17.3	22.95	19.9
Indonesia	4.91	21.5	6.93	29.9
Malaysia	6.05	231.6	8.40	316.2
Pakistan	4.27	27.5	5.33	34.0
Philippines	2.92	33.9	2.93	33.3
Singapore	24.74	5,646.5	24.14	5,441.2
South Korea	4.88	101.6	2.63	54.6
Sri Lanka	0.48	24.0	0.53	26.0
Taiwan	7.42	324.0	8.16	354.8
Thailand	9.01	142.0	9.58	149.9
Vietnam	2.36	27.5	6.74	77.5

Source: UNCTAD, BMI.

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 Cam-

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.

bodia – 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 EU, China, Australia and New Zealand.

Vietnam is also 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. 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. 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: The National Assembly passed Vietnam's first ever personal income tax bill on November 20 2007. The bill, which became effective on January 1 2009, replaces a previous system in which expatriates and domestics were taxed at different levels. The new bill provides a common set of rules for individuals resident in Vietnam for 183 days or more in a 12-month period. However, the bill is also applicable to those having

TABLE: TOP EXPORT DESTINATIONS

	2000	2001	2002	2003	2004	2005	2006	2007
UNITED STATES	733	1,066	2,453	3,940	5024.8	5,924	7,845	10,089
JAPAN	2,575	2,510	2,437	2,909	3542.1	4,340	5,240	6,070
AUSTRALIA	1,272	1,042	1,328	1,421	1884.7	2,723	3,745	3,557
CHINA,P.R.: MAINLAND	1,536	1,417	1,518	1,883	2899.1	3,228	3,243	3,357
SINGAPORE	886	1,044	961	1,025	1485.3	1,917	1,812	2,202
Total exports	14,483	15,020	16,705	20,144	26,485	32,447	39,826	48,561
Top 5, % of total	48.4	47.1	52.1	55.5	56.0	55.9	54.9	52.0

Source: IMF, *Direction of Trade Statistics*.

a permanent residence in Vietnam, a definition which includes a rented house. How this paragraph will be interpreted is still unclear, but could extend tax liabilities to expatriates and locals who reside in Vietnam less than 183 days per year. The new bill stipulates that personal income is to be taxed at a rate between 5% and 35%, with a personal allowance of VND48mn (US\$2,800) and an additional allowance of VND19mn (US\$1,120) per dependent. As such the new bill reduces the highest marginal tax level applicable to expatriates from 40% to 35%. A new feature in the bill compared to previous legislation is that it covers non-employment income such as interest, dividends, capital gains on real estate and securities investment.

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.

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

2008 Growth Slumps – Figures released by the Vietnam National Administration of Tourism (VNAT) indicated that the tourist industry suffered a major slowdown in 2008. Full-year international tourist arrivals totalled 4.25 million, only a 0.6% rise y-o-y. This arrivals data is well below recent rates of growth. In 2007 visitor arrivals totalled 4.1mn, having grown by 16.0% y-o-y. Such rates had been maintained into Q108, when arrivals grew by 15.7% y-o-y, before slowing to 6.6% in Q208 and declining yet further towards the end of the year.

This data confirms our concerns that Vietnam would suffer heavily from the global economic downturn, which is weighing on tourist arrivals from the US and Europe in particular. With the US economy set to contract in 2009 and European growth to remain minimal, prospects for a recovery of the tourist industry will remain constrained. Indeed, Minister for Culture, Sports and Tourism Hoang Tuan Anh has warned that the industry faces no or negative growth in 2009, and has asked the government to invest US\$20-30 billion in a global marketing campaign to attract new visitors. This gloomy prediction was borne out by January and February 2009 arrivals figures. In the first two months of the year, arrivals fell by 10% y-o-y, to 688,753.

Vietnam Airlines Borrows VND7 trillion In a sign that even national carrier Vietnam Airlines is suffering from the tourism slowdown, in March the airline agreed a VND7 trillion (US\$ 400 million) loan with the Bank for Investment and Development of Vietnam (BIDV). The loan, set with an undisclosed interest rate, is intended to support the carrier's operations from 2009-2011 and VND2 trillion is earmarked particularly to cover all the airline's fuel imports over the period. The remaining VND5 trillion is to cover project development, staff training and expansion of the airline's fleet. Under the terms of the deal, Vietnam Airlines and BIDV will buy shares in each other, becoming strategic partners. Vietnam Airlines is already involved in a business venture with BIDV, with the two companies, alongside three other domestic firms, having formed an aircraft leasing company in September 2007.

Government Help For Jetstar Pacific – The slowing tourism industry is creating difficulties for budget airlines, which are less well-equipped to cope with lower passenger numbers than more heavily capitalised airlines. Budget airline Jetstar Pacific is suffering particularly heavily, stating in early 2009 that its 2008 losses totalled nearly US\$50 million. It stated that its bottom line had been damaged by high petrol prices in 2008, as well as a volatile exchange rate (the company's revenues are denominated in VND but much of its costs are in US\$). In late 2008 the government according approved a proposal by the State Capital Investment Corporation (SCIC) to allow Jetstar to issue new shares to its shareholders in order to increase its capital. This will allow SCIC to reduce its stake to

BMI VIEW

Figures released by the Vietnam National Administration of Tourism (VNAT) indicated that the tourist industry suffered a major slowdown in 2008. Full-year international tourist arrivals totalled 4.25 million, only a 0.6% rise y-o-y. This arrivals data is well below recent rates of growth. In 2007 visitor arrivals totalled 4.1mn, having grown by 16.0% y-o-y. Such rates had been maintained into Q108, when arrivals grew by 15.7% y-o-y, before slowing to 6.6% in Q208 and declining yet further towards the end of the year.

51%, from 75.78%. Other shareholders include Qantas (18%) and Saigon Tourism Corporation (Saignontourist; 6.18%). Under existing national legislation, Qantas, as a foreign company, can increase its stake to a maximum of 30%. In an effort to cut costs prior to the share issue, Jetstar has cut unpopular routes, such as Ho Chi Minh City to Hue, and delayed opening new routes such as Ho Chi Minh City to Da Lat and Buon Me Thuot and from Hanoi to Hue, Da Lat and Buon Me Thuot.

Market Overview

Commercial Airlines – Vietnam’s airline industry had been expanding rapidly from 2000, with the emergence of low-cost airlines boosting domestic as well as international travel. This rapid expansion – which saw air passenger growth of approximately 10% per year from 2000 – has laid a positive foundation on which airlines can hope to build despite the expected tourist industry slowdown in 2009.

The country has three international airports – Ho Chi Minh City, Hanoi and Danang. A new international standard terminal was recently opened at Noi Bai Airport in Hanoi. A loan of US\$182mn from Japan has also been earmarked for the expansion and upgrading of Tan Son Nhat Airport in Ho Chi Minh City. In addition, there are 13 other domestic airports around the country. Some of these, such as Cat Bi in Haiphong and Da Lat in Lam Dong, are also being upgraded for international flights. Cam Ranh airport, located in the popular southern coastal region of the country, is to be developed and become an international airport, with assistance from foreign consultants. In addition, the airport on the resort island of Phu Quoc is also to be upgraded, reflecting the popularity of the island and the amount of passenger traffic through the terminal. The aim is to equip the airport to handle passenger capability of 2.5 million by 2020, and 7 million by 2030. The airlines transportation business in Vietnam is dominated by **Vietnam Airlines**, the national flag carrier, which has around an 85% market share. Other players, such as **Pacific Airlines**, **Vietnam Aviation Service Flight Corporation** (VASCO), and **Service Flight Corporation** (SFC), retain a minor position. **Dragonair** (based in Hong Kong) began flights from Hong Kong to Hanoi from December 2008.

Pacific Airlines was previously subsumed by Vietnam Airlines, given the latter’s then status as a key shareholder, but in January 2005 that Vietnam’s Ministry of Finance took control of the smaller operator. Following restructuring of the airlines debts by the government, a share offering in the carrier was made, with the eventual deal in July 2007 resulting in ownership by the State Capital Investment Corporation of Vietnam, Saignontourist, Mr Luong Hoai Nam (Pacific’s CEO) and Australia’s Qantas airline. Qantas initially purchased an 18% stake and has increased this incrementally to 30% in 2008. As part of the sale agreement, the airline was renamed Jetstar Pacific in May 2008, in line with Qantas’ other operations, Jetstar Airways of Australia and Jetstar Asia Airways in Singapore. In order not to compete with the dominant national carrier, Vietnam Airlines, the new entity has been repositioned in the market as a low-cost airline, of which there are relatively small amounts currently operating in Vietnam. Jetstar Pacific is now the only majority-owned Vietnamese airline to offer low-cost domestic and international flights.

Jetstar Pacific operates primarily out of Ho Chi Minh City, with subsidiary hubs in six other Vietnamese cities. As of January 2009, the airline operated five Boeing 737-400 and was

due to lease eight Airbus A320-200 from parent company Qantas by the end of 2008.

However, Jetstar Pacific is suffering particularly heavily from the slowing tourist industry, stating in early 2009 that its 2008 losses totalled nearly US\$50 million. It stated that its bottom line had been damaged by high petrol prices in 2008, as well as a volatile exchange rate (the company's revenues are denominated in VND but much of its costs are in US\$). In late 2008 the government according approved a proposal by the State Capital Investment Corporation (SCIC) to allow Jetstar to issue new shares to its shareholders in order to increase its capital. This will allow SCIC to reduce its stake to 51%, from 75.78%. Other shareholders include Qantas (18%) and Saigon Tourism Corporation (Saignontourist; 6.18%). Under existing national legislation, Qantas, as a foreign company, can increase its stake to a maximum of 30%. In an effort to cut costs prior to the share issue, Jetstar has cut unpopular routes, such as Ho Chi Ming City to Hue, and delayed opening new routes such as Ho Chi Minh City to Da Lat and Buon Me Thuot and from Hanoi to Hue, Da Lat and Buon Me Thuot.

Given Vietnam's consistently strong tourism sector growth, budget airlines are seeking to make inroads into the growing market. In November 2006 Australia's **Jetstar Airways** began operating flights between Sydney and Ho Chi Minh City. Meanwhile, Macau's **Air Macau** is in negotiations to begin flights to Vietnam in 2007, while **Air Asia** is seeking to fly from Kuala Lumpur and Bangkok to more destinations within Vietnam. In response to this growing interest, Pacific Airlines launched a domestic budget airlines service in February 2007 in an effort to capture the market before the arrival of rival airlines into the sector, which has now been subsumed into the new Jetstar Pacific brand. In addition, Thai budget airline Nok Air is awaiting a licence to launch flights between Bangkok and Hanoi and Ho Chi Minh City.

Vietnam Airlines' current fleet comprises 48 aircraft (as of August 2008), including 10 Boeing 777, 11 Airbus A320, 13 A321, 4 A330, eight French-made ATR-72 and two Fokker-70. Orders have also been placed for 22 A321s, 10 A350s, 5 ATR-72s and 16 Boeing 787s. It was reported in late March 2006 that Vietnam Airlines needs over VND28.25trn (about USD1.78bn) to develop its fleet and facilities in the period to 2010. In September 2006, Vietnam Airlines announced that it plans to sell shares both on the domestic stock market and in foreign stock markets, in order to fund its expansion. The news was announced by Pham Ngoc Minh, the firm's executive vice President, who expects sales growth of 10% y-o-y through to 2010. Foreign share sales could take place on Hong Kong's Hang Seng Index, or Singapore's Straits Times Index.

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

	2006	2007	2008e	2009f	2010f	2011f	2012f	2013f
Tourist arrivals	3,783,145	4,170,000	3,944,170	4,125,670	4,327,000	4,687,000	4,997,800	5,347,646
Tourist departures	241,184	262,891	286,551	303,744	323,487	350,983	380,816	407,473
Airline passenger arrivals	2,246,984	3,300,000	2,633,987	2,791,010	2,972,425	3,225,082	3,499,213	3,744,157
Cruise arrivals	379,123	224,389	445,224	471,937	502,613	545,334	591,687	633,105
Land arrivals	1,157,038	685,234	1,333,167	1,415,033	1,507,010	1,635,105	1,774,088	1,898,274
Total airline passenger numbers	9,759,291	10,637,627	11,595,014	12,290,004	13,088,854	14,201,406	15,408,525	16,487,122
Foreign exchange receipts (US\$m)	2,352	2,611	2,859	3,087	3,287	3,567	3,870	4,140

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

Vietnam Airlines announced in October 2007 that it had signed a deal to buy 12 Boeing 787-8 Dreamliners, to begin delivery in 2015. It has also signed a memorandum of understanding to buy a further 12, although delivery dates have not yet been confirmed. A memorandum of understanding has also been signed with Airbus to buy 10 new generation A350-900s and 20 A321-200s. The airline is seeking to expand its market share in the region. At present it dominates the local market but faces strong competition from regional peers.

The law on civil administration came into effect on 1 January 2007, allowing foreign investors to establish airlines with capital contributions of up to 49%. Previous regulations permitted only a 30% allowance for foreign ownership of Vietnam's airlines. Nonetheless, the 49% cap itself shows the limitations of the government's positioning, as this cap effectively ensures that a golden share is reserved for the authorities (Vietnam Airlines is therefore likely to remain in state hands for some time to come).

Some deputies have proposed that the National Assembly permit foreign carriers to operate routes to poor, remote, mountainous areas, which would result in better competition among domestic carriers. The current law only allows for Vietnamese carriers to provide air services to remote mountainous areas of the country.

Opening up Vietnam's skies is a key precondition for its hoped-for WTO accession, so it is to be hoped that deputies can agree on a common course soon. Economists and industry insiders said they expected the amended law on Civil Aviation to create a better legal framework and more attractive incentives for the aviation sector to lure foreign investment and develop further.

The government projects the nation's aviation industry will require US\$12bn in development financing over the next 20 years if it is to reach a target of becoming the fourth-largest in the ASEAN block by 2025.

As the country opens up to foreign influence, Vietnam Airlines has been careful to move with the times, cementing a partnership with Australia's **Qantas Airways**. The latter opened a representative office in Vietnam in 2004, after previously agreeing with Vietnam Airlines to conduct four flights a week from Ho Chi Minh to Sydney, three to Melbourne and several more to European cities via Hong Kong and Bangkok. In late November 2005, American Airlines announced that it had applied to the US Department of Transportation for authorisation to begin code-sharing operations with Vietnam Airlines, from early 2006 onward. The two airlines will reportedly implement the code-sharing in phases. In the first phase, Vietnam Airlines is placing its VN designator code on American Airlines flights to Tokyo, Osaka, Paris and Frankfurt from the US, which connect to Vietnam Airlines flights to Hanoi and Ho Chi Minh city. In the later phase, American Airlines is reportedly intending to place its 'AA' designator code on Vietnam Airlines' services from Hanoi and Ho Chi Minh City to Tokyo, Osaka, Paris and Frankfurt.

Industry Forecast

Tourism Outlook – Figures released by the Vietnam National Administration of Tourism (VNAT) indicated that the tourist industry suffered a major slowdown in 2008. Full-year international tourist arrivals totalled 4.25 million, only a 0.6% rise y-o-y. This arrivals

data is well below recent rates of growth. In 2007 visitor arrivals totalled 4.1mn, having grown by 16.0% y-o-y. Such rates had been maintained into Q108, when arrivals grew by 15.7% y-o-y, before slowing to 6.6% in Q208 and declining yet further towards the end of the year.

This data confirms our concerns that Vietnam would suffer heavily from the global economic downturn, which is weighing on tourist arrivals from the US and Europe in particular. We had hoped that particularly low arrivals growth in August reflected the diversion effect of the Olympic Games in China, with tourists choosing to go to China rather than Vietnam to take advantage of the event. However, low levels of growth in October indicate that the sector as a whole is stagnating. In this context, regional tourism will continue to provide valuable support for the industry. Over the first ten months of the year regional arrivals posted the highest levels of growth. The Philippines grew by 46.1% y-o-y, followed by Singapore, Malaysia and Thailand, with growth of 19.3%, 16.5% and 14.5% y-o-y respectively. By contrast, arrivals from the US and the UK grew by only 4.6% and 0.1% y-o-y respectively. However, with Asian economies also suffering heavily from the global economic downturn, we expect regional arrivals to slow somewhat into 2009.

With the US economy set to contract in 2009 and European growth to remain minimal, prospects for a recovery of the tourist industry will remain constrained. Indeed, Minister for Culture, Sports and Tourism Hoang Tuan Anh has warned that the industry faces no or negative growth in 2009, and has asked the government to invest US\$20-30 billion in a global marketing campaign to attract new visitors. This gloomy prediction was borne out by January and February 2009 arrivals figures. In the first two months of the year, arrivals fell by 10% y-o-y, to 688,753.

Consumer Electronics

Executive Summary

Vietnam's domestic consumer electronics devices market, defined as including computing devices, mobile handsets, and video audio and gaming products, was estimated to be worth around US\$3.4bn in 2008. This is expected to increase to US\$6.4bn by 2013, driven by growing affordability of key products.

The electronics devices market dipped in 2008, due in part to the economic slowdown, but is set to grow at an overall CAGR of 13% through 2013, with key growth drivers including low-price handsets, notebook computers and LCD TV sets. A new tariff regime in 2009 is expected to provide a boost to the market.

Computers – Computers accounted for around 35% of Vietnam consumer electronics spending in 2008. **BMI** forecasts Vietnam domestic market computer hardware sales (including notebooks and accessories) of US\$1.3bn in 2009, up from US\$1.2bn in 2008. Computer hardware CAGR for the 2008-2013 period will be around 12%, with notebooks accounting for about 30% of shipments by 2013.**AV Devices**

AV devices accounted for around 26% of Vietnam consumer electronics spending in 2008.

BMI VIEW

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Vietnam's domestic audio, video and gaming device market was estimated at US\$860mn. The market is expected to grow at a CAGR of 15% between 2008-2013, to a value of US\$9.4bn in that year. Video applications account for around 76% of the total market

Mobile Handsets – Vietnam mobile handset sales accounted for around 47% of Vietnam consumer electronics spending in 2008. Total Vietnam market handset sales are expected to grow at a CAGR of 12% to US\$2.4bn in 2013, as mobile subscriber penetration soars towards 156%. 3G handset unit sales are projected to increase at a CAGR of 88% from just 20mn in 2008 to 468mn by 2013.

Market Overview

Consumer Electronics Market – Vietnam's domestic consumer electronics devices market, defined to include computing devices, mobile handsets, and video audio and gaming products was estimated to be worth around US\$1.4bn in 2008, and this is expected to increase to US\$2.1bn by 2013, driven by growing affordability of key products.

A reduction in tariffs on imported electronics products and components from January 2009 is expected to have a significant impact on the market. Some multinational vendors including **Sony** have already announced plans to roll-back local assembly operations and switch to a more import-based strategy for the Vietnam market.

Computers – According to **BMI** figures, sales in Vietnam's computer hardware market will be worth around US\$1.4bn in 2009, up from an estimated US\$1.2bn in 2008, as imports soar following the steep cut in import tariffs on finished electronic products. Despite a slowdown in the middle of 2008, with high inflation and the effects of the global economic crisis, the long-term fundamentals should support solid growth.

The market slowed to about 8% growth in 2008, with high interest and inflation rates and currency instability meaning that consumers and small and medium-sized enterprises (SMEs) cut back on spending to save money. However, sales showed some signs of recovery in H208 and growth is expected to be about 18% in 2009.

In H208, vendors turned the situation around with promotions for the back-to-schools period, and new models which were launched to capitalise on the traditionally higher demand in the second half of the year. The biggest threat to continued growth was inflation, which peaked at around 27% in 2008 and made computer products less affordable. An easing of inflation, and cuts in tariffs in 2009, should see sales growth pick up again.

The main driver of sales is notebooks, of which around 300,000 units were sold in 2008, up from fewer than 200,000 in 2007. Notebooks are currently less than 20% of sales, but should reach about one-third within the forecast period. In particular LCD screen notebooks are forecast to grow at a close to triple-digit rate over the next year. Desktop shipments were estimated at about 2.1mn in 2008.

Current growth is being driven by the consumer segment, with government and business spending having slowed significantly due to the effects of the economic crisis. Vendors are

actively promoting small form-factor 'netbooks', and this segment had triple-digit growth in 2008. However, this segment will face strong competition from low-end notebooks with more features.

AV – Vietnam's domestic video, audio & gaming devices market was estimated at around US\$860mn in 2008. The market is expected to grow at a CAGR of 15% between 2008-2013, to a value of US\$1.7bn in that year, driving by growing affordability thanks to steep import tariff cuts, as well as rising incomes and more flexible consumer financing.

Video applications account for more than 70% of the total market, and are expected to grow to more than US\$1.3bn by 2012, driven particularly by fast growth in demand for LCD and Plasma TV sets, which accounted for as much as 40% of category sales in 2008. Gaming devices account for around 3% of total demand.

Sales slowed towards the end of 2008, as consumers anticipated lower prices in 2009, when import tariffs will be cut to between 0-5%. Electronics retailers responded by slashing prices, with reductions of up to 30%. The sales of LCD TVs at electronics stores in Ho Chi Minh City reportedly rose 20% in November on the back of the price cuts, with 32 inch, 37 inch and 42 inch sets from **Panasonic**, **Samsung** and Sony among the best sellers. Sales of LCD and Plasma TV sets were estimated at about US\$251mn in 2008, and this is expected to nearly double to US\$484mn by 2011.

Industry Forecast

Vietnam's domestic consumer electronics devices market, defined as including computing devices, mobile handsets, and video audio and gaming products, was estimated to be worth around US\$3.4bn in 2008. This is expected to increase to US\$6.4bn by 2013, driven by growing affordability of key products.

The electronics devices market dipped in-2008, due in part to the economic slowdown, but is set to grow at an overall CAGR of 13% through 2013, with key growth drivers including low-price handsets, notebook computers and LCD TV sets.

As of January 2009, tariffs on imported electronics products and components imported from other ASEAN countries will be reduced to between 0%-5%. In 2008 this led to purchases being deferred as consumers anticipated lower prices to come. The stronger US dollar in H208 also led to rising prices for many imported electronics devices. The new tariff regime in 2009 is expected to provide a boost to the market, and lead to a surge in

TABLE: CONSUMER ELECTRONICS DEMAND, 2006-2013

	2006e	2007e	2008e	2009f	2010f	2011f	2012f	2013f
Consumer Electronics Devices Total Demand (US\$mn)	2,388	2,807	3,408	3,803	4,341	4,947	5,665	6,366
Computers (US\$mn)	990	1,110	1,200	1,320	1,492	1,700	1,972	2,249
Video, Audio & Gaming (US\$mn)	650	780	860	980	1,137	1,319	1,517	1,730
Communications (US\$mn)	748	917	1,348	1,503	1,712	1,927	2,176	2,388

e/f = estimate/forecast. Source: BMI

imports of high-end notebooks, TV sets and other products.

Mobile handsets accounted for the largest part of consumer electronics spending in 2008, at around 40%. The share of mobile handsets in overall consumer electronics spending will fall slightly to 38% due to the growing popularity of low-priced handset models, and a slowing rate of increase in mobile subscriber penetration.

Computers were the second largest consumer electronics spending category in 2008, at 35%, and will retain this share over the forecast period. Spending on computer hardware will grow at a CAGR of 11% through 2013. Following a softening of demand in 2008, tariff cuts and lower inflation should promote growth in 2009.

The AV segment will account for around 26% of consumer electronics revenues over the forecast period. The main driver is video which will account for 76% of revenues in this segment by 2013, up from 73% in 2008. Television will be the core product in this category, with demand for high-end LCD and Plasma TV sets nearly doubling by 2011.

Lower Import Tariffs – Import taxes on electronic products and components were to be lowered from January 2009, in accordance with the government's commitments under the ASEAN Free Trade Area (AFTA) agreement, which Vietnam entered in 2006. Vietnam's admission into the WTO in January 2007 provided additional momentum for market liberalisation. As of January 2009, duty on complete build units (CBUs) electronic products from ASEAN countries have been reduced to 0-5%. Eligible products must have an ASEAN content of at least 40%. Meanwhile, the average import tax on components will also be reduced from 9.41% to 6.36%.

Impact On Local Manufacturing – The tariff reductions are likely to have a significant effect on the development of the local market, and on that of Vietnam's electronics industry. Foreign manufacturers such as Sony have already signalled their intentions to roll back or to cease their assembly operations in Vietnam, and to rely on imports from neighbouring ASEAN countries.

Meanwhile, local electronics producers are faced with a difficult situation. Due to a lack of a large scale parts and components industry in Vietnam, it is very difficult for local producers to compete on price with foreign manufacturer. Import taxes on components and other expenses continue to add to the problem. The government must decide how to react in this situation to promote the development of Vietnam's electronics industry, which after a history of about twenty years, is still mainly concerned with assembly.

Government Electronics Industry Plan – The Ministry of Industry and Trade is preparing a report which will outline a strategy to raise the technology level of Vietnam's manufacturing. The report will focus on six hi-tech industries, with the first being electronics-information technology. The government reportedly plans to set a target of increasing investment in scientific research for these industries to 3.5-5% of revenues by 2015 and 8%-10% by 2020. The current level is between 0.2-0.3% of revenues. Meanwhile, investment in technological upgrades will be raised from the current 8%-10% to 10-15% by 2015 and 20% by 2020.

The government will also prioritise technology skills and training. The aim of the plan is to enable the high-tech sector to meet domestic demand while at the same time integrating Vietnam into the global electronics industry chain. The government has identified a number of barriers to high-tech development. These include slow progress in building hi-tech industrial zones.

Focus On Semiconductors – One area where the government has had some success is in facilitating Vietnam's status as an emerging semiconductor hotspot in Asia Pacific. Recently the Ho Chi Minh City National University launched a manufacturing scheme for a microprocessor called SG 8V1, which was billed as the first of its kind in Vietnam. The University's IC R&D Centre (ICRDC) will oversee the VND12bn project to perfect the Sigma K3 chip for commercial production. According to ICRDC, the microprocessor will be priced 30% lower than similar chips from other countries. It is planned for the chip to have industrial applications in area such as electronic products and defence.

The Ministry of Information and Communications is the policy making and regulatory body in the fields of press, publishing; posts; telecommunications and internet; transmission; radio frequency; information technology, electronics; broadcasting and national information infrastructure.

In the fields of electronics and IT the ministry's specific functions include issuing policies and regulations on IT and electronics products, granting licences, and organising government projects

This report is abstracted from our latest Vietnam Tourism and Consumer Electronics reports, which include in depth research on the sectors, full five-year forecasts and a thorough analysis of the competitive landscape. BMI currently covers 24 industries across more than 60 countries. For further information, or to order a report, please contact: subs@businessmonitor.com

chapter 7 BMI Global Assumptions

Global Assumptions

Little Respite For World Economy In 2009

Our new set of global assumptions includes another downward revision to the global growth outlook for 2009 – but in a sign that the worst of the economic downturn may be behind us, our 2010 forecasts remain relatively steady. Our global real GDP growth forecast for 2009 falls to -2.5% from -2.3%, while our 2010 forecast remains at 1.7%. Economic data from Q109 was, with few exceptions, dire across the globe. However, subsequent monthly data points indicate that a tentative recovery may be afoot, and that the trough of the current global downturn may turn out to have been Q408-Q109, in line with our core view. We continue to warn of the possibility of a global ‘double-dip’ recession, in which the recovery turns out to be ‘W’-shaped, rather than linear. The twin systematic shocks of the financial sector collapse, which will reduce the availability of credit, and the decline of the buying power of the Western consumer mean that the global economy is undergoing a significant structural shift that will take years to play out.

TABLE: GLOBAL ASSUMPTIONS

	2008e	2009f	2010f	2011f	2012f	2013f
Real GDP Growth (%)						
USA	1.1	-3.3	1.2	3.0	3.3	3.0
Eurozone	0.9	-4.2	0.2	1.7	2.2	2.2
Japan	-0.7	-6.1	0.7	1.9	2.3	2.0
China	9.0	5.6	6.8	7.9	7.6	7.6
World	2.3	-2.5	1.7	3.4	3.7	3.7
Consumer Inflation (avg)						
USA	3.8	-0.9	1.5	2.4	2.4	2.3
Eurozone	2.8	0.2	0.9	1.4	1.5	1.6
Japan	1.5	-0.6	-0.6	-0.1	0.0	0.1
China	5.9	0.3	2.8	2.5	2.2	1.7
World	5.2	2.1	2.7	3.0	2.9	2.9
Interest Rates (Eop)						
Fed Funds Rate	0.00	0.00	1.00	3.00	4.25	4.25
ECB Refinancing Rate	2.50	1.00	2.00	3.50	4.00	4.00
Japan Overnight Call Rate	0.10	0.10	0.10	0.75	1.25	1.25
Exchange Rates (avg)						
US\$/EUR	1.47	1.28	1.29	1.34	1.29	1.25
JPY/US\$	103.34	99.00	110.00	110.00	110.00	110.00
CNY/US\$	6.95	6.87	6.75	6.45	6.20	6.00
Oil Prices						
Brent Crude US\$/bbl (avg)	97.06	49.00	52.00	60.00	75.00	85.00

Source: BMI

Developed States

Our real GDP growth forecast for developed markets has fallen from -3.7% to -3.9%, making the developed world the primary contributor to our downwardly revised global growth forecast.

The **US** forecast remains at 3.3%. As we had anticipated, growth contracted by around 6.0% q-o-q annualised in both Q408 and Q109, but we believe this was the worst of it. The **eurozone** and **Japan** will contract by 4.2% and 6.1% respectively in 2009. Several euro bloc members are being hit extremely hard in this economic cycle, including the worst-hit, **Ireland**, at (-9.4%). Our aggregate eurozone forecast has fallen further from -3.6% in our last edition of global assumptions, thanks to revisions to our **German** and **Italian** growth forecasts; the two countries are forecast to post falls in real GDP this year of 5.8% and 4.5% respectively. Ominously for both Japan and the eurozone, growth is not expected to pick up strongly in 2010, with the Japanese economy picking up by just 0.7%, and the euro bloc posting relatively flat growth of 0.1%.

TABLE: GLOBAL & REGIONAL REAL GDP GROWTH

	2006	2007	2008e	2009f	2010f	2011f
World	4.2	4.1	2.3	-2.5	1.7	3.4
Developed States	2.8	2.5	0.7	-3.9	0.7	2.5
Emerging Asia	8.8	9.1	6.4	3.0	5.3	6.4
Latin America	5.4	5.5	4.1	-2.2	0.6	3.1
Emerging Europe	7.4	7.0	4.3	-5.4	1.5	3.9
Sub – Saharan Africa	6.2	6.7	5.9	0.4	3.4	5.0
Middle East & North Africa	5.9	5.3	5.7	1.8	2.9	4.0
Developed Market Exchange Rates						
	2006	2007	2008	2009f	2010f	2011f
Eurozone	1.26	1.37	1.47	1.28	1.29	1.34
Japan	116.31	117.75	103.34	99.00	110.00	110.00
Switzerland	1.25	1.20	1.10	1.20	1.28	1.19
United Kingdom	1.84	2.00	1.85	1.47	1.50	1.58
Emerging Market Exchange Rates						
	2006	2007	2008	2009f	2010f	2011f
China	7.97	7.60	6.95	6.87	6.75	6.45
South Korea	955.34	929.38	1076.78	1281.00	1250.00	1150.00
India	45.18	41.17	43.40	48.29	48.00	47.50
Brazil	2.17	1.95	1.84	2.48	2.48	2.08
Mexico	10.90	10.92	11.15	14.18	14.35	13.50
Russia	27.17	25.57	24.86	33.20	36.00	34.50
Turkey	1.44	1.30	1.30	1.69	1.80	1.68
South Africa	6.75	7.08	8.25	10.12	9.75	8.45

Source: BMI

Emerging Markets

Emerging markets are forecast to post no growth in aggregate in 2009. The recovery will not be swift, nor will future growth be as dynamic as it was during the preceding boom period. We do not foresee real GDP growth in EM returning to its 2007 high of 7.2% over our forecast period.

Emerging Europe, the worst regional performer, will see real GDP shrink by 5.4% in 2009, highlighted by major contractions in **Russia** (-7.1%) and **Turkey** (-5.7%).

Emerging Asia will grow by 3.0% in 2009, but that will be due mainly to a 5.6% growth performance from China, rather than to any relative regional economic strength. Several states are going to be very hard-hit by the decline in global trade, including Singapore (-7.2%) and Taiwan (-4.5%).

Latin America will contract by 2.2%, as **Mexican** real GDP is set to shrink by 5.5%,

TABLE: EMERGING MARKETS

	2007	2008e	2009f	2010f	2011f	2012f
Emerging Markets Aggregate Growth	7.2	5.2	0.0	3.4	4.9	5.1
Latin America	5.5	4.1	-2.2	0.6	3.1	2.9
Argentina	8.7	7.0	-1.0	-0.9	1.2	1.8
Brazil	5.7	5.1	-0.6	2.0	2.9	3.4
Mexico	3.3	1.3	-5.5	-0.6	3.8	2.0
Middle East	5.6	5.9	1.4	2.8	4.0	4.0
Africa	6.7	5.9	0.4	3.4	5.0	4.9
South Africa	5.1	3.1	-0.3	2.9	3.1	4.2
Nigeria	6.2	6.3	-0.4	2.9	6.9	6.0
Saudi Arabia	3.4	4.2	1.8	1.6	2.9	2.8
UAE	5.2	6.7	-1.7	3.9	4.8	3.9
Egypt	7.1	7.2	3.7	1.8	3.3	4.8
Emerging Asia	9.1	6.4	3.0	5.3	6.4	6.4
China	12.0	9.0	5.6	6.8	7.9	7.6
Hong Kong	6.4	2.5	-3.6	2.2	4.3	4.9
India*	9.0	6.3	5.0	6.4	7.0	7.0
Indonesia	6.3	4.7	2.3	4.1	4.8	5.4
Malaysia	6.3	4.6	-1.9	2.6	4.5	4.7
Singapore	7.7	1.1	-7.2	1.3	2.3	3.6
South Korea	5.0	2.2	-3.3	1.8	3.3	3.2
Taiwan	5.7	0.1	-4.5	1.4	3.0	3.3
Thailand	4.9	2.6	-4.5	2.2	3.6	4.2
Emerging Europe	7.0	4.3	-5.4	1.5	3.9	4.6
Russia	8.1	5.6	-7.1	1.0	3.5	4.6
Turkey	4.7	1.1	-5.7	1.7	4.2	5.4
Czech Republic	6.0	3.2	-2.1	1.1	3.3	4.0
Hungary	1.1	0.5	-6.4	0.1	2.6	3.1
Poland	6.6	4.9	-2.7	2.8	4.3	3.6

*Fiscal years ending March 31 (2009=2009/10)

amid a two-year recession that will see negative growth again in 2010. As a whole, Latin America is set to underperform every other region in aggregate in 2010, with expansion of just 0.6%.

Sub-Saharan Africa will narrowly escape recession as a region, posting 0.4% growth in 2009, with a decent rebound to 3.4% in 2010. Among other states, **Nigeria** and **South Africa** will both have mild economic contractions in 2009.

The **Middle East & North Africa** region is expected to outperform with a 1.7% regional growth rate in 2009, thanks mainly to steady growth performances in **Saudi Arabia** (1.8%) and **Egypt**(3.7%), and despite a contraction in the **UAE** economy (-1.7%).

TABLE: COMMODITIES

	2007	2008	2009f	2010f
Brent Crude Oil, US\$/bbl,ave	72.83	97.06	49.00	52.00
Copper, Three-Month, US\$/tonne	7,103.03	6,886.23	3,500.00	4,200.00
Aluminium, Three-Month, US\$/tonne	2,663.94	2,623.02	1,350.00	1,700.00
Wheat, Usc/bushel	6,37.71	795.31	500.00	580.00
Corn, US\$/bushel	373.36	527.17	400.00	500.00
Soybean Usc/bushel	863.07	1,232.84	900.00	1,050.00
Coffee (Arabica), Usc/lb	117.29	131.98	105.00	115.00
Sugar #11, Usc/lb	9.90	12.10	13.00	14.00

Source: BMI