INTESA SANPAOLO

Vietnam: Trade Specialisation, Banking Development and Economic Perspectives

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Summary

In the past decade, Vietnam has increasingly attracted the interest of international observers and investors. Over the 2004-2008 period, it experienced an economic growth rate of around 8% p.a., one of the highest in Asia. In terms of GDP, Vietnam ranks just beneath the fastest-growing Asian economies (China and India had average GDP growth rates of 10.5% and 8.8% respectively in the same period), but leads both the ASEAN 5 countries and the “newly industrialised economies”, whose average growth rate in 2004-2008 was around 5%-6% p.a. and, respectively 4.5% and 7% p.a. Alongside economic growth, in the past five years per capita GDP has also risen sharply, at an average annual rate of around 6.5%, with Vietnam once again beaten in the Asian region only by China (10%) and India (7,2%) and bettering both the average rate in the ASEAN 5 (around 4%) and the NIEs (around 4.5%-5%).

This study intends to contribute to the analysis of Vietnam from two complementary standpoints, macro and microeconomic. The first section – *Current Economic Cycle and Long-term Growth Perspectives*, by Silvia Guizzo and Antonio Pesce – discusses the recent dynamics of the Vietnamese economy together with the determinants of long-term growth. The following two sections – *International Trade, FDI Flows, and Industrial Structure,* by Wilma Vergi, and *Banking and Financial System*, by Davidia Zucchelli – focus on the changes taking place at the microeconomic level in the structure of foreign trade, in the country’s industrial specialisation, and, respectively, in the local banking and financial systems*.

This paper points out the high growth potential of Vietnam in the Asian area, enhanced by the country’s progressive opening up to foreign trade and direct investments, as well as by its economic integration in the region. The Industrial policy action undertaken by the Authorities in recent years has proven to be decisive. The further advancement of the structural reform process is in any case still crucial in guaranteeing a sustained economic growth trend in the long term. Measures specifically addressed to raising infrastructure quality, improving workforce qualification, and promoting banking and financial system advances, remain essential in stepping up the still modest combined productivity of labour and capital factors.

Several factors have contributed to the country’s industrial take-off. The first is the opening up to international trade. In the past decade, Vietnam has entered into numerous bilateral and multilateral agreements, which have provided decisive impulse to foreign trade and direct investment flows. Vietnam joined the *Association of South East Asian Nations* (ASEAN) and the *ASEAN Free Trade Area* (AFTA) in 1995, and the *Asian Pacific Economic Cooperation* (APEC) in 1998. In 2001 it ratified an important bilateral agreement with the United States. In 2006 it became an official member of the *World Trade Organization*. The country’s openness to trade – measured in terms of the weight of foreign trade on GDP – has increased from less than 100% at the end of the decade, to 160% in 2007, with import-export volumes in excess of USD 110Bn in 2007.

The second factor has been the industrial policy pursued with the “Doi Moi” (“Renovation’ in Vietnamese) program, which kicked off Vietnam’s transition from planned economy to market economy. The measures introduced in the past few

* The Authors wish to thank Mr. Tomaso Andreatta, of the Intesa Sanpaolo International Network Corporate and Investment Banking Division, for his helpful comments on a draft version of this study. The authors are fully responsible for any remaining errors in their respective sections.

years have encouraged first of all the privatisation of the juridical status of the state-owned companies and the opening up of their capital to domestic and foreign shareholders (*equitisation*). At the end of 2006, only 22.5% of companies were still state-owned, as opposed to 33.3% non state-owned and 44.2% with foreign capital. The measures put in place were also aimed at implementing important development projects in specific strategic business sectors, such as the chemical industry, energy, and the mechanical, auto and textile industries, as well as in specific areas, with the creation of special zones enjoying tax incentives (*Export Processing Zones*, *High Tech Zones*, and *Industrial Zones*). New legislation – in particular the law on investments and the law on enterprise – have created favourable conditions for the inflow of foreign capital. In recent times, FDI flows have increased significantly, to around 8% of GDP in the past two years. At the end of 2007, cumulative FDI amounted to around USD 40Bn, or over 50% of GDP, a higher percentage than the average in Asia and worldwide.

Progressively greater commercial and financial openness has proven very beneficial in two respects: it has given direction to the country's industrial specialisation, favouring its commercial and economic integration in Asia and in the world; and it has created new challenges in governing the economy. As regards the former aspect, industry currently contributes to GDP by over 40%, and has specialised in the past few years in mining & extraction (in particular oil and natural gas) and, on the manufacturing front, in the food sector, textiles & clothing, leather and shoes. The resulting productions are largely exported to mature economies: oil to the Pacific region, and manufactured products to the United States and EU countries. The low cost of labour in the country has created investment opportunities in labour-intensive sectors, reaped in part by foreign enterprises, primarily from South East Asia including China, which have delocalised production phases to Vietnam. The industrial take-off phase has stimulated the demand of capital goods, met through imports mostly originating in the more advanced industrial economies of the region, i.e. Japan and the NIEs and China.

To date, Italy has only marginally taken advantage of the country's industrial take-off and of its increasing need of capital goods. With import and export flows worth around EUR 1.2Bn, and authorised direct investments in the country of EUR 150Mln between 1998 and 2007, Italy ranks only 18th and 31st respectively in the world tables referred to these items. A more detailed analysis of trade between the two countries shows that Italy mostly purchases from Vietnam agricultural products, leather, textiles and clothing. Its main exports to the country are machinery and mechanical equipment, and means of transport.

An analysis of the long-term determinants of Vietnamese growth shows that a significant rise in per capita GDP (6.5%) stemmed in part from an increase in employment (contribution of 1.7%), in part from capital accumulation per person employed (contribution of 2.7%), and for the residual part (2.2%) from Total Factor Productivity, i.e. the combined efficiency of the labour and capital factors. These findings are in contrast with the situation in other countries of the region, as well as in other emerging and in particular transition economies, where TFP tends to play a greater role than capital accumulation in per capita GDP growth.

The most likely explicative factors identified by economic literature on the topic include the still modest quality of infrastructures, the fragmented industrial structure, the poor quality of the workforce, and the slow pace of the privatisation process[1]. An additional factor which deserves to be mentioned is the still insufficient development of the banking and financial sectors. Despite recent advances, the local banking system is still affected by several weaknesses. The first two are the system's fragmentation and the still limited participation of foreign investors. Five major state-owned banks operate in Vietnam and account for around 60% of deposits and total assets. Foreign banks are represented by 37 branches (10% of the market) and limited shareholdings in local banks. Following its entry into the WTO, Vietnam has committed to abolish all restrictions imposed on foreign banks. However, the process of adjusting regulations could prove to be slow. Vietnam has recently raised the limits imposed on foreign investor participation in the capital of local banks (15% for any single investor, and 30% in total), although some foreign banks have been allowed to establish local subsidiaries. The third weakness is asset quality. Based on IMF data, the loans portfolios of local banks, and especially of private banks exposed to the booming real estate sector in the past, are weak. Total NPLs are estimated by the IMF at around 18%-20% of GDP. In addition, the level of risk tied to currency and maturity mismatching is unclear.

The advances of the banking system, against a background of higher openness to foreign investor participation, may provide an important contribution to the long-term growth of the economy. Empirical analyses referred by a vast body of literature on the topic highlight the existence of a statistically significant relationship between the level of advancement of a country's banking sector and financial markets on the one side, and Total Factor Productivity, per capita income, and GDP on the other[2].

Increasing commercial and investment openness at the international level has posed new challenges in governing the economy. In the past few years, economic policy has aided the growth of GDP essentially through exports. The authorities have therefore tried to fend off pressures calling for an appreciation of the Dong's exchange rate (which would affect the country's competitiveness), as a result of larger inflows of capitals (in particular FDI) than required to finance the current account deficit, and have accumulated reserves. Set on avoiding interest rate hikes, the authorities failed to sterilise the increase in the money supply resulting from the purchase of foreign currency. As a result, the system's liquidity was left free to grow significantly, reaping effects on the trend of credit aggregates (and, indirectly, on real estate valuations and equity indices) and of inflation.

In the opening months of this year, also due to the sharp increase in energy prices, inflation rapidly surged to over 20% while the current account deficit deteriorated dangerously, increasing to unsustainable levels (of around 15% of GDP). Therefore, the authorities were forced to take restrictive measures on demand, raising monetary policy rates and compulsory reserve coefficients, and sterilising part of the increased money supply by imposing on banks the purchase of "compulsory" bills. Action was also taken on the exchange rate, first by devaluating the Dong's nominal reference rate and subsequently by widening the national currency's daily fluctuation range against the US dollar. Lastly, the reduction of the public spending deficit should allow an improvement of the

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1 See, among others, Nguyen K. M. et. al., A Non-parametric Analysis of Efficiency for Industrial Firms in Vietnam, National Economics University, Hanoi, 2007, and Tran T. B. et al., Institutions Matter: the case of Vietnam, The Australian National University, Ian. 2008, and also O. Shrestha, Efficiency Enhances the Competitiveness of Vietnam, Presentation in Ho Chi Min City, ADB, Dec. 2006.

2 See for all, A. Demirguç-Künt and R. Levine, Finance, Financial Sector Policies and Long-Run Growth, Commission on Growth and Development, WP n. 11, 2008.

foreign trade deficit, removing what would otherwise be a serious obstacle to the country's long-term growth[3].

The stabilisation measures seem to have worked so far. Over the summer, inflation started to decline gradually, while tensions on the exchange market eased somewhat, despite the turmoil on the international financial markets. The current account deficit has narrowed, partially reducing the country's foreign financial vulnerability. According to influential international observers, the local Authorities, despite acting with some delay[4], have finally awarded the necessary priority to stabilisation goals, over pure growth maximization objectives. In October, however, in the face of increasing external risks of regional and global recession, and a sharper-than-forecast slowdown in domestic credit growth, the Central Bank eased its monetary policy again, cutting policy rates and announcing, among other measures, the buyback of the compulsory bills previously sold to banks. The Authorities are now faced with a difficult dilemma – quite common among countries in an industrial take-off phase, but made more severe by the current unfolding of a deep financial crisis at the international level – having to choose between the desire to support a strong long-term growth trend, and the need to keep inflation and the current account deficit under control. A cautious, balanced approach is essential in a long-term perspective. Given the foreign current account financing constraints, a slower growth profile may well represent a necessary price to pay, to guarantee a sustainable pace of economic growth in the long term.

Gianluca Salsecci

[3] The presence of a large current account deficit still sets Vietnam apart from the other export-led Asian economies.

[4] This is the view expressed, for example, by the World Bank in Taking Stock. An Update on Vietnam's Recent Economic Developments, Mid-year consultative Group Meeting for Vietnam, Sapa, June 5-6 2008

Current Economic Cycle and Long-Term Growth Perspectives

Introduction

Vietnam brought 2007 to a close showing an average growth rate of 8.5%, beating the 8% mark for the third consecutive year, behind only China and India in all of Asia. The slowdown in GDP growth to 6.5% y/y in the past two quarters was almost entirely due to the contraction in constructions and mining, whereas the manufacturing sector continued to expand at a solid pace. On the side of demand, growth is being driven by consumption and investments, while the foreign channel's contribution has dropped considerably. The trade balance is still negative, although monthly data show a significant recovery over the summer months compared to the first half of the year. In the first four months of 2008, the deficit had already reached USD 14.4Bn, more than in 2007 as a whole (USD 12.4Bn), and rose to USD 15.3Bn in September. The external factors which had strongly impacted foreign trade are waning.

As is the case in many other Asian countries, Inflation, which peaked at 28.3% y/y in August, is mostly fuelled by rising food and energy prices. However, in recent months other price items have also experienced double-digit increases. The widespread drop in monthly changes from peak levels over the summer, and the decline in the international prices of many cereals, combined with a favourable base effect, lead us to believe that inflation touched a high last summer, and is likely to ease gradually over the months ahead.

The sharp acceleration in the offer of money, credit and inflation, have prompted the monetary authority to put several restrictive measures in place to prevent the overheating of the economy, while at the same time avoiding a worsening of the current account balance, and a currency crisis thereafter. Further effective action was taken by the government in revising investment plans of state-owned companies and restrictions imposed on imports and exports.

Pursuing a restrictive monetary policy against in a context characterised by a deteriorating current account balance, a currency regime anchored to the US dollar, and sharply rising inflation, placed the Central Bank in a difficult situation. In fact, if on the one hand the State Bank of Vietnam (SBV) had to avoid an excessive weakening of the exchange rate, which would have further fuelled inflation, on the other it also had to prevent it from strengthening, stoking the real effective exchange rate to the detriment of exporters.

Despite the sharp rise in interest rates, real rates have remained in negative territory. However, there is a risk, by no means negligible, that the nominal interest rate increases, combined with restrictive measures on credit, could slow investments over the next few months more sharply than anticipated by the SBV. The recent monetary policy reversal show that the Central Bank shared this fears and that it is more concerned by the risk of a slowdown in growth than by the risk of a sticky inflation. Over the months ahead, especially in the event of inflation not tracing back quickly, the central bank may simply choose to leave rates unchanged to assess the impact of the measures taken so far, and to ease monetary policy only at a later stage if data deteriorate.

According to the rating agencies, that have recently placed Vietnam under Credit Watch Negative, the overheating of the economy represents a risk for the stability of the country, threatened by the excessive growth of credit in a still very weak banking sector, and by increasing foreign financial requirements (estimated at 10.4% of GDP in 2008).

We believe the size of reserves and the trend of the services and transfers balance, together with the size of foreign investments and the structure of foreign debt, limit the risk of insufficient financial backing of the current account deficit, despite the economic slowdown under way. However, the current financial market crisis and the consequent rise of investors' risk aversion will stress funding difficulties for those countries, such as Vietnam, that experienced a pronounced worsening of the current account deficit.

Since the end of the 1980's, through the implementation of the "Doi moi" plan ("Renovation" in Vietnamese), Vietnam has achieved significant advances in making the transition from a planned economic system to a market economy. In the past five years, compared to the other Asian economies, Vietnam achieved an average real GDP annual growth rate (8%) second only to China's and India's. This upbeat economic trend also determined a solid real GDP per capita growth (6.5% on average since 2004).

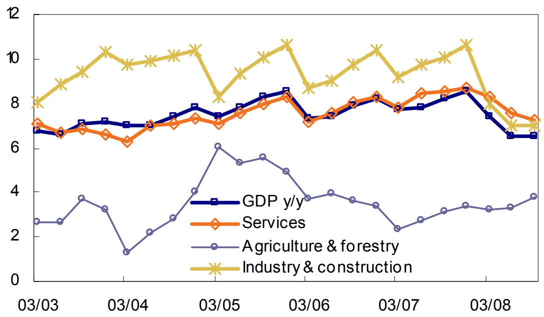
Various factors have supported the remarkable economic performance, among the others the openness degree to international trade and the strong flows of foreign direct investments (FDI). Despite the high GDP growth rate, the rise of Vietnamese productivity has been smaller than the area average, weighing on the Country's potential growth.

Current Economic Cycle

Construction sector and foreign channel responsible for the slowdown in growth

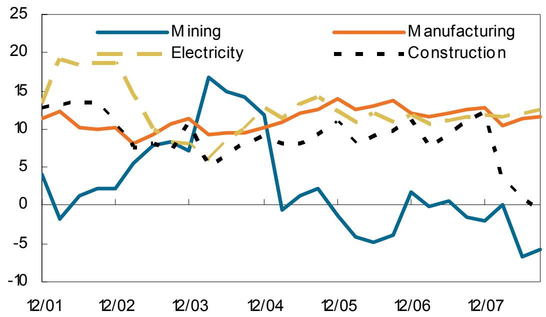
Vietnam brought 2007 to a close showing an average growth rate of 8.5%, beating the 8% mark for the third consecutive year. GDP increased by 7.4% in 1Q08 and 6.5% in both the second and third quarters of the year, fuelled by the excellent performance of the industrial sector (+7.0%), and in particular of manufacturing (+11.6%) and services (+7.2%). The agricultural sector, which also includes the fishing and forestry industries, expanded by 3.8%, at a faster rate than in the same quarter last year.

Slowing growth...



Source: *Bloomberg and Intesa Sanpaolo elaborations*

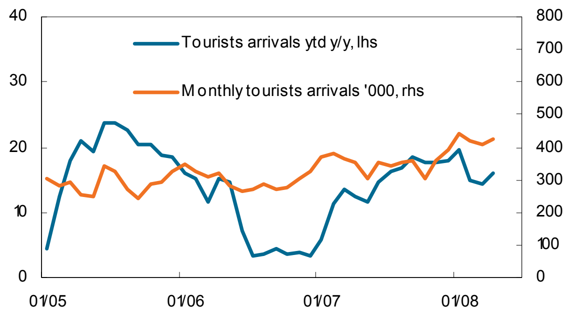
...due to the mining and construction sectors



Source: *Bloomberg and Intesa Sanpaolo elaborations*

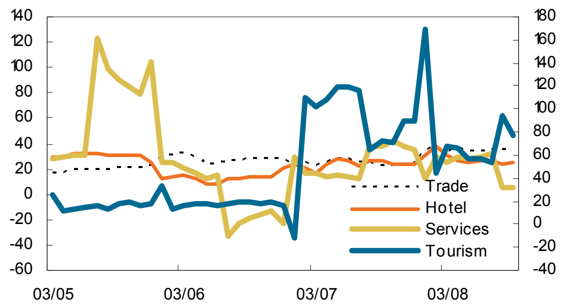
The slowdown in GDP growth from 2007 levels was almost entirely due to the contraction in mining (-5.9%) and constructions (-0.3%), which made contributions of respectively -0.3% and zero to GDP growth in 3Q08. The construction sector slowdown from an average growth rate of 10.9% in 2007 also impacted real estate services, which only grew by 1.2% y/y and 2.8% in 2Q08 and 3Q08, compared to 3.7% and 5.3% in the same quarters in 2007.

Ongoing increase in the number of tourist visitors



Source: *Bloomberg and Intesa Sanpaolo elaborations*

Retail sales in the non-manufacturing sector



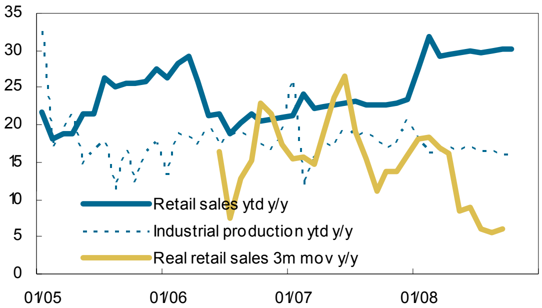
Source: *Bloomberg and Intesa Sanpaolo elaborations*

The manufacturing sector, on the other hand, is still expanding at a solid pace, at growth rates of 11.4% and 11.6% respectively in 2Q08 and 3Q08, just below the average for 2007. This was mirrored by the trend of industrial production, on the rise at rates of around 16% y/y since the beginning of the year, with increasingly strong contributions made by non-state-owned and foreign companies, testifying to the positive outcome of the privatisation process and the favourable environment for foreign investors. At current prices, the share of industrial production contributed by state-owned companies dropped from 34.2% in 2000 to

22.5% in 2006, whereas the share of foreign companies increased from 41.3% to 44.2% over the same period. A similar trend can be observed by looking at the same quotas at constant prices and at growth rates by sectors. The growth rate of non-state sector industrial production increased from 19.2% y/y in 2000 to 25.7% y/y in 2006, while that of the foreign investors sector went back in line with 2000 levels in 2006 (21.8% vs 19.9%) after a drop in 2002. The growth rate of state sector industrial production showed a strong deceleration from 13.2% y/y in 2000 to 6.3% y/y in 2006.

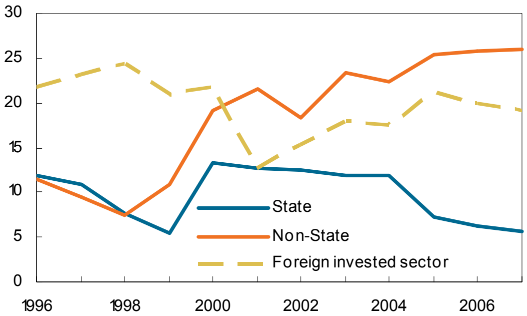
Cumulated nominal retail sales increased by 30.1% in September and have been growing at similar strong rates since the beginning of the year, although the rise in inflation has curbed the growth rate of real retail sales, which have stabilised at between 7% and 8% in the past four months.

Manufacturing and industrial sectors resilient...



Source: Bloomberg and Intesa Sanpaolo elaborations

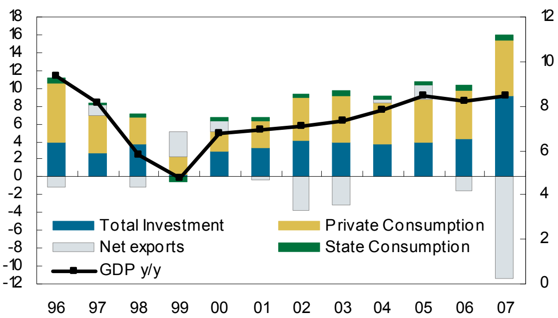
...underpinned by non-state-owned and foreign companies



Source: Bloomberg and Intesa Sanpaolo elaborations

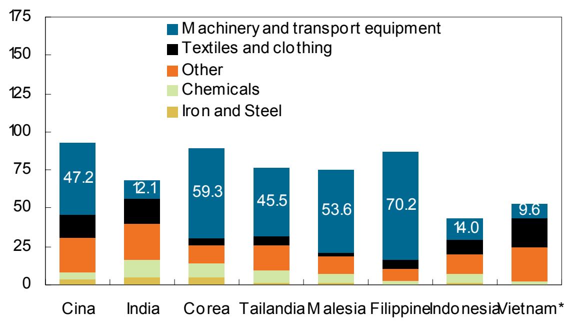
The solid trend of industrial production and resilient retail sales should result in positive consumption and investments data also in 4Q08. Net exports made a negative contribution of 11.4% to GDP growth in 2007, and in light of the trade balance trend, are likely to make an even more negative contribution in 2008 although the trade balance has improved significantly compared to the critical levels touched in mid-year. By contrast, the contribution of investments and private consumption has increased in recent years, and played a significant role in 2007 and 2008 in offsetting the foreign trade deficit.

Contributions to GDP growth (y/y)



Source: Bloomberg and Intesa Sanpaolo elaborations

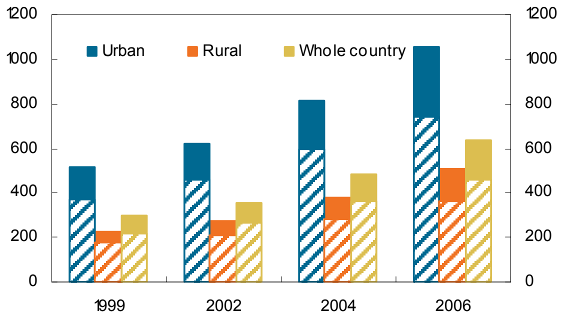
Exports of manufacturing products, year 2006



*Data referred to 2004. Source: WTO and Intesa Sanpaolo elaborations

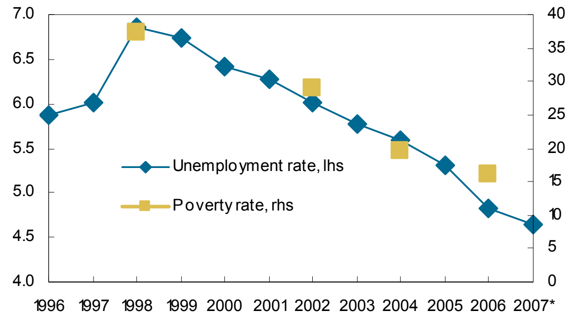
However, investments may slow significantly in the quarters ahead, due to the lagged effects of interest rate hikes, as suggested by the contraction of the real estate sector. The resilience of the manufacturing sector and of agriculture, as well as of intra-Asian trade, will become crucial in keeping the unemployment rate low, allowing the uptrend in per capita income to continue, and therefore supporting consumption, an important growth driver in recent years.

Average monthly per capita income and consumption (striped bars – VNDk)



Source: General Statistics Office (GSO) of Vietnam

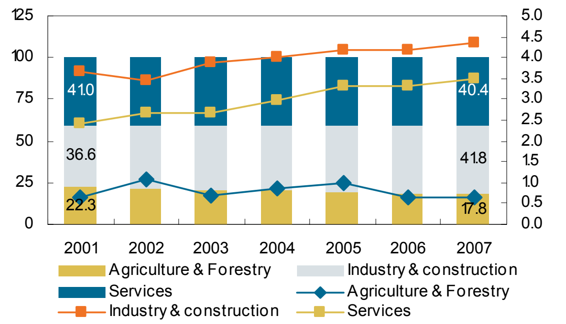
Unemployment rate and poverty rate



**Provisional data. Source: General Statistics Office of Vietnam*

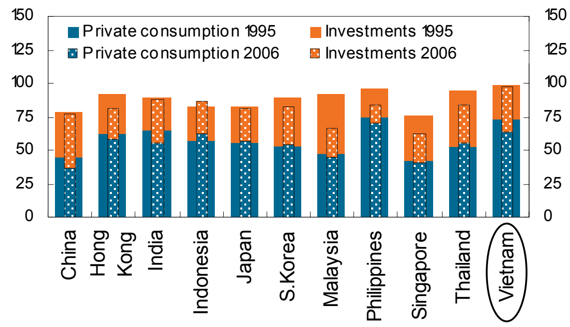
Broken down, Vietnamese growth emerges as being better balanced compared to that of other Asian countries, China first among them. The share of investments on GDP at the end of 2006 was 36.8%, much lower than in China (43%). The share of private consumption, on the other hand, was significantly higher, at 65.2% (vs. 36% in China), and according to provisional data for 2007, rose to 70.5% last year. This was the result of higher per capita income both in metropolitan and rural areas, although purchasing power is being severely threatened by the rise in inflation.

Vietnam: GDP composition by sectors (bars, lhs) and contributions to growth (lines, rhs)



Fonte: Bloomberg, GSO and Intesa Sanpaolo elaborations

Private consumption and investments, shares on GDP (%)



Source:EIU

Trade balance improving

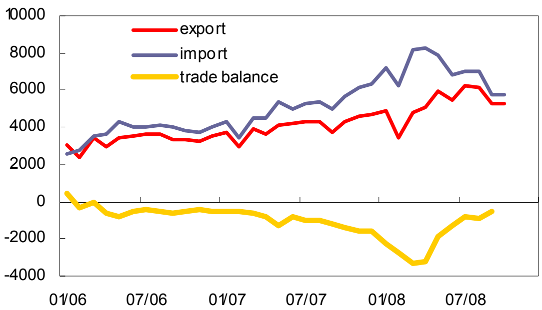
While Vietnam's foreign trade balance is still negative, monthly data over the summer highlighted a marked improvement compared to the first half of the year. In the first four months of 2008, the deficit had already reached USD 14.4Bn, more than in 2007 as a whole (USD 12.4Bn), and rose to USD 15.3Bn in September. As a result, as a percentage of GDP the trade balance deficit has increased to around 18%[5]. The growth of imports, which had greatly outpaced

[5] Estimate based on CIF imports and FOB exports, unlike IMF estimates, which consider both imports and exports FOB. Using the latter system, the percentage would drop to around 12.2% of GDP.

exports since the autumn of 2007, mostly driven by surging oil and commodity prices, slowed back to levels below exports as of mid summer.

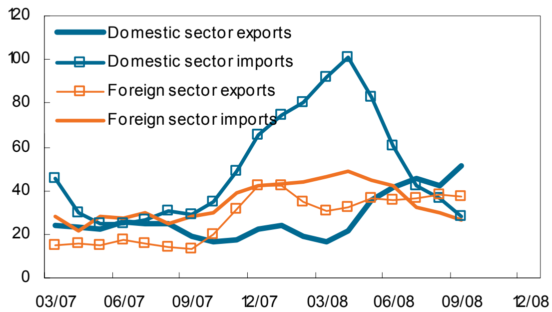
The significant deterioration of the trade balance in the first half of the year was mostly due to external factors which inflated imports and limited exports. Some of these factors, such as the rise in oil prices, restrictions on exports (restrictions on rice exports, for instance, were put in place in September 2007, strengthened in the spring, and abolished at the end of June 2008), and poor crops (coffee), disappeared in part in the second half of the year. Exports of rice and coffee increased both in terms of value and volumes, as did oil exports.

Trade balance (monthly balance in USD Mln) improving



Source: Bloomberg and Intesa Sanpaolo elaborations

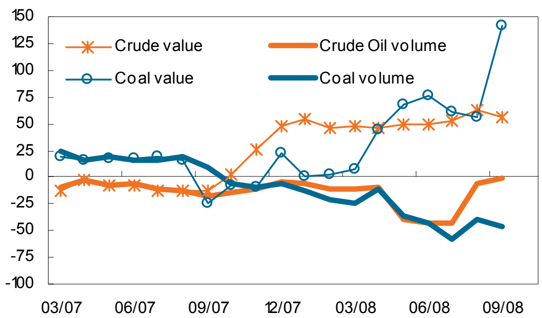
Slower imports (3M y/y)



Source: EIU and Intesa Sanpaolo elaborations

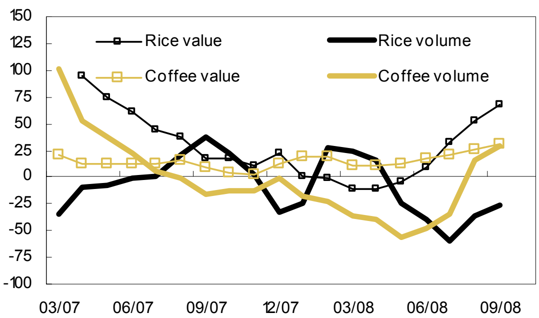
Imports of oil and steel slowed from peak levels reached in January in terms of volumes, as did the growth rate of the value of imports of electronic goods, textiles and yarn. Recent interest rate hikes will start to have an impact on investments in the months ahead, and therefore also on imports, hitting machinery and capital goods in particular. Automobile imports will also be impacted by higher import duty on auto components, ranging from 5-10% to 15-29%, as of 20 June 2008. Other duties have also been imposed on consumer goods such as mobile handsets and cosmetics.

Exports (3M y/y) increased in value thanks to higher energy product prices



Source: Bloomberg and Intesa Sanpaolo elaborations

Volumes also grew (3M y/y) thanks to easing restrictions and better crops



Source: Bloomberg and Intesa Sanpaolo elaborations

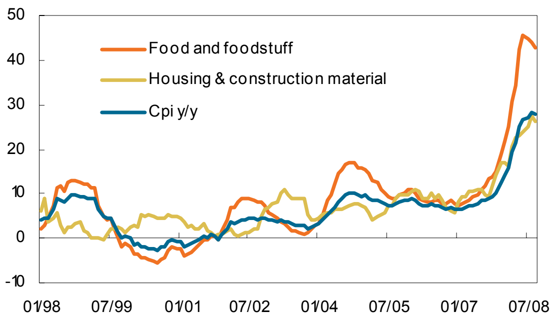
Entry into WTO, and the gradual depreciation of the dong, will continue to play to the advantage of stronger exports, although the slowdown in global demand, sharper than previously expected, will not allow the sustained growth rates seen in the past few years to be matched. However, Vietnam seems better positioned than other Asian countries as, despite its role as an assembler country, it has a relatively low share of exports of telecommunications devices and electronic products and devices (see chart on the next page), demand for which mostly originates in industrialised countries. Most of its exports are accounted for by oil and agricultural products, for which Asia will continue to be a source of additional demand.

We feel a reasonable estimate of the trade balance at the end of the year could be around USD 18.5Bn6, or around USD 14.5Bn in FOB imports. EIU estimates point to a trade deficit of USD 12.6Bn in 2008 and 9.9Bn in 2008, due essentially to a slightly more optimistic view on the export trend, and a slightly less pessimistic outlook on imports.

Inflation has probably peaked

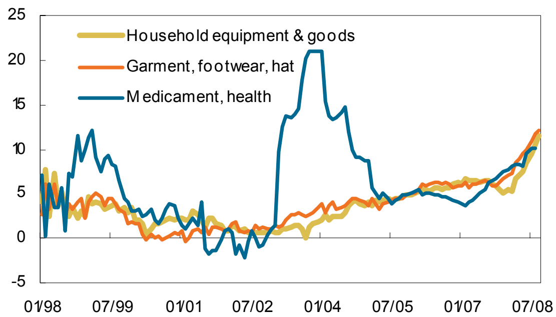
Strong economic growth has generated considerable upward pressures on the inflation rate, which peaked at 28.3% in August, soaring well above the previous historical highs set in October 1998 (9.6%) and November 2004 (9.9%). Inflation stayed high in September, at 27.9%y/y, although its monthly rise was 0.18%, still on the decline from the 3.9% m/m peak in May. Inflation is still mostly fuelled by energy and food price components.

Inflation mostly fuelled by food prices...



Source: Ecowin and Intesa Sanpaolo elaborations

... but not only



Source: Ecowin and Intesa Sanpaolo elaborations

The energy component increased substantially over the summer, following the government's decision, in step with other Asian countries, to raise the price of petrol (+31%) and diesel (+44%) starting at the end of July, by cutting subsidies to oil companies.

The food price component shot up by 65% in September, after rocketing by 74.3% y/y in May, driven primarily by the soaring price of rice. In more general terms, food and foodstuffs prices are still recording increases in excess of 40% y/y, albeit down somewhat from May's peak levels, and with a zero monthly change compared to the high set in May (+7.2% m/m).

However, other price categories continued to grow at double-digit rates in September, such as services for the home and construction materials (including the price of utilities, +26.1% y/y), transport (+26.1% y/y), but also medical expenses (10% y/y) and goods for the home (11.4% y/y). This confirms that inflation pressures have also spread to other goods and services sectors.

The widespread drop in monthly changes from peak levels over the summer, and the decline in the international prices of many cereals, combines with a favourable base effect, lead us to believe that inflation peaked last summer, and is likely to

6 See footnote 5.

ease gradually over the months ahead. However, energy price volatility and the uptrend in wages subjects our forecast to some upside risk.

Monetary policy

The sharp acceleration of the M2 aggregate (+46% in 2007), of credit (+54% in 2007 vs. 25.4% in 2006, according to ADB, and +63% y/y in March 2008 from +32% y/y in the same month in 2007 according to the World Bank7), and of inflation, have prompted the monetary authorities to implement, albeit with some delay, several restrictive measures aimed at preventing the overheating of the economy, while at the same time avoiding a worsening of the current account balance, and a currency crisis thereafter. Between May and June the central bank acted aggressively on interest rates, the compulsory reserve coefficient, and the exchange rate fluctuation range, also resorting to administrative measures, which effectively complemented those put in place by the government to improve the trade balance.

BOX 1: Measures put in place by the SBV in the first half of 2008 – Vietnam's central bank (State Bank of Vietnam, SBV) has hiked interest rates suddenly and aggressively three times since the beginning of the year: once at the end of January (+50bps on the base rate), once in mid-May (+325bps on the base rate), and once on 10 June (+200bps on the base rate), raising the refi rate from 7.5% to its current level of 15%, the base rate from 8.25% to 14%, and the discount rate to 13%. In May, the SVB also raised compulsory reserve coefficients on deposits, from 10% to 11% on maturities up to one year, and from 4% to 5% on deposits with maturities of over one year. Furthermore, it has stopped refinancing repo operations, excluding newly issued government bonds as guarantee.

The association of Vietnamese commercial banks had agreed at the end of April to place a cap on deposit rats from 11% to 12%, creating significant liquidity restrictions for smaller banks. The agreement was then abolished by the SBV, which introduced a cap of 150% of the base rate both on rates applied to deposits and loans. Therefore, the maximum rate cap increased to 18% in May and to 21% at the beginning of June. The 3% threshold on bank loans for equity market investments introduced in June 2007 was raised to 20% at the end of the year. This measure, together with the raising of the risk coefficient on this type of loan, weighed negatively on the stock market, which between the 'beginning of the year and mid-June dropped by 59% in Ho Chi Min, and by 69% in Hanoi.

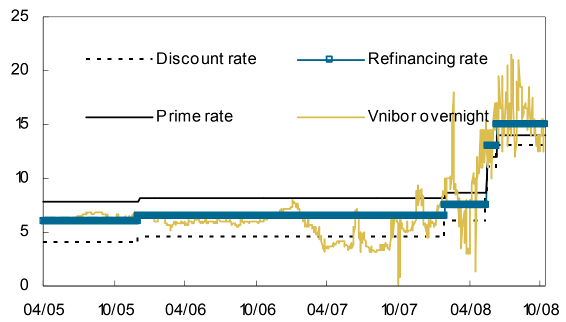
The liquidity drain created sudden movements of both the exchange rate and interest rates in recent months. The sharp exchange rate uptrend which began in September pushed the SBV to widen the dong's fluctuation range as many as three times between the end of December 2007 and July 2008, and to carry out one mini-devaluation (see box 2 on the exchange rate). In addition, the SBV made it compulsory for commercial banks to purchase securities for a total of 20.3 trillion dongs (USD 1.3Bn), with the aim of sterilizing actions on the exchange rate, and at the end of March ordered commercial banks to transfer to Treasury deposits worth a total of USD 3.3Bn at the end of 2007. This led to a severe liquidity shortage, which drove the overnight rate as highs up as 40% in spring, before subsequently retracing to levels more in line with official rates.

In August, the SBV left both interest rates and the compulsory reserve coefficient unchanged, reasserting that the central bank's main objective was to fight inflation. Despite the sharp interest rate hike, real rates remain in negative

[7] World Bank: Taking stock, an update on Vietnam's recent economic developments, 5-6 June 2008.

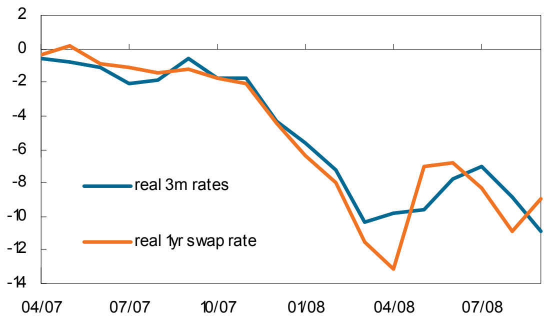
territory, even taking into account the fees applied by banks to exceed the limit imposed by the SVB. Indeed, the *Vietnam Investment Review*[8] suggests that compared to the previous limit of 18%, real rates may have been around 24%, just below the inflation rate. However, a far from negligible risk is that nominal rate increases, as well as restrictive measures on credit (30% target in 2008), may slow investment flows more sharply than estimated by the SBV.

Nominal rates have been on the rise...



Source: Ecowin and Intesa Sanpaolo elaborations

...but real rates have not kept up



Source: Ecowin and Intesa Sanpaolo elaborations

According to the Chairman of Vietnam's Small & Medium-sized Enterprises[9], many companies are suffering, or have declared bankruptcy in 2008, due to excessively high interest rates. The local press[10] estimates that around 74% of the companies interviewed by the Vietnam Chamber of Commerce and Industry, declared that obtaining bank loans has become "difficult". The country's four major banks slightly reduced their lending rates by 25 bps already in July, meeting the requests of enterprises. The SBV, while keeping rates unchanged during the summer, did take action in this sense, by raising the compulsory reserve remuneration rate twice (from 1.2% to 3.6% at the end of August, and from 3.6% to 5% at the end of September), with the explicit aim of allowing banks to use margins growth to the advantage of small and medium enterprises, already penalised by the exchange rate trend. After this hike lending rates decreased on average of about 100 bps. Surprisingly, on October 20, the SVB cut reference rates by 100 bps, decreasing the prime rate from 14% to 13%, the discount rate from 13% to 12% and the refinancing rate from 15% to 14%. The central bank also doubled the compulsory reserve remuneration rate to 10%. The measures taken were justified by the need to limit the impact of the global recession on the Vietnamese economy and the need to continue to sustain small companies' demand for credit. With the aim to increase liquidity the SVB has moreover announced that it will buy back the 20.3 billion dong of compulsory bills sold to commercial banks during spring.

These measures on the remuneration rate and on the reference rates testify to the fact that the SVB is more concerned by the risk of a slowdown in growth than by the one of a missed or very slow decrease in inflation. In the very short term, and especially in the event of inflation not tracing back quickly, the central bank may simply choose to leave rates unchanged to assess the impact of the measures taken so far, and proceed only afterwards to further monetary policy loosening.

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[8] Government review available from: http://www.vir.com.vn/Client/VIR/default.asp

[9] Kao Sy Kiem, Chairman of Vietnam's Small & Medium-sized Enterprises.

[10] Bloomberg, 26.09.08, quoting Dau Tu Chung Kohan Newspaper.

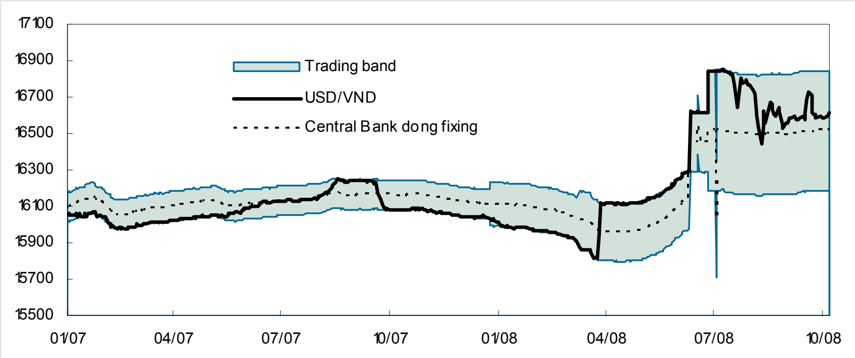
BOX 2: Exchange rate dynamics and prospects

The year 2008 was an intense one for Vietnam in terms of its exchange rate management policy. In May, there were fears of a currency crisis.

The overheating of the domestic economy, spiralling inflation, and the further, sharp increase in the current account deficit, had generated strong downward pressures on the dong.

In reaction to this situation, on 10 June the State Bank of Vietnam (SBV) announced an immediate 2% devaluation of the dong's benchmark exchange rate versus the US dollar, on the same day on which it had hiked the base rate (for the third time since the beginning of the year) to 12% to 14%, to contain inflation pressures. The SBV's simultaneous action on the exchange rate and on interest rates was aimed at preventing speculative flows on the national currency, triggered by the monetary restriction under way. From this point of view, the devaluation proved efficient. On the other hand, downward market pressures tied to fears of an uncontrolled surge in the current account deficit, while easing somewhat, remained substantial.

The exchange rate has stabilised

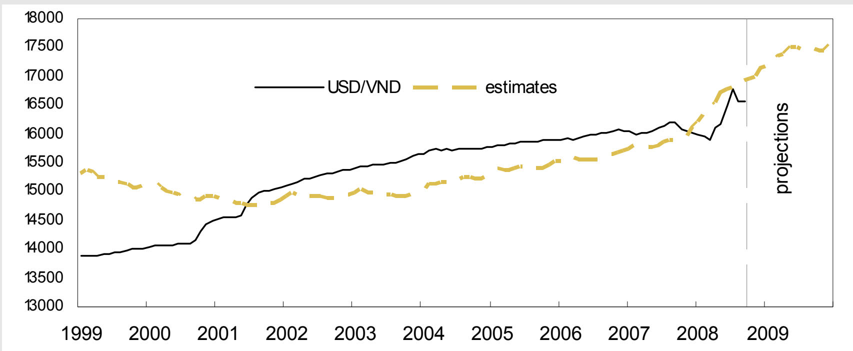


Source: Ecowin, Bloomberg and Intesa Sanpaolo elaborations

As a result, two weeks later the central bank acted again, announcing on 26 June the widening of the daily fluctuation range of the USD/VND exchange rate, doubling it from ±1% to ±2%. In doing so, the SBV intended to abide downward market pressures, and the strategy proved credible, as the exchange rate stabilised rather well. In fact, over the following months it gradually made up some ground.

However, this trend was also favoured by developments at the fundamental level, both internationally and domestically, as oil prices declined (cooling inflation expectations) and domestic demand started to show signs of sowing (leading to expectations of slowing imports and, therefore, of a gradual reduction of the foreign trade deficit).

Projections



Source: Ecowin, and Intesa Sanpaolo elaborations

Macroeconomic forecasts on a one-year horizon generally point to a continuation of these trends: inflation on the decline, further slowdown of the economy, reduction of the current account deficit. In these conditions, the SBV can reasonably be expected to let the exchange rate fluctuate in order to maintain the year-on-year depreciation of the dong against the US dollar in line with current conditions (daily fluctuation range of ±2%), therefore probably without making changes similar to those implemented this year (devaluation and widening of the range), as these actions had been called for by the deterioration of the inflation picture and of the foreign trade deficit, as well as by the overheating of the economy. Also recent developments related to the global financial crisis should lead in this direction, given the risk of contagion for the Vietnamese economy. The SBV accordingly cut rates from 14% to 13% on 20 October. Such move sent the dong about 1.5% lower against the dollar in less than a couple of days.

In order to make an initial forecast of the expected depreciation of the dong versus the US dollar on a one-year horizon, we have used purchasing power parity estimates (see fig.) which, based on inflation forecasts in Vietnam and in the United States, point to an average annual weakening of around 3.0%-4.0% in 2009 vs. 2008.

In the longer term, the prospect remains that of making progress towards allowing a free-floating exchange rate, and adopting an inflation-targeting policy. Given the extremely delicate phase the global economy is experiencing, with mounting fears of a recession and increasing uncertainty tied to the financial crisis, Vietnam could be unlikely to achieve these goals already in 2009. Therefore, as mentioned above, we expect the current conditions of the exchange rate policy to be left in place between now and next year.

Asmara Jamaleh

Fiscal policy

In June, the government cut the 2008 growth estimate from 9% to 7%, setting a still impressive target of 7.5% for 2009. Also, it announced a series of measures aimed at limiting state-owned company credit growth in some sectors, while trying not to overly affect investment flows in other sectors. To achieve this, the government restored the obligation imposed on state-owned companies to apply for authorisation to invest in real estate and in financial assets, while committing to speed up procedures for the issue of ODA (Official Development Assistance) and encourage FDI, as well as investments in infrastructures, particularly of social and economic relevance, of which the country is in need.

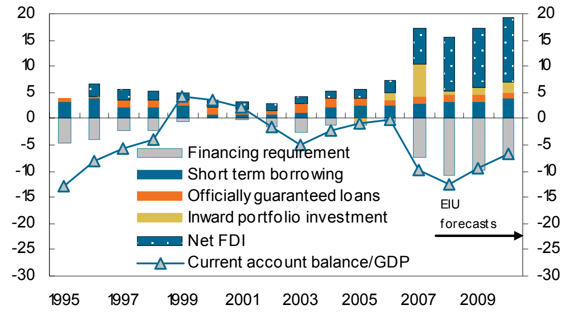
Although the increase in revenues has consistently exceeded the government's expectations in the past few years, the increase in spending has kept the balance in negative territory. According to preliminary Ministry of Finance (MOF) data, the deficit/GDP ratio was 1.7% in 2007, and is forecast to worsen to 2.4% in 2008, due to lower oil industry revenues as a result of an estimated drop in the production of crude oil, and of higher spending on education, services for the economy, social welfare and public administration. The uptrend in revenues from the private and non-oil sectors, however, will continue, also supported by the new personal income taxation system, due to come into force in January 2009, which will harmonise the tax rates imposed on foreigners and residents, and widen the taxable base.

However, most infrastructural work is financed through the issue of bonds, that are an off-balance sheet item, as are resources obtained through ODA. Taking into account all the expenses, the deficit is in any case higher. According to the MOF, it was 4.98% in 2006, and 5% in 2007, which is also the target for 2008, whereas the reclassification used by the IMF results in slightly higher rates: 6.6% in 2007 and 6.9% in 2008.[11]

External vulnerability

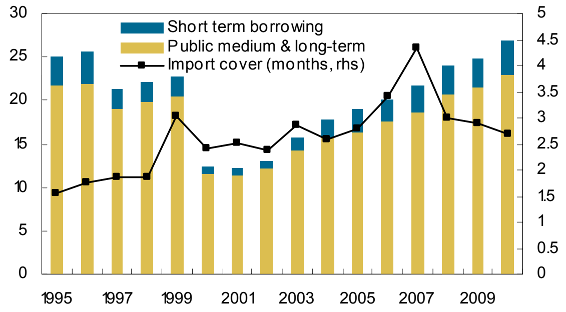
According to the International Monetary Fund (IMF) foreign currency reserves increased from USD 3.6Bn in 2001 to USD 13.3Bn at the end of 2006, and rose to a high of USD 26.3Bn in February 2008. Between February and May 2008 (latest available figure), reserves decreased by USD 4.0Bn, in line with the widening of the current account deficit. According to recent statements[12] by the SVB's Governor, foreign reserves were 21.2Bn dollars in June 2008.

Financial requirements mostly satisfied by credits to commercial banks



Source: EIU

Foreign debt is mostly made up of long-medium term debt (data in USD Bn)



Source: EIU

Alongside the trade balance deficit, the services and income balance is also negative, although it could improve compared to 2007, also driven by the stable and ongoing growth of the country as a tourist destination. Support to current account items will be provided by the balance of transfers: The National Committee for Overseas Vietnamese estimates that transfers by expatriates, of USD 6.8Mn in 2006, could exceed USD 7.5Bn in 2008.

The overall current account deficit is estimated at USD 12.7Bn in 2008 by EIU, improving to USD 9.6Bn in 2009, or respectively 12.7% and 9.6% of GDP. The IMF's forecasts are slightly more optimistic for 2008 (11.7%), and less so for 2009 (10.4%).[13]

The financial account balance has been positive so far, thanks to the strong inflow of Foreign Direct Investment (FDI), the medium and long-term loans of institutional investors and, in the past few years, also of portfolio investments, which in 2007 amounted to USD 6.2Bn according to the IMF[14], fuelled by the stock market's strong performance. The size of reserves and the trend of the services and transfers balance, together with the size of foreign investments and the structure of foreign debt, will continue to guarantee the financing of the current account deficit, despite its worsening.

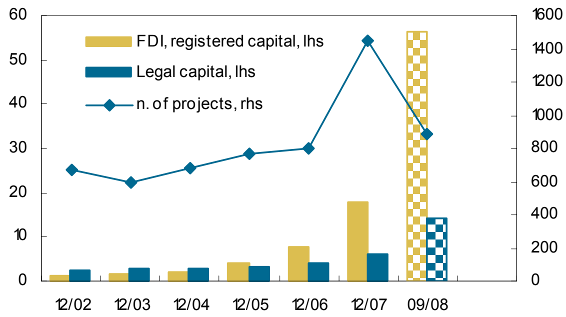
[11] IMF, Article IV, December 2007.

[12] June teleconference, quoted in the Vietnam Investment Review.

13 World Economic Outlook, October 2008.

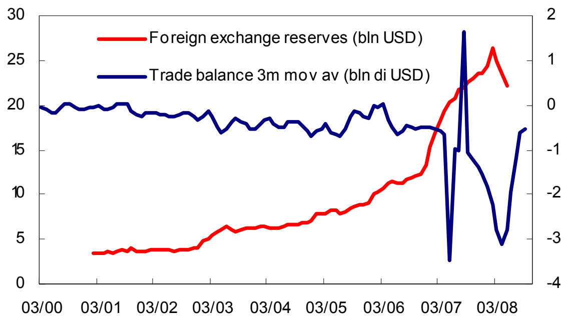
14 IMF, Article IV, December 2007

FDI in billion US dollars



Source: Bloomberg, GSO of Vietnam and Intesa Sanpaolo elaborations

Trade balance and international reserves



Source: Bloomberg and Intesa Sanpaolo elaborations

In the past 10 years, actual FDI flows have added up on average to 60% of the sum announced. According to data provided by the General Statistics Office (GSO), cumulated FDI announced between the beginning of the year and September 2008 added up to USD 56.3Bn, almost seven times the amount announced for the same period last year, of which USD 14Bn already paid, i.e. more than double the total paid in 2007. Over the years, the gap between the figures announced and the investments effectively cashed in has widened; however, despite the expected slowdown of both the global and Vietnamese economies, FDI will in any case stay high, given the greater guarantees offered by Vietnam's WTO membership and the country's good long term growth prospects.

For the time being, the crisis of the financial markets may have a stronger impact on portfolio flows, which experienced strong growth on the back of the 2007 equity boom and have helped, together with FDI, in raising foreign currency reserves and in backing the external financing requirement in the same year. Up to 2006 this was more than backed by capital inflows even without the contribution of portfolio investments. Their level was a bit less than the one of medium and long term loans in 2006 while, in 2007, when the current account deteriorated, it raised to almost fourfold. A great majority of portfolio investments are believed to be in private equity funds, and hence cannot easily be unfrozen.

However, the external financial requirement is mainly financed by FDI, medium and long term credit inflows from institutional creditors and from short term credits to commercial banks, which are net creditor to the foreign sectors. This limits the risk of insufficient financial backing of the current account deficit. Moreover, the deterioration of the import cover ratio to 3 months, compared to 4.5 in 2007, could improve in line with the expected slowdown in import growth in the months ahead and the improvement of the trade balance.

However, the current financial markets crisis and the consequent global rise of risk aversion will stress funding difficulties for those countries, such as Vietnam, that experienced a pronounced worsening of the current account deficit. Under these circumstances in fact, the drop in portfolio investments and in FDI could be faster than the expected improvement of the current account.

BOX 3: Vietnam placed under credit watch negative by rating agencies due to its weak banking system and expansion of the current account deficit

Standard & Poor's and Fitch placed Vietnam's rating (BB) under Credit Watch Negative respectively on May 2 and 28, followed by Moody's on June 4. According to the rating agencies, the overheating of the economy represents a risk for the stability of the country, threatened by the excessive growth of credit in a still very weak banking sector. While appreciable, the actions taken by the government and the central bank to cool growth and inflation, may prove late and made more complex by a context in which credit is mostly on the rise to finance the construction sector and the investments of state-owned companies. The construction sector only experienced a contraction of 0.3% in 3Q08, vs. an average rate of 10.9% in 2007, and there are indications that real estate prices are starting to slow. Similar reasoning applies to the financing of stock market investments.

Therefore, the agencies fear a deterioration of the loans/deposits ratio and an increase in bad loans, in particular among those denominated in dollars, under greater pressure due to the depreciation of the dong. In a markedly dollar-dependent economy such as the Vietnamese, according to Fitch loans in dollars account for one fourth of total credits. The main risk is that difficulties incurred by one bank may rapidly spread to the banking system as a whole. In spring, according to press sources, the SBV has already intervened several times to provide liquidity to small joint-stock commercial banks (JSCBs), those which experienced the strongest growth in credit in 2007[15]. The medium- long term rating of the banking sector remains positive, especially for the larger JSCBs and for SOCBs.

According to the rating agencies, gross external financial requirements (including payment of short-term debt) added up to around 8.7% of GDP in 2007. Forecasts for a rise to 10.4% in 2008 cast doubts on its sustainability, all the more so taking into account that reserves cover three months of imports, as opposed to an average of 5.6 months for ASEAN. In 2007 the current account deficit, the financing of which is increasingly reliant on portfolio investments flows and direct investments, deteriorated.

Foreign debt has been contracting for over a decade: it amounted to 33.2% of GDP at the end of 2006, and is forecast to drop further in 2008, to 29.9% (EIU). Foreign debt is mostly made up of medium and long term debt issued by institutional creditors on preferential terms. This is because the country benefits from ample financial support from bilateral and multilateral creditors.

In December 2007 the Consultative Group for Vietnam expressed great confidence in the country's prospects, to the point of offering USD 5.4Bn in donations in 2008, from USD 4.45Bn in 2007. However, it did call for a more open market, greater respect of human rights, and increased environmental awareness. Environmental problems in the country remain serious, with deforestation at the fore, but also include pollution of water sources and poor air quality in metropolitan areas.

Conclusions

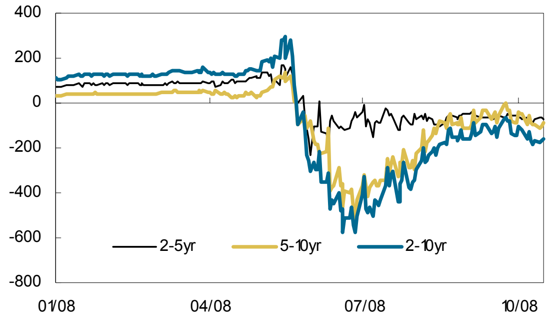
Past rate increases, as well as the measures implemented to limit both bank lending and – more recently – public spending, will contribute to further, gradually slowing

[15] According to Fitch, average credit growth in 2007 for JSCBs was higher than 100%, vs. an average of 24% for state-owned commercial banks (SOCBs).

the investment trend in the next few quarters, reining in imports as a result. The contribution of the foreign channel should therefore become less negative than in previous quarters, also thanks to a possible further easing of the restrictions imposed on the export of several products, and of confirmation of some restrictions on imports.

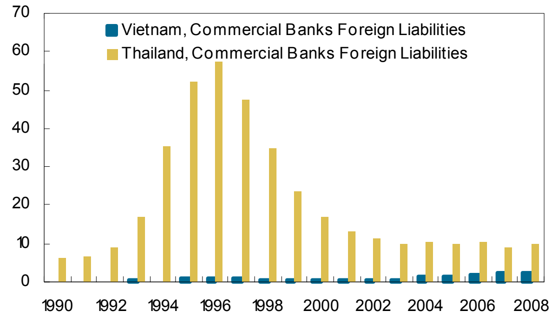
The improvement of monthly trade balance data, the size of FDI, and the structure of Vietnam's foreign debt, point to a stabilisation of the current account deficit, and do not support fears of a crisis or comparisons with Thailand. The widening of credit spreads is in line with the widening of corporate bond spreads at the international level, and since mid-October Vietnam has in any case been better positioned than the Philippines and Indonesia. While the inversion of the government curve has decreased significantly from the highs touched at the end of June, the negative slope in any case indicates that investors are guardedly pessimistic on medium-long term growth prospects.

Government curve slope: market less pessimistic



Source: Bloomberg and Intesa Sanpaolo elaborations

Comparison with Thailand not viable



Source: EIU

The slowdown in investments over the next few quarters should continue to be mostly concentrated in the construction sector, whereas support of credit to the manufacturing sector will be of crucial importance. The measures put in place by the government and the SVB to stabilise growth and contain inflation, while late, seem to be going in the right direction. However, although long-term prospects remain positive, the slowdown of the global economy adds to the downside risks weighing on the Vietnamese economy in the short term.

Consensus estimates of average GDP growth in 2008 and 2009 (Bloomberg survey, June 2008) point to a gradual slowdown to 6.7% and 6.0% respectively. The EIU, on the other hand, expects a stronger impact from the slowdown in global demand, and has issued more pessimistic estimates, of 6.0% and 5.4% respectively, in line with IMF forecasts[16] (6.3% in 2008 and 5.5% in 2009).

Silvia Guizzo

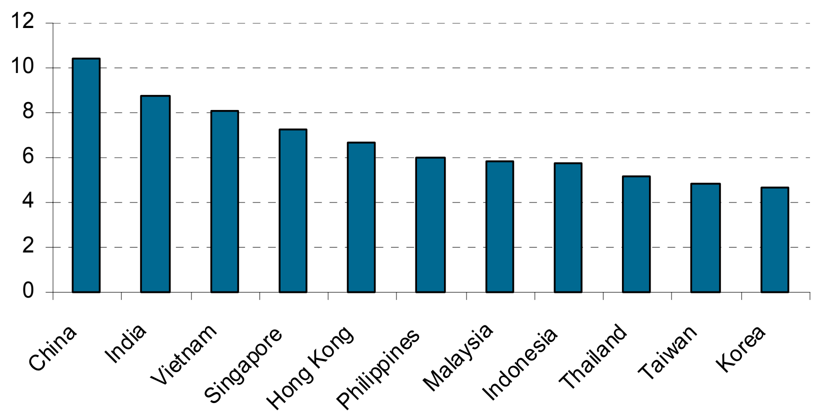
[16] IMF, World Economic Outlook, October 2008.

Long-term Growth Drivers

Through implementation of the "*Doi moi*" plan ("Renovation" in Vietnamese), since the end of the 1980's, Vietnam has achieved significant results in making the transition from a planned economic system to a market economy. The economic structure of the country has changed radically, from primarily rural to industrial and services-based.[17] Driving elements of change were: the introduction of reforms in 1987, which reduced subsidies to state-owned companies; de-collectivisation of the right to use land (1988); almost total price liberalisation (1989); reduction of barriers to domestic trade; and the opening up of the economy to foreign trade and investments (1987). Vietnam's progressive economic integration at the regional and global levels received strong impulse from the signing of important bilateral and multilateral international agreements. The country became a member of the Association of South East Asian Nations (ASEAN) and of the ASEAN Free Trade Area (AFTA) in 1995, it signed a bilateral trade agreement with the United States in 2001, and, more recently, in 2006, it entered into the World Trade Organization (WTO).

While creating the conditions for a gradual transition of the country's economic system to a market economy, reform also fuelled a sharp acceleration in productive activity. In the past five years, compared to the other Asian economies, Vietnam achieved a real GDP annual growth rate (8%) second only to China's and India's.

Real GDP growth % (average 2004 2008*)



*Source: Intesa Sanpaolo elaboration on FMI data; * FMI forecast (World Economic Outlook, ap. 2008)*

Upbeat economic performance also determined solid real GDP growth in per capita terms (6.5% on average in the past five years); The next table shows the contributions made to per capita GDP by labour (employment/population ratio) and labour productivity (production per employee). The data highlights that in Vietnam, as is the case in the other Asian emerging economies, increased labour productivity is the main variable supporting GDP growth in the medium-long term, contributing 4.9% a year. The more intensive use of labour plays a secondary role, albeit still significant, contributing 1.7% a year.

[17] At the end of the 1980's over 40% of nominal GDP was generated by the agriculture; in recent years, the share has halved, dropping to 20% to the advantage of industry and services, which in 2007 accounted for 42% and 38% of GDP respectively.

GDP Growth and Drivers (average 2004 2008)

%	Real GDP Growth	Real GDP growth per head	Employment/Population growth	Output per worker growth	Real stock of capital/Employment growth	Total factor productivity growth
		(1)	(2)	(3)	(4)	(5)
ASEAN 5						
Vietnam	8,0	6,5	1,7	4,9	2,7	2,2
Philippines	6,0	3,7	0,1	3,6	0,1	3,5
Thailand	5,2	4,4	0,7	3,7	0,5	3,2
Malaysia	5,8	4,0	0,0	4,0	0,9	3,1
Indonesia	5,7	4,4	0,8	3,6	1,0	2,6
NICS						
Korea	4,6	4,3	1,1	3,2	1,1	2,1
Singapore	7,2	4,6	2,1	2,5	0,1	2,4
Taiwan	4,9	4,2	1,0	3,2	1,0	2,2
Hong Kong	6,6	5,8	0,2	5,6	0,8	4,8
China	10,5	9,9	0,5	9,3	3,8	5,5
India	8,8	7,2	0,7	6,4	2,9	3,5

Source: our calculation on FMI data; Note: (1) is about (2)+(3) and (3) is about (4)+(5)

Using a basic growth-accounting model, the trend of production per employee may be explained as the joint effect of two factors[18]: the **accumulation of capital** and the growth of **Total-factor productivity** (TFP). Both are significant in Vietnam's case, with the former variable making a slightly larger contribution to economic growth (2.7% per year) than the latter (2.2%). This sets Vietnam apart from the other Asian emerging economies, where the contribution of TFP is higher than that of capital accumulation.

Obstacles hindering faster TFP growth

Therefore, while TFP plays an important role in Vietnam's economic growth, it is relatively less influential than in other Asian countries. Several indicators confirm this. The efficiency of investments in Vietnam, as measured by the Incremental Capital Output Ratio (ICOR)[19], is inferior (4.0) than in other countries experiencing fast economic growth, such as China (3.7) and India (3.3)[20]. The Global Competitiveness Index[21], which measures the competitiveness of a country, places Vietnam in 70th place in a ranking of 134 countries. Vietnam is the lowest-ranking of all Asian countries except the Philippines, which are in 71st

[18] The function underlying our analysis is a Cobb-Douglas production function in which α=0.35, in line with the majority of empirical studies on economic growth. More in detail, g[GDP/L] = α*g[(K/L)] + g[TFP] where g is the percentage change of the variable in square brackets ,GDP/L is production per employee, K/L is the capital/labour ratio. TFP is estimated as residual, and therefore includes the effects of other factors in addition to capital and labour efficiency, such as, for instance, economic policy changes and institutional factors, often very important in transition economies. The breakdown is not aimed at identifying the causes of growth, but simply, as also stressed by Bosworth and Collins (2003 The Empirics of Growth: An Update, Brooking Papers on Economic Activity), to "provide a framework for examining the proximate sources of growth" (p. 116).

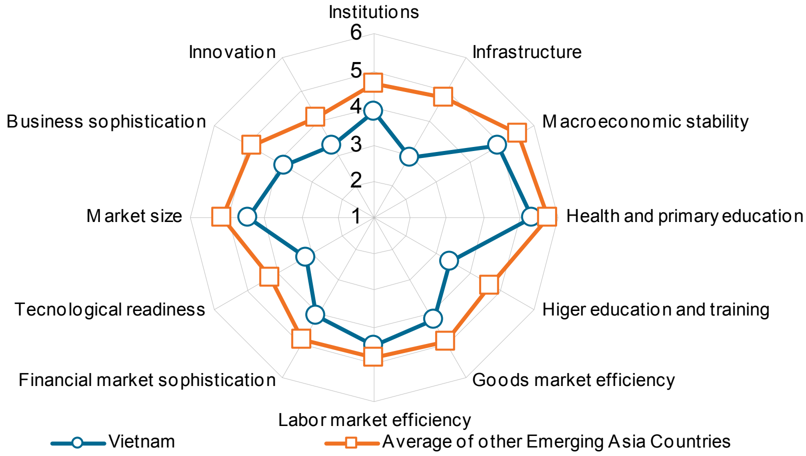
[19] The ICOR is an index which measures the marginal amount of investment capital necessary to generate a next unit of product; the higher the ICOR value, the greater the investment necessary to increase production will be. Therefore, high ICOR values indicate a lower efficiency of investments.

[20] IMF data. See IMF Article IV for each country.

[21] The Global Competitiveness Index (GCI) is a synthetic index calculated by the World Economic Forum based on a series of sub-indices on numerous aspects of a country's economic, social, and institutional setup. The GCI ranges between 1 and 7. The higher the number, the more competitive the country is. The World Economic Forum also uses the GCI to compile a ranking of countries from the most competitive to the least competitive.

position[22]. Vietnam's competitiveness is mostly held back by the poor quality of its **infrastructures** and **higher education system**.

Components of Global Competitiveness Index Score



Source: Global Competitiveness report 2008, Intesa Sanpaolo elaborations

Vietnam's network of infrastructures, and especially roads and ports, rank 93[d] in terms of quality and efficiency in the table compiled by the World Economic Forum, whereas the quality of the higher education system rank is only 120[th].

Vietnam's TFP has been the object of several papers, including one by Nguyen Khac Minh and Truong Tri Vinh (2007)[23]. While underlining its importance for the economic growth of the country on the one side, on the other this paper attempts to identify the variables which may penalise growth by hindering a more efficient use of production factors. By analysing a sample of 1,000 manufacturing sector companies over the 2000-2003 period, the authors found that these companies could have reduced the use of production factors by up to as much as 56%, on average, without reducing production, by eliminating inefficiencies in the use of the production factors. According to the authors of the paper, inefficiency mostly lies in the poor quality of the labour factor. This view is supported by Omkar Shrestha, who listed[24] the most penalising factors affecting Vietnam's TFP as being the poor quality of labour (due to an inefficient education system), inadequate infrastructures, and the high cost of administration, sea transportation, and telecommunications.

Drivers of total-factor productivity (TFP) growth

The fundamental transition from centralised economy to market economy has undoubtedly provided strong impulse to TFP growth. Specifically, based on the experiences of other transition economies, TFP growth may be attributed to at least three main factors: **openness to foreign markets**, **openness to**

[22] See: World Economic Forum, Global Competitiveness Report 2008, 2009.

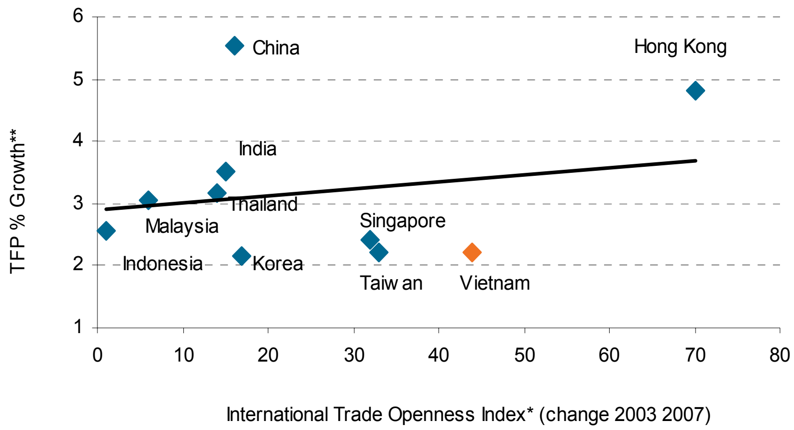
[23] Nguyen Khac Minh and Truong Tri Vinh (2007). "A Non Parametric Analysis of Efficiency for Industrial Firms in Vietnam". In "Technical Efficiency and Productivity Growth in Vietnam" published by Publishing House of Social Labour.

[24] Address at the "Enhancing Efficiency of Vietnamese Economy" workshop, Ho Chi Minh City, December 2006.

international capital movements, and the substantial inflow of foreign direct investment (FDI), with the transfer of technology and know how it brings, and the **reallocation of workforce** from low-productivity, primarily state-controlled sectors, to the more productive sectors.

Vietnam's international trade policies, and above all the bilateral trade agreement signed with the US in 2001, and the more recent entry into the WTO (2006), have greatly aided the country's integration in the world market. The index of openness to international trade[25] has increased significantly, rising from 114.7% in 2003 to 158.9% in 2007. Also, its share of world trade grew from 0.2% in 1999 to 0.36% in 2006[26]. Vietnamese companies, increasingly exposed to foreign competition, have had to make a effort to innovate, increasing productivity as a result. The next chart shows that the correlation between greater openness to trade and TFP growth is also positive in the other Asian countries.

Total factor productivity and International Trade Openness



Source:Intesa Sanpaolo estimations; Sum of Export and Import in % of GDP; ** average 2004 2008*

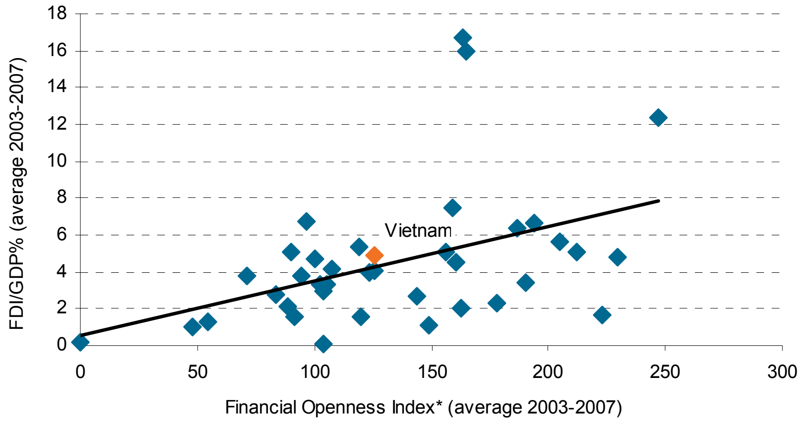
The opening up to international trade was accompanied by greater financial openness. Measured as the ratio of total foreign financial assets plus liabilities, and GDP[27], Vietnam's financial openness improved between 2003 and 2007 from 127% to 138%. This boosted FDI, which increased from 3.6% of GDP to 9.5%.

25 The index of openness to international trade is calculated as the ratio of total exports and imports, and GDP.

26 Source: World Trade Organization International Trade Statistics.

27 This ratio is also known as "Financial openness index". The index is calculated based on data surveyed by the IMF, International Financial Statistics, International Investment Position section. However, the IMF does not provide data on Vietnam's International Investment Position; therefore, the sum of foreign financial assets and liabilities is calculated based on data on foreign debt provided by rating agency Fitch, and data on the foreign direct investment stock released by UNCTAD.

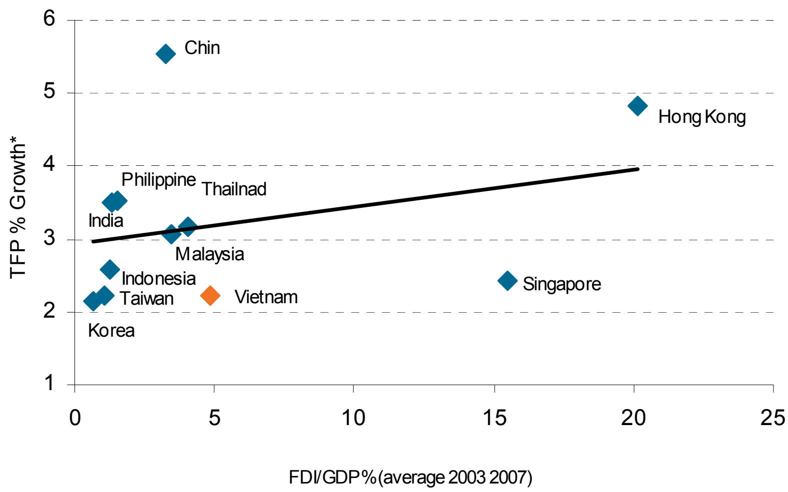
FDI and Financial Openness



Source: EIU, Own elaborations based on EIU data and IFS data; Stocks of Foreign Asset and Liabilities in % of GDP*

Chart "FDI and Financial Openness" highlights the positive correlation which exists between financial openness and FDI in 38 emerging economies of different regions. Foreign direct investment provides great stimulus to the technological advancement of the recipient country, thanks to the transfer of know how it implies.

Total factor productivity and FDI

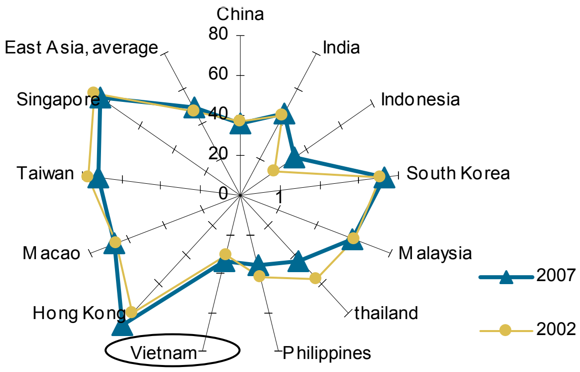


*Source: Intesa Sanpaolo elaborations; * average 2004 2008*

Antonio Pesce

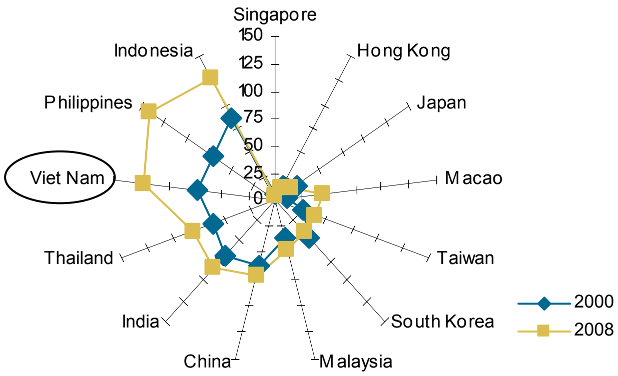
Social-political indicators – comparison with other Asian countries

Economic governance index



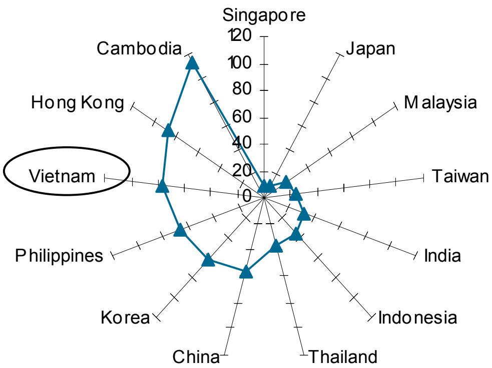
Source: World Bank, score from 1 to 100

Corruption perception index



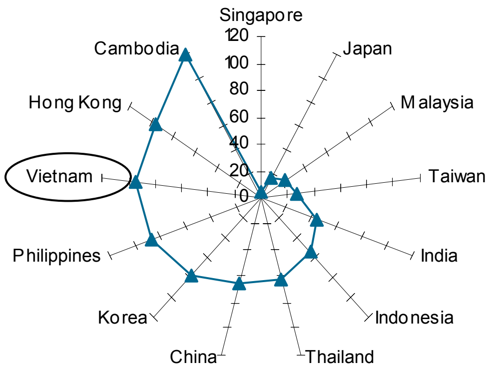
Source: Transparency, ranking 1-180

Business Competitiveness Index 2007-2008



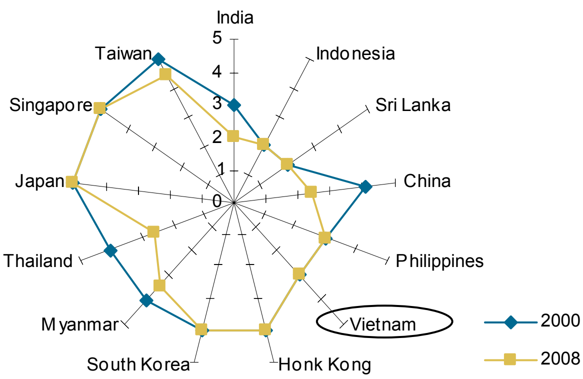
Source: World Economic Forum, rankings 1-127

Higher Education and Training Index 2007-2008



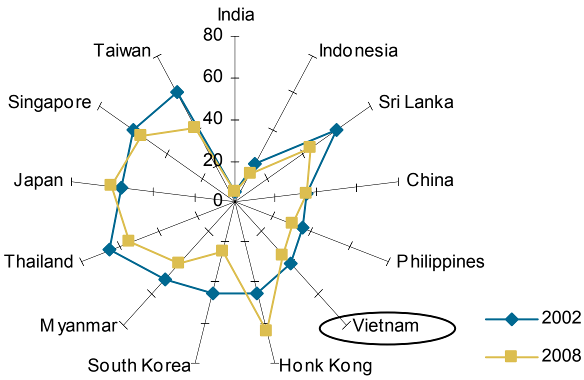
Source: World Economic Forum, ranking 1-131

Risk of social unrest



Source: EIU, 5 = lowest

Risk of political instability



Source: EIU, 100 = highest

Vietnam - Macroeconomic data summary table

Real economy

	1995-2000	2004	2005	2006 e	2007 e	2008 e
Population (mln)	75.9	82.7	83.8	84.9	85.9	87.0
GDP per capita ($ PPP)	1200	1930	2130	2340	2580	2790
Real GDP (%)	7.4	7.8	8.4	8.2	8.5	6.2
Private consumption (%)	5.4	7.1	7.5	7.3	6.7	3.9
Public consumption (%)	3.7	7.8	7.9	8.8	7.5	5.2
Gross fixed investments (%)	10.5	10.4	9.8	8.6	11.0	9.0
Exports of goods & services (%)	15.8	25.7	20.5	17.2	15.4	14.5
Imports of goods & services (%)	12.4	21.9	15.9	14.6	15.8	16.7
Inflation (average)	5.9	7.8	8.3	7.4	9.0	24.9
Labour cost** US$ (var.%)	-1.8	3.1	3.8	4.7	5.0	9.7
Budget balance/GDP (%)	-1.2	0.9	-1.2	-0.3	-1.6	-1.7
Vnibor 3m (%)	-	6.4	7.4	7.8	7.5	14.0
Exchange rate (VND/USD, average)	12522	15746	15859	15994	16179	16551
Real effective exchange rate (CPI)	97.7	85.8	89.6	92.2	92.9	103.0

Current account balance

	1995-2000	2004	2005	2006 e	2007 e	2008 e
CA (bln USD)	-0.8	-1.0	-0.6	-0.2	-7.0	-11.2
CA / GDP(%)	-3.8	-2.1	-1.1	-0.3	-9.9	-13.6
Trade balance (bln USD)	-1.1	-2.3	-2.4	-2.8	-10.4	-13.8
Service balance (bln USD)	-0.4	-0.9	-0.3	0.0	-0.9	-1.4
Income balance (bln USD)	-0.5	-0.9	-1.2	-1.4	-2.2	-1.9
Transfers balance (bln USD)	1.1	3.1	3.4	4.0	6.4	5.8

External Debt

	1995-2000	2004	2005	2006 e	2007 e	2008 e
External debt / GDP (%)	85.8	39.7	36.3	33.2	30.9	28.9
Debt service / Export (%)	7.2	2.3	2.3	1.8	1.5	1.3
Short term external debt / Total external debt (%)	11.3	11.9	13.4	12.4	13.7	13.3
Short term external debt / Foreign reserves	1.1	0.3	0.3	0.2	0.1	0.1
Reserves (in imports months)	2.1	2.6	2.8	3.4	4.4	3.1

Backing of the external financial requirement (bln USD)

	1995-2000	2004	2005	2006 e	2007 e	2008 e
Gross external financial requirement (bln USD)	-2.2	-1.4	-1.1	-0.6	-7.5	-11.8
Medium & long term dbt inflows (ODA)	1.0	1.7	1.3	1.2	1.3	1.4
Portfolio investments (net flows)	0.0	0.0	-0.6	1.3	6.3	0.8
Direct investments (net flows)	1.8	1.6	1.9	2.3	6.6	10.2
Other capital flows (net)	-1.4	-1.1	-0.2	0.1	3.7	-1.4
Change in international reserves (negative sign=increase)	-0.4	-0.8	-2.0	-4.4	-10.3	0.8

Rating

Fitch*	BB- / negative
Standard&Poor's*	BB / negative
Moody's*	Ba3/ negatve

Source: EIU, October 2008, E, F EIU estimates and forecasts.

** rating on foreign currency long term sovereign debt*

*** unit of product*

International trade, FDI Flows and Structure of production.

Introduction

Over the past ten years, the structure of production in Vietnam has changed substantially, stimulated by market-oriented economic policies and by the globalisation process, which have encouraged more open trade and large inflows of foreign capital. Foreign trade has been a fundamental ingredient and key driver of the entire local economic and social setup, leading to changes of historical in the country. Vietnam's openness to trade in 2007 was 158.9% of the value of GDP in the same year. The total worth of imports and exports added up to USD 111.3Bn.

Foreign capital flows have increased, thanks to structural reforms of the economic system, making Vietnam one of the main destinations of FDI in Asia. Up to 2007, foreign investments amounted to over USD 40Bn, or 56.3% of GDP. The "equitisation" process, or the transformation of state-owned companies into joint stock companies, has attracted the interest of international investors, who have found appealing opportunities in Vietnam.

Italy still plays a marginal role in the Vietnamese economy, both as an investor, with a very modest share of total investments in the country (0.16%, or USD 156Mln), and as a trade partner, despite some progress over the past few years. Italian exports to Vietnam account for only 1.1% of total Vietnamese foreign trade, and imports only represent 0.8% of the total.

Industrial production, while still concentrated in sectors of long historical tradition (leather and shoes, textiles, clothing, and food) has diversified considerably in recent years, to the advantage of sectors tied to mechanics, electronics, and vehicles. The creation of special areas dedicated to export, industrial processing, and high technology, has encouraged the development of the industrial sector.

The cost of labour, competitive compared to other competing economies in the region, has encouraged the delocalisation of production facilities by many foreign manufacturing companies, especially Asian.

Foreign trade

International agreements

Following its entry into the World Trade Organisation in January 2007, Vietnam has enjoyed a substantial increase in trade with the rest of the world. The government has acted to reduce customs duties and restrictions on the transit of goods, to cut subsidies to public state-owned companies, and to liberalise the services industry by 2019. Vietnam is part of ASEAN (Association of Southeast Asian Nations), of which AFTA (Asian Free Trade Association) is the commercial and economic branch and APEC (Asia-Pacific Economic Cooperation). AFTA's aim is to abolish all economic barriers and duties by 2015, creating a single market modelled on the EU. Two agreements were ratified by ASEAN with China and Japan, respectively in 2002 and in 2003, authorising the creation of free trade zones in which, by 2012, the liberalisation process will be completed. Vietnam has also recently taken part in ASEM (Asia-Europe Meeting) work sessions, geared to encouraging trade between EU member states and Asian states. Vietnam had already ratified a bilateral agreement with the United States in 2001, which drastically cut duties on exports to the US, and kick started the country's economic growth.

Main commercial allegiances: ASEAN – APEC

	Asean/Afta	Apec
Founded in:	1967	1989
by:	Indonesia Malaysia Philippines Singapore Thailand	Australia Brunei Canada Indonesia Japan South Korea Malaysia New Zealand Philippines Singapore Thailand USA
successivamente hanno aderito:	Brunei (1984) Vietnam (1995) Laos (1997) Burma (1997) Cambodia (1999)	New members over following years: China (1991) Hong Kong (1991) Taipei (1991) Mexico (1993) Papua New Guinea (1993) Chile (1994) Peru (1998) Russia (1998) Vietnam (1998)
Aim:	- Accelerate economic growth and cultural and social development - Promote peace and stability - Abolish trade barriers and duties - Promote efficient production across countries	- Encourage economic growth, free trade, investments in the region

Source: Asean - Apec

Exports and imports

In recent years, Vietnam has become an important trade partner for several countries and numerous geographical regions, as a supplier of finished products, or as an executor of specific parts of the production process. From the imports, the increasing weight of the secondary sector of the Vietnamese economy, encouraged by the transition to a free market economy, has led to a consistently stronger demand for raw materials, semi-finished products, and capital goods. In the 1996-2006 period, Vietnam experienced one of the highest growth rates of total exports in the world (ranking 9th overall), +19.64%, second only to China in the entire Asian region[28].

According to the World Trade Organisation[29], in 2006 Vietnam was 50th in the world ranking of export countries, with a 0.3% share of total global exports, and rose to 44th place among importers, accounting for 0.4% of the total.

28 Elisa Gamberoni and Richard Newfarmer, Aid for Trade: Matching Potential Demand and Supply, WorldBank, 12/9/2008

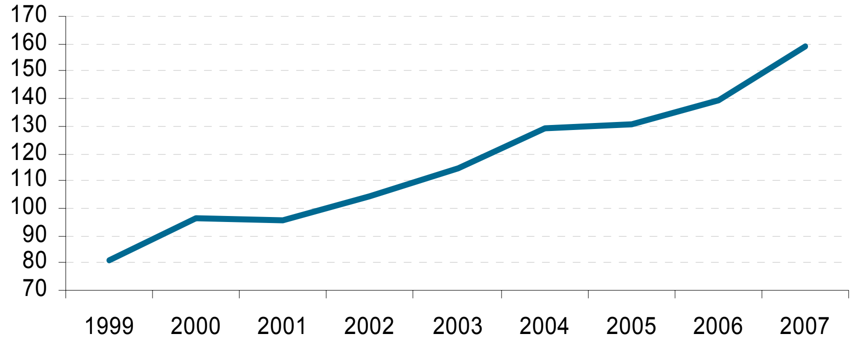
29 WTO – International Trade Statistics 2007

Trend of imports/exports

USD Bn	Exports	% of GDP	Imports	% of GDP	Balance
2002	16.7	47.6	19.7	56.1	-3.0
2003	20.2	51.0	25.3	63.9	-5.1
2004	26.5	58.3	32.0	70.4	-5.5
2005	32.4	61.3	36.8	69.6	-4.4
2006	39.8	65.4	44.9	73.7	-5.1
2007	48.6	69.4	62.7	89.5	-14.1
Jan/Aug 2008	43.3		59.3		-16.0

Source: EIU – GSO data

Openness to trade (exp.+ imp./GDP)



Source: EIU – GSO data

The Vietnamese balance of trade shows that energy has become an increasingly important item in recent years, reducing the quote of the traditional shoe and textile sectors, which in any case still account for a substantial part of exports. The demand for machinery and steel is on the rise, given the expansion and diversification of the industrial sector, which is widening its range of products to marginal sectors in Vietnamese manufacturing. China is an important partner in the clothing sector, as it has delocalised part of its tailoring activities to the country. Japan is one of the main suppliers of equipment and machinery, whereas it mostly imports oil and oil derivatives.

Main import/export sectors by product in 2007

Exports	USD Bn	% of tot.	Imports	USD Bn	% of tot.
Crude oil	8.5	17.5	Machinery & equip.	10.7	17.1
Textile and clothing.	7.8	16.1	Refined oil	7.7	12.3
Shoes	4.0	8.3	Steel	5.1	8.1
Fish & shellfish	3.8	7.9	Tex. industry materials	4.1	6.5

Source: EIU – GSO data

In the world trade, exports of Vietnamese shoes in 2006 covered a 7.37% share of the global market, whereas tea, coffee and spices accounted for a 7.26% share. Refined energy products exported by Vietnam accounted for 0.52% of the world total, and clothing for 2.38%. Fish & shellfish covered almost 4% of global exports.

As regards imports, Vietnam purchases around 3% of the world production of yarn and semi-finished products for the textile industry, 0.85% of iron and steel, 0.34% of machinery, and 0.2% of electronic machinery.

Main import/export countries in 2007

Exports	USD Bn	% of tot..	Imports	USD Bn	% of tot.
USA	10.1	20.8	China	12.5	19.9
Japan	6.1	12.5	Singapore	7.6	12.1
Australia	3.5	7.3	Taiwan	6.9	11.0
China	3.4	6.9	Japan	6.2	9.9
Singapore	2.2	4.5	South Korea	5.3	8.5

Source: GSO data

Vietnamese trade within Asia is lively, as is the case for other countries in the continent, thanks to important regional commercial agreements, and to a peculiar geographical distribution geographical of the intermediate phases of the production processes. Vietnam is a particularly attractive country for labour-intensive productions, as it offers both a flexible manufacturing structure and labour at competitive costs. According to International Monetary Fund data, intra-area trade in Asia has been especially lively: between 1990 and 2006, emerging economies in Asia have stepped up trade with non-Asian countries by 300%, with other, more industrialised Asian countries by 500%, and with other developing countries in the region by 850%.

Vietnamese imports/exports by geographical area (2006)

	Exports (USD Bn)	% of tot.Vietnam	Import (USD Bn)	% of tot. Vietnam
ASEAN	6,6	16.7	12,5	27.9
APEC	29,3	73.7	37,5	83.5
EU	7,1	17.8	3,1	7.0
OPEC	1,4	3.6	1,4	3.1

Source: GSO data

World imports/exports by geographic region (2006)

Export areas/ Direction %	Asia	Asia Em.	Asia Ind.	NAFTA	EU15	Rest of world
Asia	51.9	42.1	9.9	20.7	14.2	13.2
Asia Emerging	51.6	40.8	10.8	20.1	14.6	13.6
Asia ind.	53.1	46.5	6.6	22.5	12.8	11.6
NAFTA	19.5	13.5	6	52.5	14.6	13.4
EU15	8.2	6.1	2.2	9.6	59.2	23

Source: IMF data

Trade restrictions

Every five years, the Prime Minister, based on indications provided by the Minister of Commerce, compiles a list of products whose importation into Vietnam is prohibited, or subject to the issue of a special licence. The most recent list bars the following products from importation: weapons, ammunition and explosives, fireworks, used consumer goods, ideologically unapproved books, newspapers, magazines and other publications, waster and refrigerators containing CFC, some categories of used vehicles and spare parts.

Law n. 45/2005/QH11, which came into force on January 1st 2006, regulates all customs duties and tariff barriers applied to imports. There are three categories of customs duties: ordinary duty, duty applied to imports from countries that have entered trade agreements with Vietnam, and special duty applied to goods from AFTA and WTO countries.

Vietnam has committed to reduce the average duty applied by 2019, to 13.4%. Despite the efforts being made, some categories of goods are still penalised, including automobiles and motorcycles, cement and construction materials, which are still subject to high customs duties.

Degree of trade specialisation

The country's index of trade specialisation, calculated using Lafay's formula[30], taking into account the main categories of goods, sees a prevalence of shoes and clothing, followed by refined oil products, furniture and fish & shellfish. Higher is the index (max. 100), higher is the degree of trade specialisation.

Trade specialisation index

Sector	Lafay index
Shoes and parts	87
Non textile apparel	61
Refined oil products	52
Furniture	39
Fish & shellfish	38
Textile apparel	36
Coffee and spices	26
Cereals	12
Leather goods	10
Processed fish products	9

Source: International Trade Center

Table xxx details the country's main productive sectors and draws an overall picture, assessing the breakdown and dynamics of exports, and also the share of these exports on the global total. The traditional sectors effectively represent an important share not only of the Vietnamese balance of trade, but also of their respective world markets. The diversification of target markets provides an indication of the elasticity of offer, and emerges as being quite high in many sectors of activity. The compound commercial performance index, which groups numerous basic export indicators, sees Vietnam rank among the top exporters in the world of leather goods, clothing & apparel, and food.

Analytical breakdown of exports

Year 2006	Fresh Food	Processed Food	Wood Prod.	Textile	Chemicals	Leather Prod.	Basic Manufact.	Non electr. Machinery	IT consum electronics	Electronics Componets	Trasp. Equipments	Clothing	Various Manufact.	Minerals
Exp.growth in value p.a.	12%	8%	9%	13%	21%	10%	20%	20%	15%	31%	23%	14%	26%	19%
Share on world market (%)	1.55%	0.22%	0.11%	0.33%	0.05%	2.83%	0.09%	0.04%	0.08%	0.13%	0.03%	1.52%	0.28%	0.37%
Share on national exp.(%)	21%	3%	1%	2%	2%	10%	3%	1%	2%	4%	1%	14%	7%	24%
Net Exp.(Mld USD) **	5.29	-0.59	-0.87	-2.75	-4.72	2.14	-4.42	-3.49	-1	-1.01	-1.49	4.08	1.15	2.03
Markets diversification	14	10	7	13	7	10	11	7	9	2	11	2	7	6
Current Index *** commercial performance	14	61	65	40	76	3	70	76	46	66	54	6	30	47

Source: International Trade Center (Trade Competitiveness Map)

** Net Exp = exp - imp (without re-exp)
*** The current Index of commercial performance is calculated on the value of nex export, per capita exp., the share on world market, markets and products diversification. The Index shows the level of a country in a world ranking of 184 countries

30 International Trade Centre (Unctad/WTO) – The trade performance index – technical notes – may 2007

The Lafay index, calculated for a specific country (i) and a specific sector (j) on total exports (k) is equal to LIij = 100[(XijMij)/(Xij+Mij)k(XikMik)/k(Xik+Mik)] (Xij+Mij)/k(Xik+Mik), where X and M are exports and imports.

Inter-area trade and the delocalisation process

Breaking down data on foreign trade in main categories of goods by geographical region, the importance of the commercial flows within the Asian continent, and the role played by the different countries in the various stages of the production chain, becomes clearer. The importance of Vietnam is evident as executor of part of the processing of some important categories of goods; also, it emerges as becoming an end seller to the more mature markets.

Exports/imports of shoes by geographical region (2006)

Exports	USD Mln	% of tot.	Imports	USD Mln	% of tot.
USA	803	22.0	China	64	27.7
UK	520	14.2	Hong Kong	51	22.1
Germany	359	9.8	South Korea	35	15.2
Belgium	233	6.4	USA	35	15.2
Netherlands	213	5.8	Other Asian	32	13.9
Italy (7th)	195	5.3	Italy (10th)	1	0.4

Source: Comtrade data

Exports/imports of apparel by geographical region (2006)

Exports	USD Mln	% of tot.	Imports	USD Mln	% of tot.
USA	1,730	51.1	South Korea	46	31.3
Japan	439	13.0	Hong Kong	29	19.7
Germany	228	6.7	China	23	15.6
UK	152	4.5	Other Asian	22	15.0
France	98	2.9	Japan	14	9.5
Italy (12th)	46	1.4	Italy (11th)	0.6	0.4

Source: Comtrade data

Exports/imports of el. machinery by geographical region (2006)

Exports	USD Mln	% of tot.	Imports	USD Mln	% of tot.
Japan	1,007	48.6	Japan	764	20.9
Hong Kong	232	11.2	China	638	17.5
China	97	4.7	Singapore	529	14.5
South Korea	79	3.8	South Korea	414	11.3
Australia	59	2.8	Thailand	182	5.0

Source: Comtrade data

Exports/imports of mech. machinery by geographical region (2006)

Exports	USD Mln	% of tot.	Imports	USD Mln	% of tot.
Thailand	343	20.9	Japan	1138	19.7
USA	217	13.2	China	1043	18.0
Japan	207	12.6	Other Asian	641	11.1
Philippines	148	9.0	Singapore	590	10.2
Australia	125	7.6	Thailand	385	6.7
Italy (12th)	26	1.6	Italy (11th)	106	1.8

Source: Comtrade data

Exports/imports of crude oil and fuel by geographical region (2006)

Exports	USD Mln	% of tot.	Imports	USD Mln	% of tot.
Australia	3,072	31.6	Singapore	3,548	52.6
Singapore	1,217	12.5	Other Asian	952	14.1
China	1,043	10.7	China	673	10.0
USA	1,030	10.6	South Korea	526	7.8
Japan	893	9.2	Singapore	504	7.5

Source: Comtrade data

Exports/imports of furniture by geographical region (2006)

Exports	USD Mln	% of tot.	Imports	USD Mln	% of tot.
USA	743	41.0	China	39	40.6
Japan	210	11.6	Thailand	9	9.4
UK	136	7.5	Japan	8	8.3
France	97	5.4	Malaysia	6	6.3
Germany	89	4.9	South Korea	6	6.3
Italy (12th)	27	1.5	Italy (11th)	2	2.1

Source: Comtrade data

Trade with Italy

As released by the Italian National Statistics Office, Italy ranks 18th among purchasing countries and 19th among sellers, commanding shares of total Vietnamese exports and imports of respectively 0.8% and 1.1%. The total value of traded goods has risen in the past few years, highlighting the increasing interest of Italian industrialists for this important Asian market, although it still does not account for a significant share of Italian exports and imports. Italian exports to Vietnam account for just under 0.15% of the total, whereas imports from the country only represent 0.18% of the total.

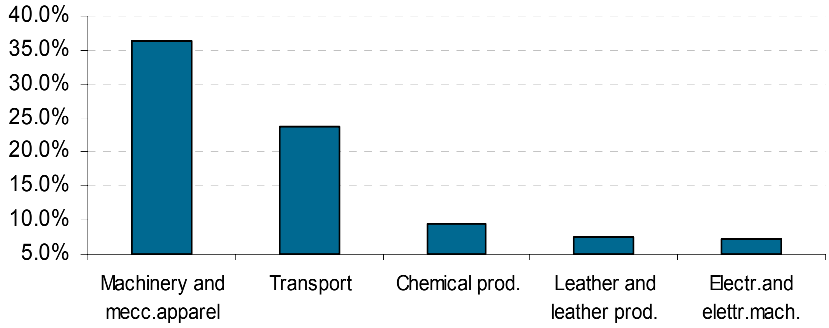
Trend of Italy–Vietnam exports/imports

EUR Mln	2002	2003	2004	2005	2006	2007	Jan/May 2008
Italian imports	395.2	397.3	403.5	471.6	608.5	695.2	322.0
Italian exports	300.6	326.6	283.7	218.4	300.2	515.1	175.4

Source: ISTAT data

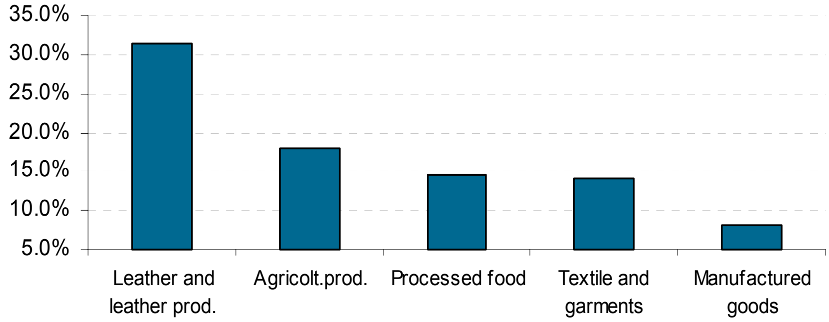
When examining in detail the main categories of goods which make up the trade flows with Italy, Italian companies emerge as mostly purchasing from Vietnam leather goods and leather derivatives, agricultural products foodstuffs, textile products, and clothing & apparel. On the other hand, Vietnam is a target market for Italian companies which produce mechanical, electric and electronic machinery and equipment, means of transport, and chemical products. A significant portion of Italian exports is also represented by leather and semi-finished products which are processed in Vietnam and then return to Italy as imports at a more advanced stage of their working. The main categories of machinery e equipment exported to Vietnam by Italian companies are those used in the ceramics, textile and clothing & apparel industries, in the processing of stone, marble and granite, shoes and the processing of leather, construction, and steel and metal works. The increasing importance in the country of the wood and furniture business has created opportunities for Italian producers of machinery used in the sector. Another line of business which is offering a host of export opportunities for “Made in Italy” products is the wine and quality foods sector: the growth of disposable income and the development of tourism have led to the diffusion of Italian restaurants and the distribution of certified with the Protected Origin Denomination (DOP) and the Controlled and Guaranteed Origin Denomination (DOCG) products in major cities, seaside resorts, and through departments stores and the leading retail chains.

Main categories of export goods
Italy–Vietnam – (2007) Share of the total



Source: ISTAT data

Main categories of import goods
Italy–Vietnam – (2007) Share of the total



Source: ISTAT data

Italian industrial districts

Vietnam accounts for a very modest share of the total exports of the main Italian industrial districts. The regions which export most to the country are Tuscany for leather and textiles, and Lombardy, Liguria and Veneto for mechanical products. As regards imports, several shoe-manufacturing and wood industry districts are located in Tuscany, Veneto and Lombardy.

Exports of Italian industrial districts to Vietnam by economic macro-sector

	EUR Mln		% breakdown		% of district's total exports	
(elaborations on data at current prices)	**2000**	**2007**	**2000**	**2007**	**2000**	**2007**
Fashion system: intermediate goods, *of which:*	4.65	48.80	13.63	60.07	0.06	0.76
- Tanning	1.59	28.71	4.67	35.34	0.06	1.27
- Textile products	2.51	19.55	7.34	24.06	0.06	0.57
Mechanical tools	16.13	17.08	47.25	21.03	0.26	0.22
Fashion system: consumer goods	2.09	3.66	6.12	4.51	0.01	0.02
Construction goods	0.78	3.44	2.27	4.23	0.01	0.05
Furniture and electric appliances	7.82	2.47	22.90	3.04	0.08	0.02
Various products for the home	0.55	1.11	1.60	1.37	0.02	0.03
Metal products for industrial use	0.28	0.39	0.81	0.47	0.03	0.03
Food	0.15	0.35	0.44	0.43	0.01	0.01
Other products	1.70	3.93	4.97	4.84	0.04	0.06
Total	**34.14**	**81.24**	**100.00**	**100.00**	**0.06**	**0.12**

Source: Intesa Sanpaolo elaborations on ISTAT data

Exports to Vietnam: leading Italian industrial districts

	EUR Mln		% of district's total exports	
(elaborations on data at current prices)	**2000**	**2007**	**2000**	**2007**
Electronics - Sestri Ponente	0.33	1.49	0.4	1.3
Textile industry machinery - Biella	0.00	1.11	0.0	1.2
Tanning - Arzignano	0.37	15.58	0.0	1.2
Tanning and shoes - Santa Croce S/Arno	0.85	9.67	0.1	1.1
Textiles - Prato	0.48	15.05	0.0	1.0
Ceramics - Sesto Fiorentino	0.42	0.58	0.5	0.9
Mechanical tools - Vicenza	2.01	9.01	0.2	0.8
Tanning - Solofra	0.37	0.93	0.1	0.6
Tanning machinery/leather - Vigevano	1.21	1.02	0.5	0.5
Textiles and clothing & apparel - Val Seriana	1.04	2.68	0.1	0.4
Mechanical tools - Varese	0.52	2.30	0.1	0.2
Mechanical tools - Val Seriana	0.43	1.70	0.1	0.2
Florentine leather pole	0.08	3.56	0.0	0.2
Clothing & apparel/textiles - Gallarate	0.37	0.97	0.0	0.2
Mechanical tools – Brescia province	1.47	1.07	0.2	0.1

Source: Intesa Sanpaolo elaborations on ISTAT data

Imports of Italian industrial districts from Vietnam by economic macro-sector

	EUR Mln		% breakdown		% of district's total imports	
(elaborations on data at current prices)	**2000**	**2007**	**2000**	**2007**	**2000**	**2007**
Fashion system: consumer goods	85.68	137.19	92.56	81.73	1.72	1.67
Furniture and electric appliances	3.01	12.77	3.25	7.61	0.49	0.97
Fashion system: intermediate goods, of which:	1.31	11.55	1.41	6.88	0.04	0.38
Various products for the home	0.59	4.34	0.64	2.59	0.11	0.48
Metal products for industrial use	0.21	0.76	0.23	0.45	0.09	0.20
Food	0.02	0.33	0.02	0.20	0.01	0.06
Construction goods	0.00	0.22	0.00	0.13	0.00	0.03
Mechanical tools	0.01	0.02	0.01	0.01	0.00	0.00
Intermediate construction goods	0.00	0.00	0.00	0.00	0.00	0.04
Other products	1.74	0.66	1.87	0.40	0.06	0.01
Total	**92.56**	**167.85**	**100.00**	**100.00**	**0.63**	**0.75**

Source: Intesa Sanpaolo elaborations on ISTAT data

Imports from Vietnam: leading Italian industrial districts

	EUR Mln		% of district's total imports	
(elaborations on data at current prices)	**2000**	**2007**	**2000**	**2007**
Leather goods - Tolentino	1.02	2.58	14.2	9.1
Art ceramics - Bassano del Grappa and Nove	0.38	1.36	2.8	7.7
Sports shoes - Montebelluna	21.90	46.47	6.1	7.0
Shoes - Lucca	5.64	6.63	5.1	5.8
Art furniture - Bassanese	0.02	1.95	0.1	4.8
Shoes - Brenta	6.75	12.52	4.0	4.4
Clothing & apparel – Southern Abruzzi	2.23	4.90	3.9	3.7
Shoes - Vigevano	3.05	0.59	12.2	3.0
Tanning and shoes - Santa Croce S/Arno	0.16	10.41	0.1	2.9
Textiles and clothing & apparel - Treviso	2.94	29.68	0.4	2.4
Chairs and tables - Manzano	0.15	1.70	0.2	2.3
Shoes - Northern Bari province	0.81	2.00	1.7	2.3
Shoes - Fermo	8.95	7.83	3.4	1.9
Wood/furniture - Brianza	2.63	6.46	1.2	1.9
Furniture - Livenza and Piave river valleys	0.03	1.37	0.1	1.7

Source: Intesa Sanpaolo elaborations on ISTAT data

Resources and commodities

Energy and mining resources

In the past twenty years, Vietnam has become an increasingly important producer in South East Asia of energy commodities, and of oil in particular. Its oil fields, all offshore, make it the third supplier of oil in the region. The country's natural gas reserves could satisfy all the Vietnamese economy's production requirements, but are not appropriately exploited. Mining activities have played a key role in supporting industrial growth, and have contributed indirectly to improving the living conditions of the population, avoiding burdening the balance of trade with energy components and, in fact, contributing significantly to export growth.

The production and distribution of electricity is managed by a single state-owned company (Electricity of Vietnam). To satisfy increasing demand tied to industrial development and to the needs of the population, the national utility mostly resorts to hydroelectric power stations, which make offer vulnerable, especially in the dry seasons, when the facilities cannot operate in full swing.

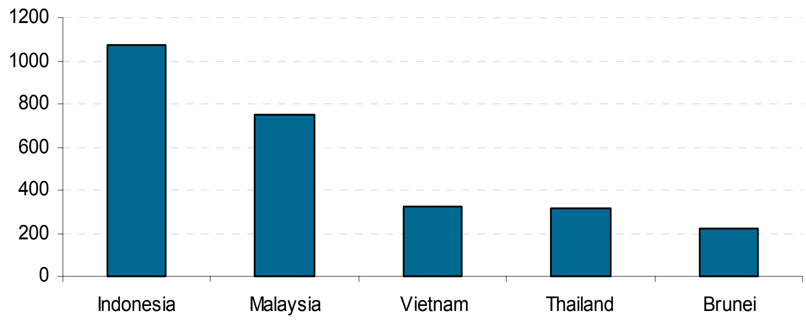
The country can count on substantial mineral resources, and namely phosphates, coal, anthracite, manganese, bauxite, copper, tin, zinc, iron, marble, granite, antimony, and chromate. Most mines are located in the North West of the country. Coal in particular is used as fuel both by power stations and directly by industry, in a significant proportion. Given the high percentage of forests on the country's total surface, the production of wood is an important activity, and especially of ebony, of which Vietnam is one of the leading producers in the world.

Energy resources

Electricity			Oil			Natural gas		
Production	59.01	Kwh Bn	Production	319,500	b/d	Production	6.86	m^3 Bn
Consumption	51.35	Kwh Bn	Consumption	271,100	b/d	Consumption	6.86	m^3 Bn
Exports	0.00	Kwh Bn	Exports	315,700	b/d	Exports	0	m^3 Bn
Imports	0.00	Kwh Bn	Imports	271,100	b/d	Imports	0.0	m^3 Bn

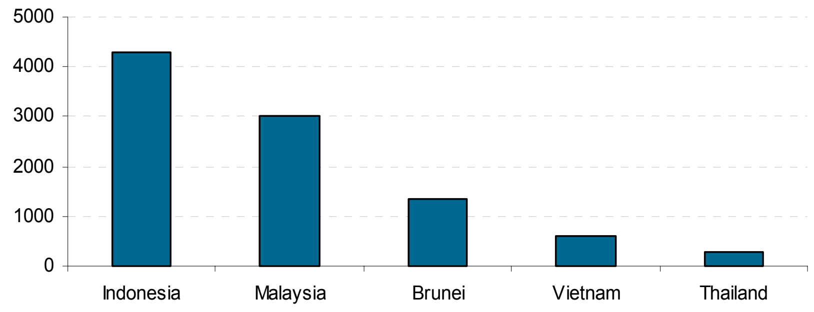
Source: CIA data as at 2007

Oil production (b/d K)



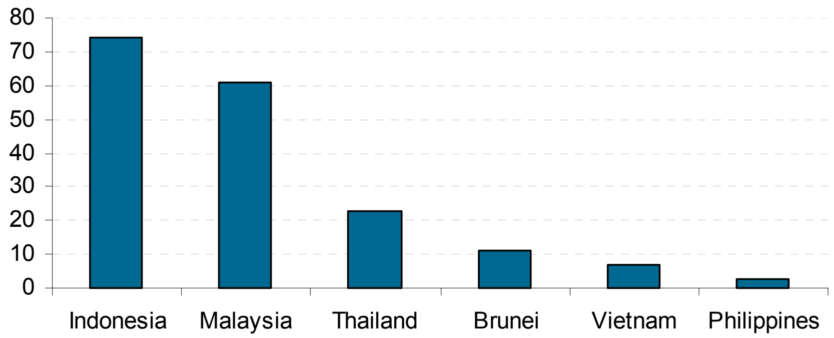
Source: EIA data

Oil reserves (b Mln)



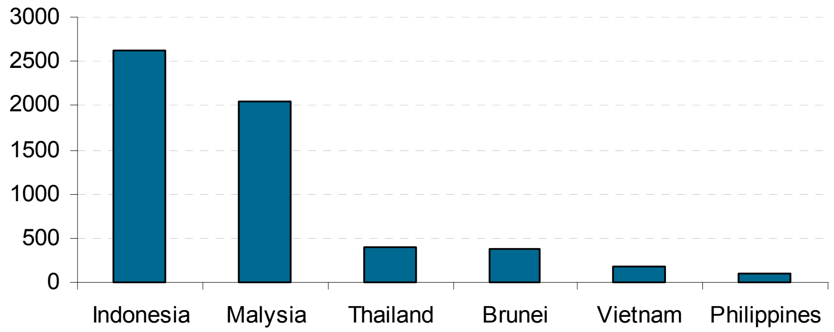
Source: EIA data

Natural gas production (m^3 Bn)



Source: EIA data

Natural gas reserves (m^3 Bn)



Source: EIA data

Food resources

Rice is a fundamental cereal for the Vietnamese economy, not only because the country is the world's second overall exporter, but also because of its role as a local basic food, which fuels strong domestic demand. According to USDA estimates published last September, production should decline slightly next year due to adverse weather conditions last summer. Restrictions on exports imposed by the Vietnamese government last year to meet domestic requirements were suspended in July 2008.

Leading exporters of rice in the world (Tons Mln)

	2006/07	2007/08
Thailand	8,50	9,00
Vietnam	4,60	5,00
USA	2,94	3,42
India	4,20	3,40
Pakistan	3,00	3,20
China	1,30	1,60
South America (other)	1,14	1,31
Egypt	1,00	1,10
Other	1,17	1,04
Argentina	0,45	0,45
EU 27	0,15	0,15
Australia	0,20	0,02

Source: USDA data

Main producers of rice in the world (Tons Mln)

Tons Mln	2007/08	2008/09 estd.
World	429,5	432,0
China	129,8	130,6
India	96,4	97,0
Indonesia	35,5	36,3
Bangladesh	28,6	29,4
Vietnam	24,1	23,7
Thailand	19,3	19,5
Burma	10,7	9,4
Philippines	10,1	10,2
Brazil	8,4	8,5
Japan	7,9	8,0
USA	6,3	6,6
Pakistan	5,5	5,8
South Korea	4,4	4,5
Egypt	4,4	4,4
Cambodia	4,1	4,2
Nigeria	3,0	3,1

Source: USDA data

Foreign Direct Investments and Infrastructures

Foreign Direct Investment

In recent years, Vietnam has been one of the leading destinations of foreign capital flows in all of South East Asia, with a FDI (stock)/GDP ratio of 56.3% in 2007. Up to last year, over USD 40Bn were invested into Vietnamese production activities, approximately double the 2000 figure (USD 20.5Bn). Starting in 2006 a FDI boom began, mostly triggered by the agreements signed by Vietnam in view of its entry into the World Trade Organisation. These agreements, as well as concerning the customs duty applied to the transit of goods, and on imports in particular, also embraced investment sectors. The Law on Investments, which came into force in July 2006 (L. n. 59/2005/QH11), abolished most of the disparities in the treatment reserved to national, state-owned and private companies, compared to foreign capital entities. Restrictions in contrast with international directives were lifted, the possibility was introduced of resorting to international arbitration in case of disputes over investments, and the bureaucratic setup which in many cases caused entrepreneurial initiative to stall was simplified.

Direct foreign investments may be made through limited companies with one or more partners, with public limited companies, and based on commercial collaboration contracts. There are also other types of contracts, entered into by private individuals with companies or State bodies for the construction of public works, based on the following systems: Build Operate Transfer (BOT), Build Transfer Operate (BTO), and Build Transfer (BT). (see Box xxx)

Box 4: Type of FDI contracts for the realisation of public works

BOT (Build Operate Transfer): the State issues a concession to a private company for the construction and operation of a specific facility: the company covers all financial costs in exchange for the awarding of exploitation rights tied to the project for a specified number of years.

BTO (Build Transfer Operate): the State finances the construction of the facility and the private investor is charged with its design and construction. The facility is then operated by the promoting body, which may then issue a concession to a joint-stock company.

BT (Build Transfer): this contract is similar to the previous in terms of the financing of the project and the role of the private investor. However, upon completion, the foreign investor must transfer operation of the facility to the public body, which will then hold exclusive rights over it.

Source: Ministry of Industry

The law introduced in 2006, and followed that same year by five decrees and two application memorandums, also simplified procedures governing the issue of the licences necessary to start up a business activity or invest in an existing one, delegating this function to provincial authorities, and to the boards of directors of IZs (Industrial Zones) and EPZs (Export Processing Zones)[31] for investments of small or medium size (up to EUR 12.5Mln) and in business lines other than the so-called “special” sectors.

If foreign investments are addressed to “special” sectors and are substantial, they need to be authorised in advance by the Prime Minister, based on an opinion provided by the Ministry of Planning and Investments. The sectors subjected to this special administrative procedure are mainly maritime transport, radio communication networks and mail services, publishing, and independent research institutions. In some particularly sensitive sectors, no foreign or private investments are permitted (defence, policing, health care, environmental protection, exploitation of substances banned by international agreements). On the other hand, tax breaks and land concessions are used as incentives to encourage investment in the following sectors: production of new materials, new energy sources, high-tech products, biotechnologies, IT and mechanical industry, processing of agricultural products, fish and shellfish, environmental protection, labour-intensive industries, construction and development of infrastructures and large-scale industrial projects, education and job training, promotion of Vietnamese culture, development of arts and crafts and traditional industries. The geographical regions which benefit from these schemes are the particularly depressed areas of the country and industrial parks such as EPZs, IZs and HTZs (High Tech Zone).

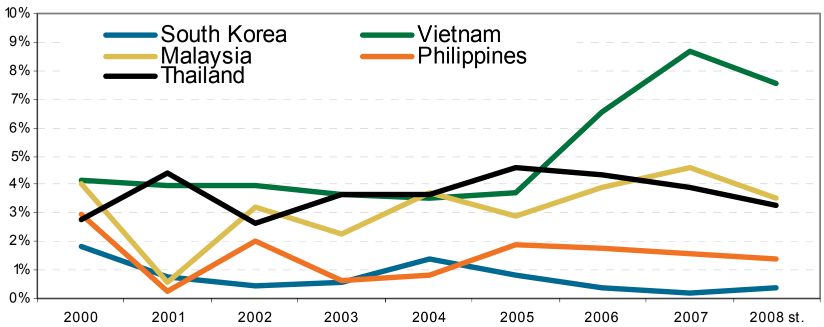
The main investor-countries are Asian. However, the figure may be overestimated due to investments made by foreign multinationals transiting through their Asian branches or through companies in which they hold stakes. The importance of some tax havens, used as transit bases, should be borne in mind (for instance, US

[31] See below

companies frequently use branches based in the British Virgin Islands to carry out their investments). Among European countries, the major investors are France and the Netherlands. While Italy accounts for a marginal share of investments in the country, its position in the world ranking is improving. When considering total investments over the 1988/2006 period, Italy ranked only 36th, whereas in 2007 Italian investments in Vietnamese business activities added up to around USD 50Mln, lifting Italy up into 18th place.

Industry on the whole is the main recipient of FDI, accounting for more than 52% of the total. In addition to heavy industry, particularly interesting light industry segments are textiles and wood processing, in which, however, single investments are of rather small size. Services are also an increasingly important destination item, whereas agriculture has not attracted relevant FDI flows to date.

Foreign Direct Investment flows /GDP



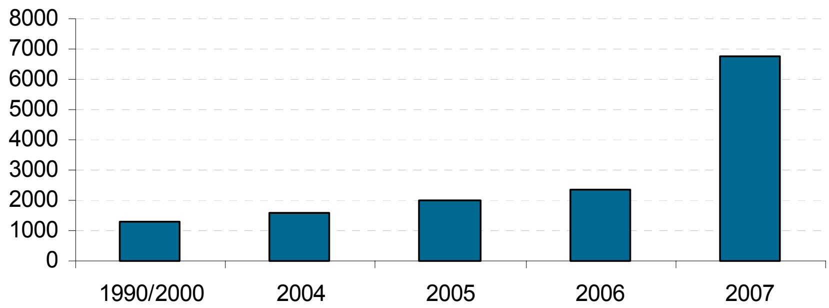
Source: Intesa Sanpaolo elaborations on EIU data

FDI in the region (2007)

	FDI Stock / %GDP
Vietnam	56.3
China	10.1
South East Asia	43
Asia and Oceania	28.6
World	27.9

Source: World Investment Report 2008 - Unctad

FDI flows (Mln USD)



(1990/2000 – annual average)

Source: World Investment Report 2008 – Unctad

Main recipient sectors

FDI authorised between 1988 and 2007 (USD Bn)		
Total	**99.6**	**% of tot.**
Manufacturing	52.3	52.56
Real estate	14.2	14.25
Hotels and restaurants	7.6	7.65
Construction	6.8	6.84
Transport; warehouses and communications	5.1	5.09
Mining and extraction	3.7	3.76
Agriculture	3.4	3.41
Electricity, gas and water supplies	1.9	1.95
Cultural and sporting activities	1.7	1.69
Financial intermediation	0.9	0.87

Source: GSO

Main investing countries and share of total

FDI authorised between 1988 and 2007 (USD Bn)		
Total	**99.6**	**% of total**
South Korea	14.6	14.71
Singapore	12.6	12.63
Taiwan	12.1	12.15
Japan	9.8	9.82
British Virgin Islands	9.8	9.81
Hong Kong	7.0	7.04
USA	3.5	3.52
France	3.1	3.14
Malaysia	3.0	3.05
Netherlands	3.0	3.01
Italy	0.15	0.16

Source: GSO data

Distribution of total investments

Trend of investments by ownership (% of total)			
	State	**Private**	**Foreign**
2002	57.3	25.3	17.4
2003	52.9	31.1	16.0
2004	48.1	37.7	14.2
2005	47.1	38.0	14.9
2006	46.4	37.7	15.9
2007	43.3	40.7	16.0

Source: GSO data

Distribution of foreign investments (1988-2007)

Investment forms	% of total
100% foreign capital	61.6
Joint venture	28.9
Business Cooperation Centres (BCC)	5.4
BOT, BT, BTO	2.0
Joint Stock Companies	1.9
Subsidiaries	0.1

Source: MPI data

Role played by Italy

Italy ranks only 31st in the world among foreign investors in Vietnam. Of the total FDI addressed to Vietnam, Italy's share only amounts to 0.16%, adding up to just over USD 150Mln[32]. The main Italian names present in Vietnamese territory are Cir, Fiat Auto, Iveco, Mapei, Merloni Termosanitari, Perfetti, Piaggio. Other companies of medium size are also present, mostly active in clothing & apparel and accessories, in

[32] See table of main investing countries

the production of machinery for the ceramics sector, transportation, wood processing, furniture, and food processing.

Infrastructures

According to the World Bank report published in July 2006, investments in infrastructure in Vietnam, worth around 9/10% of GDP, were mostly used to extend and modernise the transportation network, telecommunications, energy, drinkable water, and sewage systems.

Despite the efforts being made, rural areas, which are particularly vast, are not served by an effective reaching network of infrastructures, which still only reach the main industrial areas, cities, and tourist destinations.

The road network is still inadequate to meet the needs of a fast-growing economy. Connections between the major industrial areas, located in the North and South of the country, are still insufficient.

Given the physical characteristics of its territory, Vietnam has numerous ports which aid the movement of goods both domestically and abroad. The most important ports are located near Haiphong in the North, Danang in the Center, and Ho Chi Minh City in the South.

Infrastructure index

Infrastructure (max = 10)				
	2005	**2006**	**2007**	**2008 (st.)**
Vietnam	3	3.2	3.4	3.7
China	4.7	4.9	5.1	5.4
India	4.7	4.8	5	5.2
Hong Kong	8.7	8.7	8.7	8.6
South Korea	7.8	7.8	7.8	7.8
Singapore	9.2	9.2	9.2	9.2
Malaysia	6.8	7	7.1	7.3
Indonesia	4	4	4.1	4.2
Thailand	4.9	5	5.1	5.2
Taiwan	7.8	8	8.2	8.4
Italy	*7.5*	*7.5*	*7.6*	*7.6*

Source: EIU data

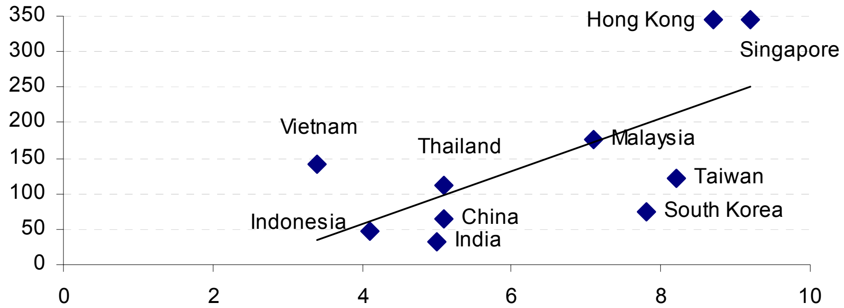
An important role in building up the country's infrastructures in the past twenty years has been played by ODA (Official Development Assistance) promoted by several countries close to Vietnam for cultural or historical reasons, and by the main supranational banks (World Bank, Asian Development Bank). Assistance mostly consists of long-term loans at markedly favourable rates, with a very long interest-free initial period.

Flows from these institutions have been particularly strong since 1993, and have allowed a significant reduction of the population's poverty rate.

During the last meeting between supranational organizations (World Bank, International Monetary Fund, and Asian Development Bank) and donor countries (Japan, France and Germany are the main supporters of Vietnamese projects), held in August 2007, over USD 5.4Bn were appropriated for the country for 2008, as opposed to USD 4.4Bn in 2007 and USD 2Bn in 2006.

Emerging and developing economies show a positive correlation between infrastructure and openness to trade. Indeed, this factor has often stimulated not only industrial development, but also the building of the infrastructures necessary to support growth. The chart below shows that some nations hold considerable growth potential in terms of their infrastructures, given their propensity to international trade, while the situation is already mature in others. Vietnam, in light of its recent economic history and its degree of openness to trade, shows a margin for further growth.

Infrastructure index (x) and openness to trade in the main Asian countries (y= exp+imp/GDP)[33]



Source: Intesa Sanpaolo elaborations on EIU data

Production Structure and Business Climate

Progress towards a market economy

Since 1986, Vietnam's industrial structure has changed radically, thanks to implementation of the "Economic Renovation" (*Doi Moi*) policy, initially aimed at defining a socialist model opened to the market, and then geared to promoting a gradual reduction of the State's presence in the national economy. Within ten years, given the commitments made with the WTO, Vietnam will have a mostly market-oriented structure, where public intervention will be limited to activities deemed of vital importance for the nation.

Box 5: Key legislation

- 1987 - Decree 217/HDBT. State-owned companies are freed from the obligation of selling their products to the State, and may choose whom to sell to. Prices are no longer imposed, but defined by demand and offer. Profits may be retained.

- 1989 – Law on foreign investments – First opening to foreign investors

- 1991 – Decree 388/HDBT. State-owned companies may be restructured or shut down if fail to meet specific fundamental requirements (profitability, capital, adequate technology, market for finished products)

- 1992 – Decree 202CT. Vietnam's first privatisation plan (*Co Phan Hoa*). In this phase, the possibility of intervening with private capital is conceded, but majority stakes must remain state-owned.

[33] Infrastructure index, calculated by EIU, scores countries between 1 and 10 on a variety of telecoms, transport, energy and office space measures, with 1 being low and 10 being high.

- 1996 – Decree 28CP. The possibility of private participation is extended to include small and medium enterprises

- 1998 – Decree 44/1998/NDCP. Greater openness and aided transformation of state companies into limited companies.

- 1999 – Law on enterprise. All the possible juridical statuses of enterprises are defined, and private enterprise is contemplated for the first time .

- 2000 – Law on foreign investments in the territory of Vietnam. Investment opportunities are extended and disparities in the treatment reser4ved to local and foreign players are reduced.

- 2002 – Decree 64/2002/NDCP. Further simplification of procedures for the transformation of state-owned companies .

- 2003 - Law on state-owned companies – Areas of activity and investment possibilities are defined. Law on cooperatives – Cooperative companies are also regulated.

- 2005 – Law on enterprises – This law definitively opened up state-owned companies to private capital, and the entry of foreign capital was completely liberalised.

- 2006 – Law on investments – Equality in the treatment of foreign and national investments.

Privatisation process

The private sector holds considerable weight in today's Vietnamese economy: alongside a historical economic development plan of socialist conception, for years now private companies have been working together with state-owned companies to improve competitiveness on the international markets, and guarantee continuation of the country's industrialisation process.

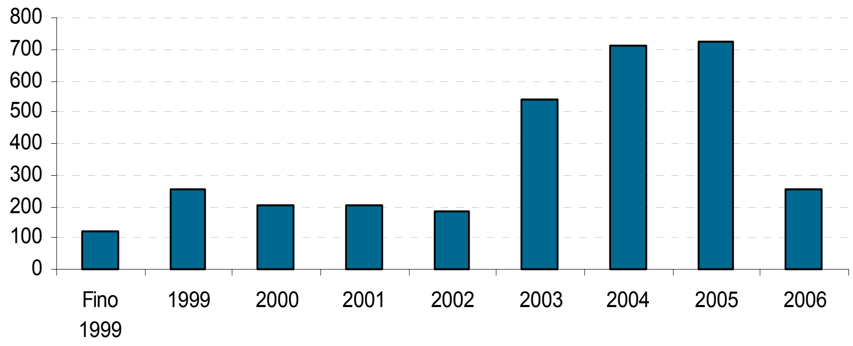
Industrial structure by ownership category

	1996	2001	2002	2003	2004	2005	2006
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0
State-owned	**49.6**	**31.4**	**31.4**	**29.3**	**27.4**	**25.1**	**22.5**
Central	33.1	21.7	22.0	20.8	20.5	19.3	17.7
Local	16.5	9.7	9.4	8.5	6.9	5.8	4.8
Non-state-owned	**23.9**	**27.0**	**27.0**	**27.6**	**28.9**	**31.2**	**33.3**
Collective	0.6	0.5	0.6	0.4	0.4	0.4	0.4
Private	7.9	16.3	16.7	18.4	20.4	22.7	25.5
Family-owned	15.5	10.2	9.7	8.7	8.1	8.1	7.5
Foreign invest.	**26.5**	**41.6**	**41.6**	**43.1**	**43.7**	**43.7**	**44.2**

Source: GSO data

The industrial policy pursued until 2007 included a vast privatisation programme, focused on small and medium state-owned companies, and from which the largest national companies were excluded. Still today the State's presence is dominant in oil companies, utilities, telecommunications, and air and rail transportation. The State also holds majority stakes in companies dealing with infrastructure, the production of steel and cement, and the chemical and pharmaceutical industries.

Number of companies privatised every year



Source: CIEM

Following its entry into the WTO (World Trade Organisation) in January 2007, the Vietnamese government has given considerable impulse to reform in the country, including the privatisation process. According to EIU estimates, privatisations could attract FDI of around USD 50Bn by 2009. In 2007 a plan to rationalise the entire state-owned productive establishment was launched, and a new Law on Enterprise was passed, that by 2010 will lead to the conversion of state companies into limited or public limited companies ("equitisation" process).

Structure of production

The importance of the secondary sector in the Vietnamese economy has increased over the past 10 years: in 2007 around 42% of gross domestic product was generated by the industrial sector, as opposed to just under 30% in 1995 (28.75%).

Vietnam's production setup is characterised on the one side by the presence of a large number of small companies, active in the country's traditional industrial sectors, such as shoes and textiles, as well as in the processing of food products, wood, and arts & crafts, and on the other by large groups, fed by state or foreign capital. In 2006, the four largest industrial groups (Vietnam National Oil and Gas Group (PetroVietnam), Vietnam Electricity Group (EVN), Vietnam Coal and Minerals Industries Group (Vinacomin), and Garment and Textile Group (Vinatex)), accounted for around 10 per cent of the total value of the country's industrial production.

In the past five years productive sectors have undergone considerable diversification, to the advantage of those with a higher technological content, thanks to the positive effects of the policies implemented by the government, such as the establishment of HTZs (High Tech Zones)[34] and the offer of incentives to encourage greater job specialisation. Many recently privatised state-owned companies also work in the production of light industry components and accessories, and in the processing of commodities, increasing their end value and limiting purchases abroad. Companies active in the production of electric, electronic and precision machinery, and automobiles, are proving particularly lively.

[34] See below.

Industrial production breakdown (2006)
(% of the total at current prices)

Mining & extraction	**10.3**
of which:	
Oil and natural gas	7.8
Manufacturing industry	**84.5**
of which:	
Food & beverages	20.4
Textiles, clothing and leather.	12.9
Chemicals and plastic	10
Metals	8.7
Machinery and equipment	8.7
Vehicles	6.9
Furniture and wooden products	6.4
Electricity, gas and water	**5.2**

Source: GSO data

In recent years, industrial production has experienced an uptrend, while diversifying the offer of products and becoming less dependent on target markets. The creation of industrial parks, the "equitisation" process, and the series of projects aimed at encouraging industrial development, have had positive effects on production activity in the country. In the past five years, low cost of labour has been taken advantage of also for more sophisticated industrial processes than the traditional, making Vietnam an important assembly and production centre for electric appliances, and mechanical material for the auto and precision industries, directed not only to other Asian countries, but to Europe as well.

Industrial trend:
change in the value of industrial production at constant 1994 prices

	% chg. 1995/2007
Total	**452.1**
Mining & extraction	**165.1**
Manufacturing	**502.1**
of which:	
Food & beverages	357.2
Textiles and clothing	365.9
Accessories	708.2
Shoes	662.4
Chemicals	570.4
Rubber and plastic	999.7
Metal products	1066.0
Office machinery	27280.3
Electric machinery	1789.7
Motor vehicle engine assistance	702.5
Other means of transport	1238.4
Furniture	1046.3
Electricity, gas and water	**425.7**

Source: GSO data

Cost of labour

For years now, the main feature of Vietnamese industry has been the availability of low-cost labour, still largely used for low-technology content, labour-intensive productions. The promotion of qualified job training has only begun in recent years, especially by means of HTZs[35], bridging the gap the labour market was generating. Many companies, mostly foreign, had to face a lack of specialised workers in the past, and were forced to seek them elsewhere abroad. The current availability of labour, even of the skilled kind, has allowed the manufacturing sector to branch out to different activities. Compared to other Asian countries,

[35] See below.

Vietnam offers competitive advantages which have encouraged delocalisation to the country of intra-regional production processes.

Unit labour cost index (2005 = 100)

	2006	2007	2008
Vietnam	105.0	110.1	122.2
China	106.1	115.5	136.6
India	99.9	113.3	126.1
Hong Kong	97.5	97.5	99.7
South Korea	103.2	105.5	103.8
Singapore	107.8	118.3	135.2
Malaysia	105.0	113.5	124.3
Indonesia	111.7	114.5	121.9
Thailand	113.3	127.6	142.4
Taiwan	96.1	92.4	96.0

Source: EIU data

Distribution of workers by activity and type of company

	Preliminary 2007	% chg. 2000/2007
Total	**100.0**	
State-owned	9.00	-3.3
Non-state-owned	87.52	-2.4
Foreign capital companies	3.49	252.5
Total	**100.0**	
Agriculture	50.20	-19.6
Fish & shellfish	3.70	40.7
Mining & extraction	0.90	32.4
Manufacturing	13.50	43.0
Electricity, water and gas	0.45	104.5
Construction	5.13	85.2
Commerce	11.98	15.6
Hotels & restaurants	1.84	1.1
Transport, warehousing and communications	2.76	-11.5
Financial intermediation	0.48	140.0
Scientific and technological activities	0.06	20.0
Real estate	0.49	188.2
Administration and defence	1.80	80.0
Education	3.07	15.8
Health care	0.87	45.0
Leisure and cultural activities	0.31	-11.4
Party and members of organisations	0.44	158.8
Social services	2.03	55.0

Source: GSO data

Development projects

The government has launched a series of projects geared to encouraging industrial growth, that will contribute to improve the productive framework and Vietnam's competitive position among the major industrialised countries in the region. At the present stage, five broad strategic development plans are being implemented in the main industrial sectors, programming activity up to 2010. The projects are focused on the chemical, energy, mechanical, auto and textile industries.

The development of the agricultural and food business will take on an important role in promoting the growth of the secondary sector in Vietnam, as it will enable the country to evolve from its status as simple producer of primary goods, encouraging the transformation and preservation of foodstuffs, and stepping up higher added value productions.

The naval industry is also at the centre of the government's attention, given the territory's physical characteristics. The development of ship-building activities will act as a driver of the steel and metal industries, as has previously been the case for South Korea.

The tourist industry will also be supported, by aiding not only the coastal regions, but also smaller inland urban centres of particular historical, religious and environmental appeal, and large industrial cities, promoting related activities and businesses.

Industrial and export zones

Vietnam has numerous special status areas comprising industrial parks, zones dedicated to the production and assembly of export goods, and zones of technological vocation (EPZs - Export Processing Zones, HTZ – High Tech Zones, IZs – Industrial Zones), mostly located in proximity of the country's major cities, Hanoi and Ho Chi Minh, and along the central coast. These areas, defined by government decrees, may overlap: an EPZ or IZ, for instance, may contain part, or the entirety, of an HTZ.

HTZs were introduced in 1999 and are devoted to the research, development and application of advanced technology, with the creation of research and study poles for the training of highly qualified staff, and the production and commerce of high-tech products. Investment in HTZs benefit from an initial eight-year tax exemption, and a subsequent tax rate of 10% of profits.

Investors, not only foreign, who choose to establish their production facilities in these areas, benefit from numerous tax breaks: in EPZs, the corporate tax rate applied to manufacturing companies is 10%, and is applied only as of the fifth year in which profits are generated. The tax rate increases to 15% for services companies, with a two-year initial tax-free period. Companies are also exempted from the payment of customs duty on imports of machinery, commodities and goods used for production. The same benefits are conceded to companies whose production is destined to the domestic market, if at least 40% of the goods they use are imported from other ASEAN member countries.

From the point of view of customs, the entire production delle EPZ is considered non-Vietnamese and is therefore subject to duty.

The first IZs were established by the Ministry of Planning and Investment in 1991. Since then, around 150 have been authorised in total. The current government has authorised the extension of the surface of these special zones, which should double by 2015. Some have also been created thanks to the contributions of other nations, which have delocalised numerous production facilities, or particular industrial projects, in those areas.

IZs created with the collaboration of foreign states

IZ name	Province	State	Investment	Start-up date
Amata	Dong Noi	Thailand-VN	USD 69Mln	1994
Loteco	Dong Noi	Japan-VN	USD 41Mln	1996
My Xuon A2	Ba Ria-Vung Tau	Taiwan-VN	USD 21Mln	2001
Viet-Sing	Binh Duong	Singapore-VN	USD 139Mln	1996
Tan Thuan	HCMC	Taiwan-VN	USD 96Mln	1991
LinhTrung I	HCMC	China-VN	USD 1,440Mln	1992
Linh Trung II	HCMC	China-VN	USD 13Mln	1997
Da Nang	Da Nang	Malaysia-VN	USD 13Mln	1994
Noi Bai	Ha Noi	Malaysia-VN	USD 30Mln	1994
Bac Thang Long	Ha Noi	Japan-VN	USD 77Mln	1997
Nomura-HP	Hai Phong	Japan-VN	USD 137Mln	1994

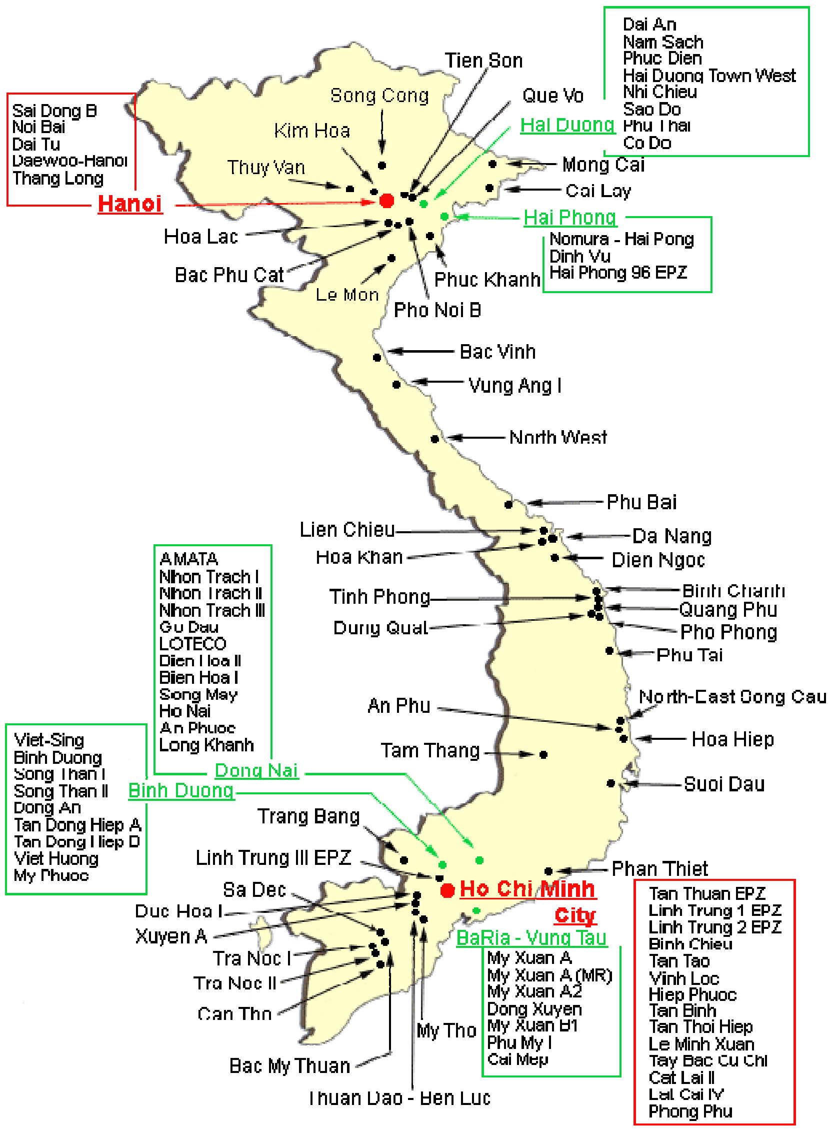
Source: Business in Asia

In IZs, corporate tax varies between 10% and 20%, depending on the line of business. For companies which address over 80% of their production to foreign markets, taxation is suspended for two years, as is the case in EPZs, and a subsequent tax rate of only 10% is applied. Those which produce primarily for the domestic market are subject to a 15% taxation of profits, whereas the tax rate for services companies is 20%.

All these zones can also count on a modern network of infrastructures and dedicated services. The procedures to start a business in these areas are the same as those required in the rest of the country, as is the bureaucracy leading up to the authorisation of foreign investment; also, the cost of land is higher.

In IZs, some activities are limited or discouraged. These include the production of construction materials, cigarettes, alcoholic beverages, paints and solvents, and local arts and crafts. The State forbids investments in nuclear power, radioactive materials, explosives, chemical weapons, and the leather and tanning industries.

EPZs (in green) and IZs (in red)



Source: GRIPS Development Forum (http://www.grips.ac.jp/vietnam/VNIPs/fullmap.htm)

The trend of the value of industrial production in the different provinces has been varied in the past few years, with special industrial zones coming out on top. As shown in the table below, the most productive areas are the EPZs in the South and North of the country, in the Red River Delta, whereas production capacity has dropped sharply in the areas left out of the government's growth plan.

Industrial production by province

		Preliminary 2007	% chg. 1995/2007
Total		**100.00**	
Red River Delta			41.1
of which:	Hà Nội	8.89	8.4
	Vĩnh Phúc	3.15	1203.7
	Hưng Yên	1.54	425.6
	Bắc Ninh	1.26	186.0
North East		**5.08**	-15.1
North West		**0.25**	-19.2
Centre-North Coast		**3.45**	-3.9
Centre-South Coast		**5.03**	4.5
Central plateaus		**0.83**	-30.2
South East		**46.58**	-5.8
of which:	Đồng Nai	9.12	52.0
	Bình Dương	6.95	286.1
	Hồ Chí Minh city	22.12	-22.8
Mekong River Delta		**9.24**	-22.0

Source: GSO data

The Doing Business Index

Based on the Doing Business Index (World Bank), in 2009 Vietnam ranks significantly lower compared to other South East Asian countries. However, access to credit facilities has improved, thanks to the reduction of bureaucratic impediments. The registering of property has also benefited from greater transparency, although the evolution of the sector is still far from complete, and the overall situation is still very difficult.

Doing Business Index

Ease of	2009	2008	Chg.		2009	2008	Chg.
Doing business (*)	**92**	**87**	**5**				
Starting a business	108	101	7	Tutela degli investitori	170	168	2
Obtaining licences and permits	67	64	3	Pagamento tasse	140	131	9
Employing workers	90	72	18	Esportazioni	67	65	2
Registering property	37	38	-1	Tutela contrattuale	42	42	0
Getting credit	43	51	-8	Chiudere un'attività	124	124	0
(*) Ranking among 181 countries							
lower number = higher efficiency							

Source : World Bank data – Doing Business

The World Bank has developed a number of indicators to describe a country's attitude to foreign trade, comparing them to those referred to the region the country belongs to, and OECD countries. Vietnam emerges as being more competitive than the other nations of South East Asia, and has a competitive edge in terms of costs.

Competitive comparison

Geographical Region	Documents for export (number)	Time for export (days)	Cost to export (USD per container)	Documents for import (number)	Time for import	Cost to import (USD per container)
East Asia & Pacific	6.7	23.3	902.3	7.1	24.5	948.5
East Europe & Central Asia	7.1	29.7	1,649.10	8.3	31.7	1,822.20
Latin America and Caribbean	6.9	19.7	1,229.80	7.4	22.3	1,384.30
Middle East & North Africa	6.5	23.3	1,024.40	7.6	26.7	1,204.80
OECD	4.5	10.7	1,069.10	5.1	11.4	1,132.70
South Asia	8.5	33	1,339.10	9	32.5	1,487.30
Sub-Saharan Africa	7.8	34.7	1,878.80	8.8	41.1	2,278.70
East Asia & Pacific	6.7	23.3	902.3	7.1	24.5	948.5
Cambodia	11	22	732	11	30	872
China	7	21	460	6	24	545
Hong Kong, China	4	6	625	4	5	633
South Korea	4	8	767	6	8	747
Indonesia	5	21	704	6	27	660
Malaysia	7	18	450	7	14	450
Philippines	8	16	816	8	16	819
Taiwan, China	7	13	757	7	12	769
Thailand	4	14	625	3	13	795
Vietnam	6	24	734	8	23	901

Source : World Bank – Doing Business

Wilma Vergi

Banking and Financial System

Introduction

Vietnam's banking system has made significant progress over the past few years. However, it is still marred by several weaknesses, which include modest capital ratios, lack of transparency on the quality of loans portfolios, and inefficient recovery procedures. Potential for growth, especially in the retail segment, is strong, also considering that in recent years most loans have been issued to the corporate sector, and to the real estate segment in particular.

The weight of the major state-owned banks is still relevant. Their aggregate total assets account for approximately a 60% share of the market. These banks are stronger in the deposits market than the smaller private banks, which, in turn, are more aggressive on the credit market. Leading international institutions own shareholdings in some Vietnamese private banks. In any case, the presence of foreign banks is still limited due to legislative restrictions, which, however, are in the process of being lifted, following Vietnam's entry into the WTO.

Several reform projects are being approved on both banking supervision and operating modes, indispensable to support an adequate strengthening of the banking system.

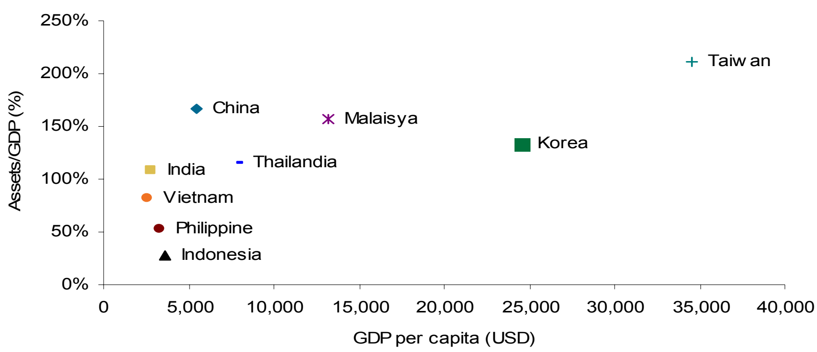
Banking System

Evolution and structure

The Vietnamese banking system is still in its initial stage of development, given its brief history of operating in a more open economic context, after staying under state control for many years.

Even compared to the main countries of the Asian continent, Vietnam shows significant growth potential, especially given the low level of per capita income, expected to growth in the near future.

Total bank assets/GDP and per capita GDP (2007)



Source: EIU and Intesa Sanpaolo elaborations

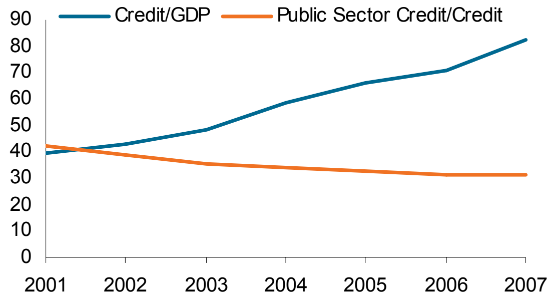
The fast growth of credit, at an average year-on-year rate of 33.4% since 2004, driven by strong demand from the corporate sector, has increased the degree of financialisation of the country, while at the same time introducing new elements of vulnerability. In 2007, indicators such as the Credit/GDP and M2/GDP ratios rose sharply (respectively to around 90% from 40% in 2001, and to 112% from 23.8% in 1996). The level of credit issued in the country strikes as being even higher in light of the modest per capita GDP, of USD 835 at the end of 2007, as opposed, for instance, to USD 1,900 in Indonesia, USD 1,600 in the Philippines.

Structure of the banking system

	2007
State owned commercial banks	5
Joint stock commercial banks	34
Foreign bank branches + JVBs	42
Market share (% in dep.) SOCB*	60
Market share (% in dep) JSCB*	30
Market share (% in dep) foreign banks+JVBs	9
Market share (% Total asset) 15 major banks	92.4
EIU Index – Banking Sector risk *	63

*Source: SBV, IMF. EIU. Note: *100 = high.*

Credit/GDP and share of the public sector



Source: IMF and Intesa Sanpaolo elaborations.

Five state-controlled commercial banks operate in Vietnam – four of large size, and one smaller institution, which account for around 60% of total assets – alongside around 70 private commercial banks, of which 34 limited companies located in the main cities, which command a market share of around 30%; five are small joint ventures with foreign banks, and the other 37 are branches of foreign banks that own a 10% stake. According to the most recent data made available on the central bank's website (State Bank of Vietnam - SBV), the total number of bank branches in the country is 1,171, of which 44% (515 branches) of state-owned banks, and 51% (593) of local private banks. The number of branches in relation to the population is small: around 1.4 branches per 100,000 inhabitants.

The fragmentation of Vietnam's banking system is an element of weakness. The leading banks are: Vietcombank (Vietnam's bank for foreign trade), controlled by the state, based in Hanoi and with branches throughout the country; the Bank for Industry and Trade (Vietinbank), also controlled by the state, born as a spin-off of the central bank, and present on the entire national territory; the Bank for Investment and Development, which is playing a leading role in financing infrastructure; and, among private banks, Asia Commercial Bank (ACB), and the Technological and Commercial Bank (Techcombank). Over the past decade, the largest banks have incorporated some small, distressed banks. The high fragmentation of the banking system, and the weakness of some small local banks, especially in terms of asset quality, could support a similar consolidation process in the next few years.

There are 27 branches of foreign banks in the country, and over 50 branch offices, most of which operate almost exclusively in support of companies of their same nationality active in Vietnam. In June 2007, also following entry into WTO[36], the SBV issued guidelines for the application of rules on the structure and organisation of banks of foreign ownership. At present, foreign banks may establish 100% owned branches with total assets in excess of USD 10Bn, and may collect deposits in dongs and issue credit cards. The cap on foreign shareholdings has been raised to 15% for single investors, and is 30% for the

[36] Vietnam became a WTO member in November 2006, and undertook to progressively abolish all restrictions imposed on foreign banks by 2010. The specialised press is speculating that there may be delays in the adjustment of regulations, also considering the current financial market turmoil.

total foreign investment in a bank. HSBC, Standard Chartered and Australian bank ANZ recently obtained licences[37].

Main shareholdings owned by foreign bank

Foreign bank	Share (%)	Local Bank
HSBC Holdings Plc	20	Techcombank
Standard Chartered Plc	15	ACB
SMFG	15	Eximbank
Maybank*	15	ABBank
ANZ	10	Sacombank
BNP Paribas	10	Oricombank
Deutsche bank *	10	Habubank
Oversea-Chinese banking Corp*	10)	VP Bank
United Overseas bank *	10	Phuong Nam
Mirae Asset Securities	15	Phuong Nam
Societé Generale	10	SeAbank

*Source: specialised press. Information as 15 August 2008. *The foreign bank has applied for a further 5% shareholding.*

In 2007, 46 applications to exercise banking activity were submitted (22 by domestic banks and 24 by foreign entities), a record-breaking number for Vietnam. Despite the fragmentation and high level of bankability of the system, in the past few months the central bank has issued approximately a further 10 licences to domestic shareholders. To make the system more solid, encouraging a concentration process rather than an increase in the number of banks would have been a better choice[38]. Uncertainty over the appropriateness of this decision also stems from the fact that licences have been issued to industrial enterprises (also state-owned) that do not currently operate in the banking sector (primarily in the utility and real estate sectors)[39].

The gradual process of disposing of stakes in state-owned banks has been slowed by adverse market conditions. To date, the Government has sold only a minority shareholding in Vietcombank, to domestic investors. Based on the rules, foreign banks may submit offers to purchase stakes up to 15% even in the major state-owned banks, although the specialised press generally agrees that a more realistic assumption is that the government will sell smaller shareholdings, of between 7% and 10%, to foreign investors.

The para-banking sector is still scarcely developed, and is mostly made up of a number of financial leasing companies.

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[37] According to press sources, various institutions attempted to acquire control over a Vietnamese bank in the past, including Austrian bank Raiffeisen International, ING, Barclays, and Bank of America.. HSBC owns a 14.5% shareholding (and has applied for permission to increase it to 20%), in Techcombank, the third joint-stock bank in terms of profits, which is rapidly expanding in the retail segment, planning to open 50 new branches by the end of 2008, in addition to the 120 operational ones. ANZ opened its first branch in Hanoi in 1993, and gradually broadened its offer the retail and corporate clients, also acquiring a 10% stake in joint-stock bank Sacombank, and a further 10% shareholding in its subsidiary specialised in trading. ANZ intends to open 12 branches by the end of 2008.

[38] The large number of new banking licence applications by foreign institutions is also due to a lack of potential target banks with solid fundamentals on the market, as confirmed by the Governor of the SBV last January. See “Herd instinct warnings as foreign banks rush in”, in The Banker, 2 January 2008. Before the recent correction of equity market indices, some banks were listed at 15 times their book value, with a PE ratio of 30: valuations by no means justified by fundamentals.

[39] See Fitch, Vietnamese Banks, A Home-Made Liquidity Squeeze? 5 June 2008.

The synthetic rating assigned to the Vietnamese banking system by the major rating agencies is low, despite upward revisions. However, further upgrades are now very unlikely, given the current international financial crisis and the weakness of Vietnamese banks[40]. In April 2007, S&P raised the ranking of Vietnam's banks by promoting them in its Banking Industry Country Risk Assessment (BICRA) from Group 10 – where the quality is lowest – to Group 9 (in a range of 1 to 10: the banking systems with the best risk assessment are placed in Group 1). The decision was mostly prompted by the improvement of economic risk conditions, in light of the positive growth prospects, supported by investments and productivity gains, as well as by improving infrastructures (albeit still inadequate)[41].

Fitch places the country's banking system among those with the lowest rating: Vietnam's Banking System Indicator (BSI) – which measures the quality of the banking system in stand-alone terms, based on the individual rating of single institutions – is E (in an A-E range, where A indicates the highest quality)[42].

Moody's also assigns a low rating to the Financial Strength of Vietnam's banks (D-, in an A-E range), in line with China, Ukraine and Venezuela, among others[43].

Main banking indicators

	2004	2005	2006	2007	2008E
Assets/GDP (%)	62	67	70	81	85
Deposits/GDP(%)	42	48	50	69	74
Loans/Deposits	97	94	94	89	86
Deposits (YoY %)	22	33	22	59	23
Credit (YoY %)	29	29	21	51	19

Source: SBV, IMF, EIU.

Deposits and liquidity.

Most of the strong loans growth recorded in recent years has been financed through deposits, especially by the four major state-owned banks and the leading private banks. The data available show an uptrend in the system's liquidity, with the loans/deposits ratio (currently close to 90%) on the decline. The deposits/GDP ratio increased from 40% in 2003 to around 70% in 2007, and is expected to increase slightly further this year. The growth of deposits is also fuelled by substantial remittances from emigrant workers, expected to increase to USD 8 billion in 2008 (+60% y/y)[44].

Asian banking systems are being affected only indirectly by the US subprime mortgage crisis[45]. However, after years of robust growth, Asian banks are also facing a period of significant turbulence, albeit without the connotations of a crisis similar to that of the 1990's, thanks to more cautious foreign exchange risk management, and more adequate asset-liability matching[46]. The cost of credit is

[40] The Outlook of the Republic of Vietnam has been changed to Negative by the 3 major rating agencies between May and June 2008.

[41] S&P, Banking Industry Country Risk Assessment On Vietnam Raised to Group 9 From Group 10, April 23, 2007.

[42] Fitch, Bank Systemic Risk Report, 7 April 2008.

[43] Moody's, Banking System Outlook, October 2008.

[44] Cfr. Reuters, 5 August 2008.

[45] Confirmed by Moody's, Vietnam International Bank, Credit Opinion, 4 July 2008.

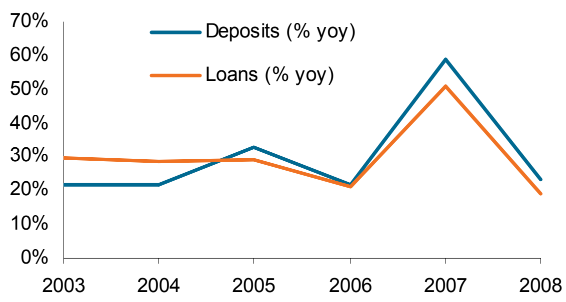
[46] Moody's stresses: "Strong liquidity is an important factor in emerging markets like Vietnam, where deposits can be highly confidence sensitive", in Vietnam International Bank, Credit Opinion, 4 July 2008.

now expected to increase, after having dropped to historically very low levels. Among Asian banks, the Vietnamese seem to be the most vulnerable[47].

Vietnam's banks have only marginally been affected by the widening of spreads triggered by the international financial crisis, as their dependence on foreign debt remains low. The lesson taught by the crisis of the 1990's, and the abundance of domestic liquidity – with high rates, increasing penetration of the retail segment, and capital inflows on the rise – have in fact reduced recourse to foreign sources[48].

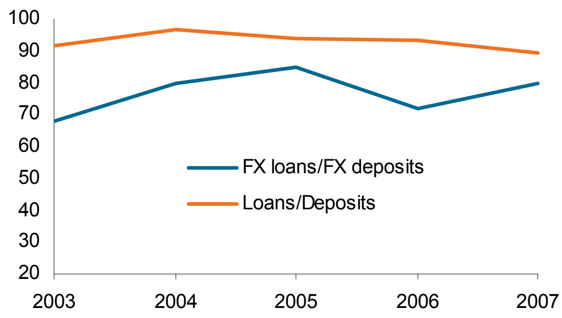
In 2008, with the primary aim of controlling inflation, the SBV has pursued a restrictive monetary policy, using several different tools which have impacted the activity of banks: 1. increase of the compulsory reserve coefficient from 10% to 11%; 2. prime interest rate hike from 8.25% to 14%; 3. purchase of compulsory promissory notes for a total of VND 20.3 trillion by commercial banks; 4. targeted loans growth of 30% in 2008, vs. actual growth of over 50% in 2007; 5. limitations on loans to the real estate sector and for equity trading, aimed at containing speculation.

Loans and deposits: year-on-year changes



Source: SBV, EIU.

Liquidity



Source: IMF,Fitch and Intesa Sanpaolo elaborations.

In a long-term perspective, growth potential in the retail segment for Vietnamese banks is high, as penetration is still relatively low[49]. At the end of 2007, there were 4,300 ATMs in Vietnam, and 8.3 million ATM cards. Of these ATMs, 64% were located in HCM City and Hanoi. The SBV expects the number of ATMs to increase to 6,900 in 2008[50]. According to some market surveys, per capita income in Ho Chi Minh City is around USD 2,400, i.e. around three times the country average[51].

47 A similar view is expressed by S&P in Slower Economic Growth Poses Turbulence But No Crisis For Asian Banking Systems, 11 Sep 2008: "…some of the systems have weak banks that could face financial distress. Vietnam and Taiwan, which have fragmented and fiercely competitive banking industries, are prominent examples".

48 The share of foreign direct investment addressed to the banking sector is modest: based on estimates contained in Vo Tri Thanh, Pham Chi Quang, Managing Capital Flows: The Case of Vietnam, ADBInstitute, Discussion Paper n. 105, May 2008, p.20 as at October 2007 the share was 2.46% of the total.

49 According to Vo Tri Thanh, Pham Chi Quang, p. 38, around 50% of household savings are not deposited in a bank and the number of personal accounts in banks is just about 8% of the total population.

50 See Fitch, Vietnamese Banks, A Home-Made Liquidity Squeeze?, 5 June 2008.

51 In the past 15 years Vietnam has achieved the fastest poverty rate decline. The poverty rate, measured as the percentage of the population that lives off less than one US dollar a day, dropped from 58% in 1993 to 16% in 2006, i.e. 34 million people have risen above the poverty line. For a discussion of the factors which explain this result, see Ajay Chhibber, "Vietnam Leads the Way in Tackling Poverty", in The Banker, 04 February 2008.

Loans

In 2007, total loans grew considerably, by 53%, driven by high available liquidity and strong demand for loans in all sectors of the economy. In order to contain inflation, the central authorities intend to slow the loans growth rate to less than 30% in 2008. In the first four months of 2008, loans growth had already accelerated to around 15%, vs. 10% in the same period last year, although a slowdown was effectively recorded in April. Private commercial banks were the most active, and achieved loans growth in excess of 100% in 2007. With the support of strategic foreign investors as minority shareholders, some of the major private banks in particular have widened the range of products offered, improving their market shares.

The four largest banks (state-owned) were less aggressive with their clients, and achieved a more moderate growth rate of +24%. In view of their partial privatisation, these banks are now particularly focused on strengthening their capital ratios and improving loans portfolio quality. This has led to a significant contraction in the market share of state-owned banks, from 62% in 2006 to 50% at present.

A large portion of newly issued loans (25%) was addressed in 2007 to the real estate sector, in both the commercial and residential segments, in part also for speculative ends.

It is important to point out that the worth of loans to state-owned companies declined from 52.7% of total lending in 1996, to 31.5% in 2007. However, the extent of the credit squeeze is hard to estimate due to the difficulty in identifying state-owned companies. Many enterprises are formally private, but effectively state-owned, as they are controlled by public entities.

According to the press, around 50% of the system's loans are backed by real estate security. This may be an indicator of weakness, as Vietnamese banks, much like those in other emerging economies where risk management systems are still unsophisticated, show a preference for issuing secured loans to reduce risks, nonetheless giving rise to concern that the loans may have been conceded with overvalued real estate as security.

One element of imbalance is represented by the mismatching of maturities. Short-term deposits account for around 75% of total deposits, but the share of medium-long term loans on the total has risen from 22% in 1995 to around 40%[52].

The quality of loans portfolios remains low. Furthermore, the central bank's supervision in the classification of loans is generally considered as falling short of international best practices. Transparency on this front is still judged to be insufficient.

Bad loans as a percentage of total loans dropped to 3%, based on domestic parameters, and to around 6% based on IFRS criteria at the end of 2007, as indicated by the central bank. The trend is tied both to strong loans growth and the adjustments made, and to the revaluation of some loans. The IMF estimates bad loans at around 15%-20% of GDP[53]. It should also be considered that a substantial portion of collateralised bad loans are and not fully recoverable due to the weak legal system, which makes recovery procedures particularly arduous. As a result of Vietnam's increasing dollarisation, loans in US dollars account for

[52] See Vo Tri Thanh, Pham Chi Quang, p. 27.

[53] Uncertainty over the size of bad loans is high. In The Banker, "The silk glove that needs an iron fist", 1 December 2007, states: "Some foreign bankers say that, under international accounting rules, official statistics showing non-performing loans of only 2.1% in the financial system in the year to date would more likely be as high as 25%".

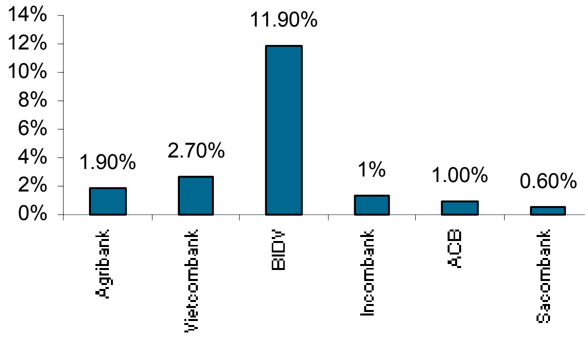
around one fourth of the total. Demand for loans in US dollars has been fuelled by the interest rate differential, as rates in dollars are lower than those in dongs, more than offsetting the limited (yet constant) appreciation of the US dollar against the dong.

Contrary to the situation during the 1999-2000 credit boom years, in recent times loans in currency, mostly destined to state-owned companies, have grown more than total loans. Dollarisation may have increased the banking system's vulnerability, especially considering that it is unclear whether adequate forex risk coverage has been put in place.

Following the recent rise in interest rates in dongs, demand for loans in US dollars should increase further, whereas the offer of deposits in US dollars will slow, placing currency-matching under pressure. Recourse to foreign debt raises fears of tensions arising, especially in the current phase of liquidity restrictions and increasing economic uncertainty in the country.

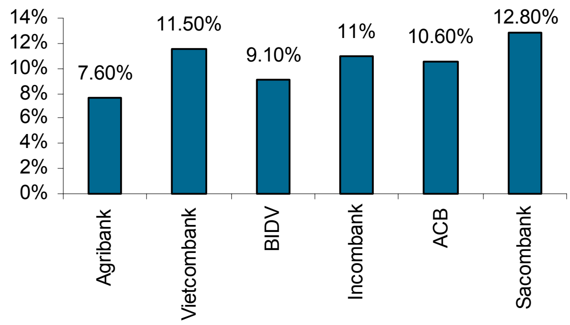
Based on the information made available so far, Vietnamese banks do not appear to be directly exposed to US subprime securities. This is not surprising, considering the numerous investment opportunities available on the domestic market, regulations, and control over capital flows, and the limited opportunities of carrying out offshore operations.

Bad loans (2006)



Source: EIU and Intesa Sanpaolo elaborations

Capital adequacy ratio (2006)



Source: Fitch, Reuters.

Profitability and capital ratios

The net result of banks is still tightly linked to the interest income trend. The weight of fees is gradually increasing, but still offers only partial coverage in the event of a decline in interest income. The restrictive policy pursued by the central bank has had a negative impact on the margins of banks, due to the time lag at which repricing was carried out.

After removal of the 12% cap on interest rates on deposits, liquidity tensions, especially for smaller banks, are expected to ease. However, higher rates could lead to an increase in the cost of credit, especially for the smaller institutions, which have grown rapidly in the real estate sector and in equity market trading[54]. The interest income downtrend is forecast to continue also due to increasing competition.

[54] It should be said that the central authorities have warned banks to limit lending destined to equity market transactions, while at the same time acknowledging the difficulties in verifying the destination the bank loans issued.

Operating costs are estimated to grow, fuelled by the updating of IT systems, the improvement of infrastructures, the launch of new recruiting and staff training schemes, new hirings, and the opening of new ATMs and branches.

Profitability and capital ratios.

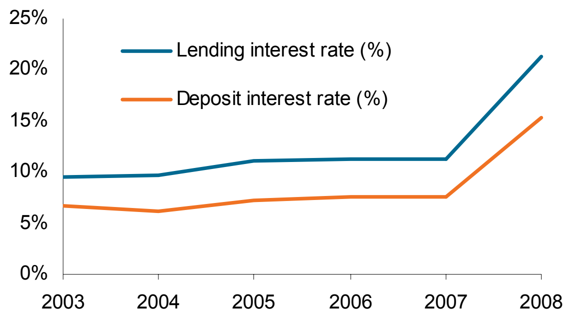
	2004	2005	2006	2007	2008E
Interest rate spread (lending minus deposit rate) (%)	3.55	3.88	3.55	3.70	6.00
Net interest income/assets (%)	3.0%	3.0%	3.1%	3.3%	3.5%
ROA (%)	na	na	1.18**	1.72**	na
ROE (%)	na	na	21.25**	26.83**	na
Equity/Private sector Credit (%)	13.4%	12.0%	13.6%	16.0%	16.2%

*Source: SBV. IMF. EIU. Note: * 2008 EIU forecasts. **average for the six major banks.*

According to S&P. the sharp rise in interest rates has reduced the capacity of many borrowers to repay debt. Therefore. the rating agency expects negative repercussions on credit quality. first in the consumer credit segment. then in the other categories of loans.

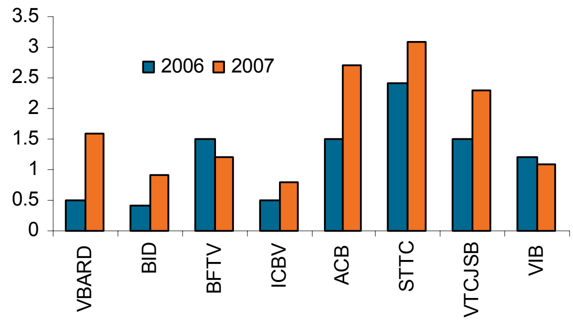
The SBV has recently stepped up minimum capital requirements. also with the aim of encouraging a consolidation process in the system[55].

Interest Rate Spread



Source: EIU and Intesa Sanpaolo elaborations

ROA (%) of major state-owned and private banks



Source: Fitch.

The country’s four major banks**,** born as spin-offs of the SBV, traditionally operate in the sectors they are named after. They were often used to finance public programs addressed to state-owned companies, but are increasingly oriented to the retail market. In view of their privatisation, they have been focusing in particular on improving their capital ratios, asset quality and accounting/transparency. Recently, their ownership has been transferred from SBV to a separate entity (State Capital Investment Corporation) controlled by the Ministry of Finance, in order to avoid conflicts of interest. This entity intends to dispose of part of the assets, with the aim of attracting the major international banks as strategic shareholders.

As regards current liquidity tensions, the rating agencies do not seem concerned about state-owned banks, which hold a very strong position on the deposits market, and which could benefit from a new flight-to-quality phase. Compared to private competitors, the category has access to broader sources of financing,

[55] According to the most recent rules, joint-stock banks must have a capital of VND 1 trillion (USD 60Mln) starting in 2008, and VND 3 trillion (USD 185Mln) starting in 2010. Half of the country’s joint-stock banks are estimated to meet these requirements. State-owned commercial banks, on the other hand, must have a minimum capital of VND 3 trillion starting in 2008.

even at the international level. Deposits growth (of around 22% in 2007), fuelled loans growth. Bad loans have decreased, but the quality of loans is lower compared to private banks[56]. Based on IFRS, doubtful loans add up to around 6% for state-owned commercial banks (SOCB), with Vietcombank showing the worst ratio, of 14.4%. The difference between IFRS and domestic VAS parameters is being reduced (also as a result of the introduction of qualitative aspects in VAS), although data show that weakness is felt most by the banks with the largest territorial networks, such as Agribank. Capital as a percentage of total assets was 5.6% at the end of 2007, and 7% of loans on the same date. Therefore, capitalisation is weak, given the quality of loans portfolios, the fragility and volatility of results due to macroeconomic and financial tensions, and weakness at the institutional level.

Private banks, mostly active in metropolitan areas, are divided by the Asian Development Bank into three subcategories: the five largest, among which Techombank, Sacombank and ACB, each with an international bank as a minority shareholder (HSBC, Australia and New Zealand Banking – ANZ, and Standard Chartered respectively); another 19 banks with very strong growth rates in market niches, and 12 small banks. The leading private banks can boast balanced accounts with a solid deposits base, generally stronger than that of smaller banks, supported by the presence of foreign shareholders and by a more diversified funding base.

Capital ratios in this category are satisfactory, with equity/loans ratios of between 13% and 21%. The quality of loans portfolios causes no reason for concern, although against a background of rising rates it could generate some worries, given the fast pace of loans growth. Profitability is still good, thanks to large volumes. In ACB's case, strong profitability in 2007 was tied to high fees, expected to be left unmatched in 2008.

The other private banks, of smaller size, seem weaker in the current liquidity crunch phase. In recent years they have financed strong loans growth by attracting deposits with high rates. The central bank has declared it has already injected liquidity into some banks. The weakness of smaller banks makes them likely acquisition targets for the larger institutions.

Top 10 banks in terms of TA (2007).

	Governance	**Total Assets (USD m)**	**NPL/ Credit 2006**	**Equity/ total assets**	**Cost/ income**	**ROA %**	**ROE %**	**Rating****
VBank for Agriculture and Rural Development (Agribank)	Public	18090	1.9	6.1	44.0	1.6	30.2	-/-/-
Bank for Investment and Development (BIDV)	Public	12518	11.9	4.3	44.1	0.9	24.4	-/Ba2/-
Bank for Foreign Trade of Vietnam (Vietcombak)	Public	12274	2.7	5.7	Na	1.2	20.6	BB/-/-
Vietnam Bank for Industry & Trade (Vietinbank)	Public	10660	1.4	6.4	45.21	0.8	14.1	-/-/-
Asia Commercial Bank (ACB)	Private *(Standard Chartered)*	5308	1.0	7.3	Na	2.7	44.3	-/Ba2/-
Saigon Thuong Tin CJSB	Private*(ANZ)*	4014	0.6	11.4	Na	3.1	27.4	-/-/-
Vietnam Technological and Commercial Joint Stock Bank	Private*(HSBC)*	2457	Na	9.4	Na	2.3	24.4	-/Ba2/-
Vietnam International Bank (VIB)	Private	2443	1.97	5.6	44	1.1	18.3	-/Ba2/-

*Source: The Banker. Moody's. Note: * foreign shareholders in brackets.**Rating: S&P/Moody's/Fitch. Vietnam's rating is BB/Ba3/BB-.*

[56] Source of data in this paragraph is Fitch, Vietnamese Banks, June 2008, p.6.

Reform under way

The central authorities have put in place numerous measures, and more are currently being discussed, to enact necessary reform in many fields: supervision, operations, but also juridical discipline, especially with regards to credit recovery procedures. The IMF estimates the overall cost of banking reform in Vietnam at 15%-20% of GDP[57] .

With regards to bad loans in particular, the first thing to do in order to implement adequate institutional response is to clearly assess the size of the problem. At present the central authorities' efforts are focused on the lack of information and on the insufficient transparency of accounting methods. Also, the creation of a "credit bureau" is being planned, with the support of the International Financial Corporation (World Bank).

New legislation in the sector is currently being prepared, to regulate the role and functions of supervisory authorities, as well as the operating modes of banks. The most important measures will concern 1. the independence of the SBV; 2. the reform of the monetary market, and therefore of the secondary bond market; 3. on the financial market front, transition to regulations modelled on the British system as of 2010; 4. starting in 2010, the establishment of a body charged with the management of currency reserves[58].

At the operational level, the freedom of setting rates and competitive terms is also being called for as desirable for state-owned banks. Indeed, most of the banks' earnings still derive from interest income (with relatively low margins compared to Vietnam's Asian peers), and an adequate diversification of income sources could increase their ability to face cyclic lending slowdown phases. In 2006, for instance, all banks, and state-owned banks in particular, were encouraged to set a cap on deposit rates, in order to avoid their escalation and a compression of margins.

On the supervisory front, there are plans to change the current relationship between the SBV and Vietnam's commercial banks. At present, the central bank is at once the supervisory authority and a shareholder in several banks, giving rise to obvious conflicts of interest. The revision plan provides for the disposal of shareholdings held by the SBV, which would be charged exclusively with banking sector supervisory functions, and defining monetary policy.

As regards insurance on deposits, introduced in 2000, coverage is guaranteed up to VND 50Mln (around USD 3,000).

Financial Markets

Equity markets

As has been the case in other Asian countries, Vietnam's financial markets have developed rapidly over the past few years. The most significant stages of the process in Vietnam were the establishment of the State Securities Commission

[57] The IMF has welcomed the authorities' measures to cool the market, but in the meantime has stressed the urgency of banking system reform: "The new possibilities for financing through the capital market, JSBs, and foreign-owned banks have increased the urgency of banking system reform. The staff welcomes the government's plans to accelerate the equitisation of the main SOCBs, and urges it to offer adequate scope and incentives for participation by foreign strategic investors.", IMF, Country Report, No.07/387, December 2007, p.19.

[58] See Moody's, Bank for Investment & Development of Vietnam, Credit analysis, June 2008.

(SSC) in 1995, and of the two stock markets, the Ho-Chi-Minh City Securities Trading Centre in 2000, and the Hanoi Securities Trading Centre in 2005, still mostly made up of companies of modest size. In May 2007 the HOSTC was transformed into the Ho Chi Minh City Stock Exchange (HOSE).

Legislation governing listing requirements, information transparency, and supervision, is being gradually aligned with international standards, although the process is still incomplete. Particular attention has been devoted to financial intermediaries, a precondition for the development of the equity market. In recent years broker/dealers have rapidly increased in number: from 14 at the end of 2005 to around 60 at present. The maximum stake foreign investors may acquire was stepped up from 20% to 30% in 2003, and to 49% in 2005. It should also be considered that the operations of joint ventures formed by local and foreign companies, are limited to 49% for foreign partners (a cap which should be raised to 100% in 2012).

The most recent measures eased listing requirements (in 2003), and introduced tax incentives for listed companies (2006). As a result of these incentives, the number of listed companies increased from 30 to 106 in 2006 alone, and then to 138 in 2007. The daily turnover rose to USD 50Mln. In 2007 trading accounts, both domestic and foreign, also surged[59].

Main stock market indicators

	2004	2005	2006	2007
Market capitalization (% GDP)	0.5	1.1	22.8	43.0
Number of listed firms HOSTC/HOSE	26	32	106	138
HASTC	-	9	87	115
Turnover (USD mln -HOSTC daily average)	na	na	8.3	50
Turnover (capitalization x)	na	0.3	0.3	na
VN Index	241	307	752	927
HASTC Index	-	91.3	243	324
Performance (% change, dong)		27	145	23
m.i. MSCI Emg.	13	32	26	30
Investment funds	1	1	21	29
Securities companies	13	14	55	78
No. of investors' accounts	21.616	29.026	130.000	330.000
– Institutional	193	257	400	500
– Foreign	207	427	1.650	8.140

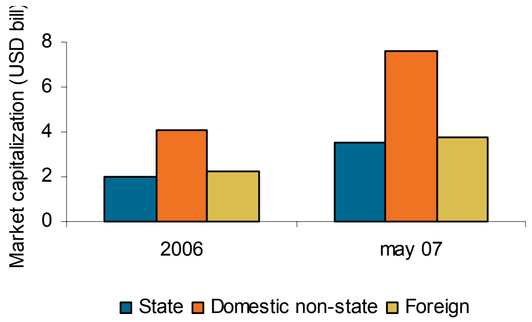
Source: SSC and financial press. Note: MSCI = Morgan Stanley Emerging Markets Index.

Market capitalisation grew from around 1% of GDP at the end of 2005 to around 23% a year later. In 2007, capitalisation rose to 43% of GDP. The market is still markedly concentrated: the top 10 shares account for around 60% of capitalisation.

The presence of foreign investors is significant. accounting for around 30% of the market's value. whereas domestic investors represent 90% of total investors and 50% of the markets value. Total flows generated by Vietnam funds worldwide were estimated at around USD 6Bn in mid 2007.

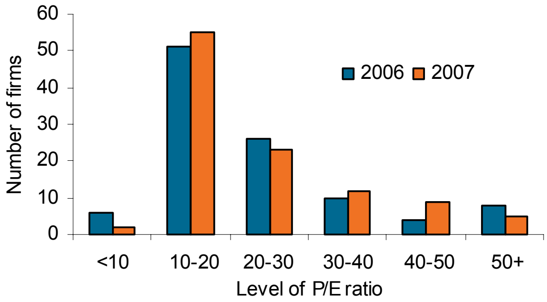
[59] See Vo Tri Thanh, Pham Chi Quang, p. 27.

Market capitalisation: breakdown by ownership



Source: HOSTC.

P/E ratio (HOSTC)



Source: HOSTC and Intesa Sanpaolo elaborations. Earnings referred to the previous year.

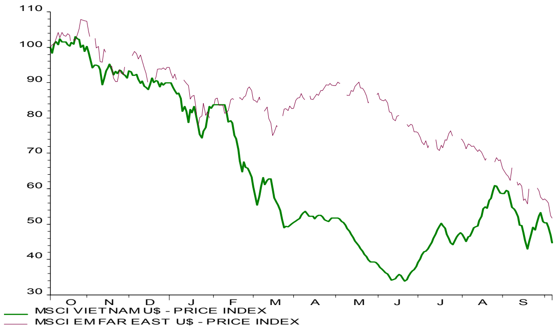
As regards performance, the VN index gained 145% in 2006, and peaked on 12 March 2007 at 1170. It subsequently traded within the 900-1100 range, and declined in the second half of the year and in 2008, due to the international crisis. The performance boom achieved between November 2006 and March 2007 was driven by fast-paced economic growth and the excellent prospects tied to WTO membership; fiscal incentives which prompted many companies, most of which state-owned, to apply for listing; and also the exuberance of foreign and domestic investors. The subsequent drop was caused, at the local level, by restrictions imposed on credit conceded by commercial banks for speculative ends, restrictive monetary policy, high inflation, and high the interest rates offered on deposits in dongs.

The market's swift growth has led to a change in strategy. In the past two years, the government has eased a number of restrictions with the aim of supporting the growth of the official market (alongside which a relatively large OTC market also exists). First of all, the cap on the stakes of foreign investors was raised from 30% to 49% in October 2005. Also, the listing of foreign companies was allowed, for instance that of Taya Electronic Wire and Cable, which has become one of the main shares on the stock list.

In January 2007 an important reform of the financial markets was approved, aimed at improving operations, with particular focus on transparency and financial information disclosure. Two of the most important innovations introduced were the distinction between brokers and asset management companies, and the awarding to the stock market of full jurisdiction over listed shares and companies. Vietnam has a State Securities Commission, controlled by the Ministry of Finance, which, however, is also an issuer, and may therefore incur conflicts of interest[60].

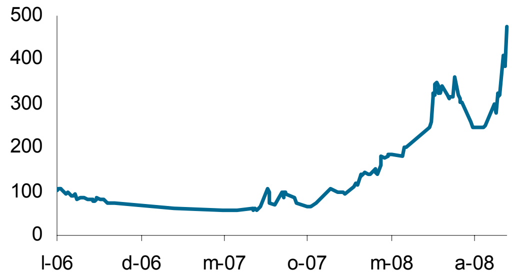
60 "The authorities are keen to improve securities market regulation (but ...) the SSC is facing serious capacity constraints, and its salary structure makes it difficult for it to attract and retain a sufficient number of adequately-qualified staff. In addition, the existing legislation includes weak penalties against insider trading, and there are concerns that the stock market can be easily used for money laundering": cfr. IMF, Country Report, No.07/387, December 2007, p.15.

MSCI Vietnam and MSCI Far East indices



Source: Datastream. MSCI = rebased Morgan Stanley Emerging Markets Index

Vietnam: 5Y CDS



Source: Reuters.

Over the next few years, as the financial crisis is overcome, a significant increase in the number of listed companies is expected. Around 2,000 companies are traded on the OTC market, with an estimated market capitalisation of between five and ten times that of the official market. Around 3,000 state-owned companies have been transformed into public limited companies, with part of their capital subsequently sold to private investors, as part of the so-called "equitisation" process[61]. This marks the first step towards the listing of these companies, which mostly belong to the transport, telecom and banking sectors. The government has created a specific body, the State Capital Investment Corporation, with the assistance of Singapore company Temasek, to manage the capital of this group of companies.

The P/E distribution of the companies listed on the HOSTC shows that the majority falls within the 10-20 range. However, most companies had a P/E ratio of over 30 in 2006 and 2007. The IMF has stressed that the index is rather high[62], whereas the World Bank does not view it as "abnormal"[63]. It should also be considered that data are not fully reliable, due to accounting manipulation issues[64].

Bond markets

The bond market – mostly made up of government bonds (85%) – has grown to a significant size, and was worth around 10% of GDP at the end of 2007; however, it is still marred by several weaknesses. At the end of 2007, 570 bonds were listed (551 at present. Source: Reuters). Vietnamese bonds are suffering because of the international crisis, as proven by the CDS upswing.

Among other issues, the bond market lacks an adequate set of rules, an efficient judiciary system, and, most importantly, an efficient and trustworthy clearing and settlement system.

61 "According to a public announcement plan, there are about 2100 SOEs at present, of which about 1500 have been or will be equitised over 2006-2010. this suggests also that close to 80 corporations and large firms will have to go public. Moreover, 550 SOEs were to be equitised in 2007. However, in 2007, only 65% of these SOEs were successfully equitised" in Vo Tri Thanh, Pham Chi Quang, Managing Capital Flows: The Case of Viet Nam, ADBInstitute, Discussion Paper n. 105, May 2008, p. 31.

62 See IMF, Report on the Article IV consultation in Vietnam, August 2007.

63 World Bank, Taking Stock – An update on Vietnam's Economic Development, 2007.

64 See Vo Tri Thanh, Pham Chi Quang, cit.

There are no limitations on the purchase of bonds by foreign investors. Trading in this segment is still modest, and although the liquidity of bonds with a maturity of less than five years has improved, a liquidity risk still exists on longer maturities. Long-term bonds, which account for around 40% of the total, are purchased by insurance companies and held to maturity, whereas the remaining 60%, largely comprising 5Y bonds, are held by the major state-owned banks. Individual issues tend to be of modest value, also due to the fact that they are carried out every 3-4 months based on the “raise-as-you-go” rule.

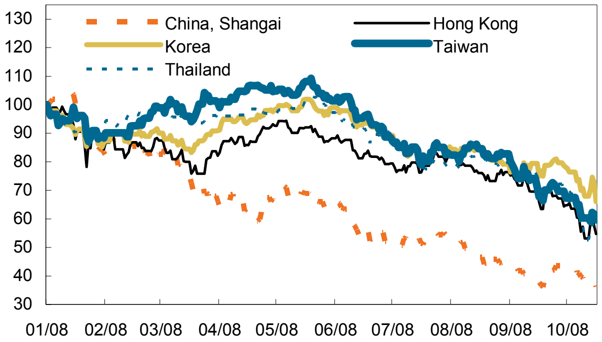
The government has mostly issued bonds to finance infrastructures (transport, water supply systems, and schools). In recent years the major cities have also issued bonds to finance local infrastructure projects. Another frequent issuer is the Vietnam Development Bank (VDB), which finances long-term public investments.

On the corporate front, the issue of corporate bonds increased and amounted to USD 500Mln in 2006. The largest issuers are Vietnam Electricity (currently with two issues outstanding) and the banking sector (Bank for Investment and Development of Vietnam, and VETCO) with 12 bonds currently outstanding.

Davidia Zucchelli

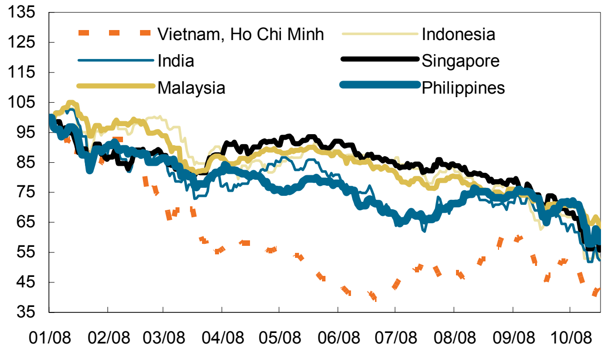
Vietnam and Financial Markets

Stock exchanges – Indices rebased on 01/01/08



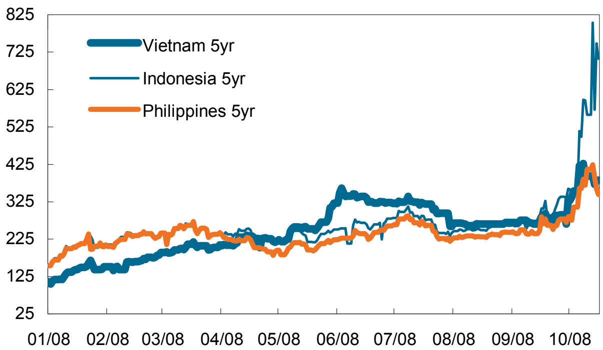
Source: Bloomberg

Stock exchanges – Indices rebased on 01/01/08



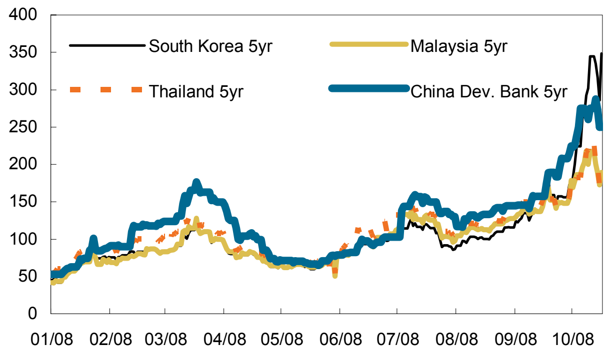
Source: Bloomberg

CDS spreads



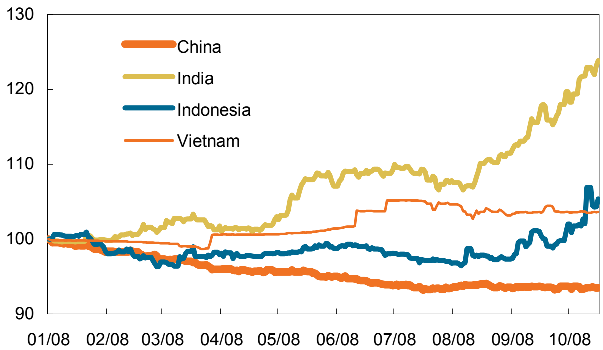
Source: Bloomberg

CDS spreads



Source: Bloomberg

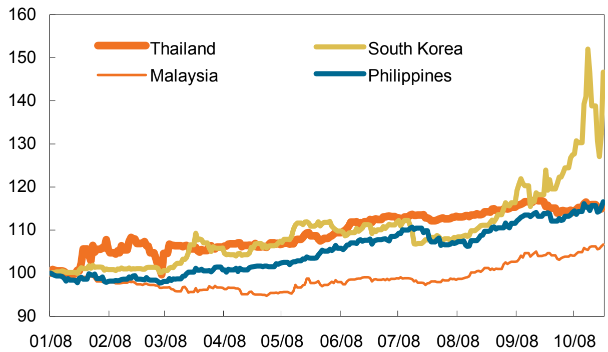
Exchange rates vs USD (rebased on 01/01/08)



Source: Bloomberg

Prices on 16.10.08.

Exchange rates vs USD (rebased on 01/01/08)



Source: Bloomberg

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