

TAKING STOCK

**An Update on Vietnam's
Recent Economic Developments**

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INTER-BANK EXCHANGE RATE: US\$ = VND 19,832

GOVERNMENT FISCAL YEAR: January 1 to December 31

ACRONYMS AND ABBREVIATIONS

ASEAN	Association of Southeast Asian Nations
CAD	Current Account Deficit
CPI	Consumer Price Index
E&O	Errors and Omissions
EAP	East Asia and Pacific
EU	European Union
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GSO	General Statistic Office
IAS	International Accounting Standards
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IFRS	International Financial Reporting Standards
IFS	International Financial Statistics
IMF	International Monetary Fund
KAS	Capital Account Surplus
LCI	Law on Credit Institutions
MOF	Ministry of Finance
MPI	Ministry of Planning and Investment
NPL	Non-performing Loan
ODA	Official Development Assistance
REER	Real Effective Exchange Rate
SBV	State Bank of Vietnam
SOE	State-Owned Enterprise
VAT	Value Added Tax
WTO	World Trade Organization

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Table 1A: Gross Domestic Products

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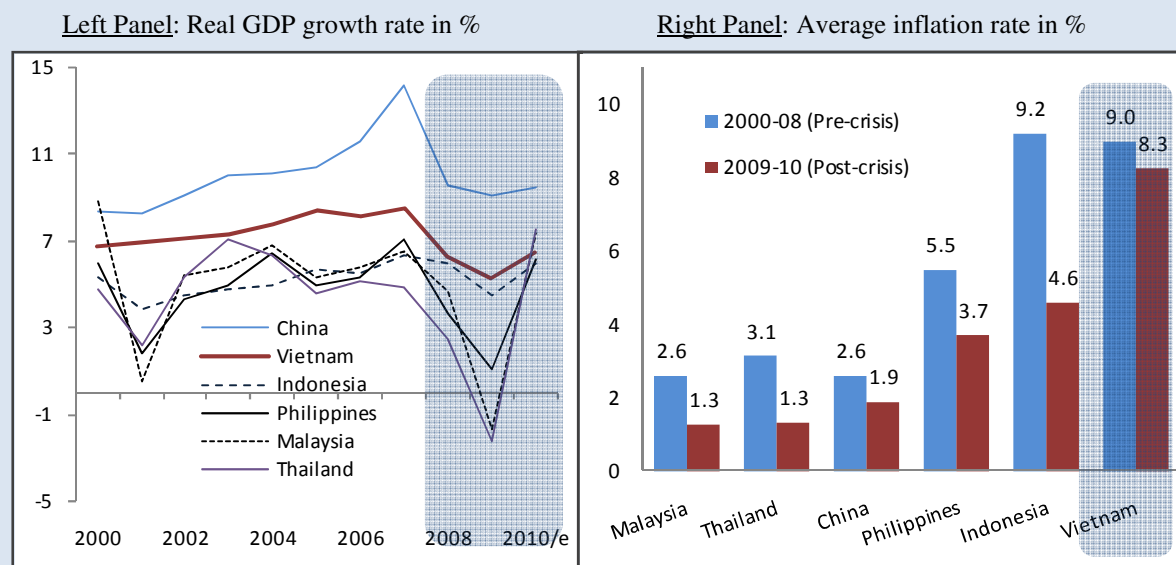
Table 3A: Import Value and Growth

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I. Rapid Growth Amidst Rising Risks

1. In the post-global economic crisis environment, Vietnam's economy continues to grow at a reasonably rapid and stable rate. While the speed of global economic recovery has been uneven across the world, Asia as a region has done particularly well. And within Asia, Vietnam's growth performance continues to be impressive. As shown in left panel of figure-1, Vietnam was one of the fastest growing economies in the East Asia and Pacific (EAP) region prior to the global economic crisis and has remained so in the post-crisis period as well¹. After registering a real GDP growth of 5.3 percent in 2009, Vietnam's economy is expected to grow between 6.5-6.7 percent in 2010. Vietnam, like China, stands out not only for achieving a higher average growth rate but also a more stable growth path. This however has meant that the speed with which the Vietnam's economy is bouncing back from the lows of 2009 appears to be less impressive than countries that experienced negative growth last year.

Figure 1: Vietnam's economy is growing impressively, but so are some of its macroeconomic problems



Source: World Development Indicators(2010)

Note: The growth and inflation projections for 2010 are based on EAP Update, October 2010 (World Bank).

2. The impressive growth performance has however been accompanied with increased macroeconomic risks. The first signs of problem can be traced back to 2007 when Vietnam experienced an unprecedented surge in external capital flow in the wake of its accession to WTO, fueling a credit boom and an asset price bubble. The problem since then has been

¹ The comparison here is between Vietnam and some of the large countries in the East Asia Pacific region (in terms of population) – China, Indonesia, Malaysia, Philippines and Thailand – that are categorized as ‘middle income country’ by the World Bank.

compounded by series of external shocks – global commodity price rise in 2008, global financial and economic crisis in 2009 and sovereign debt crisis in Europe in 2010. Vietnam now finds itself in an unenviable position of having the highest inflation rate in the EAP region – 6.5 percent in 2009 and between 10-11 percent in 2010 (see right panel, figure 1). Along with high inflation, it also has to cope with pressure on its currency, falling level of foreign exchange reserves, an underperforming stock market, high sovereign spreads and a relatively high current account deficit to GDP ratio compared to other fast growing economies in Asia. So Vietnam, despite being one of most dynamic countries in the region, finds itself an exception to the broader emerging market trend of stronger currencies, robust capital inflows and rising foreign exchange reserves (also see figure 1A of the Annex).

3. This edition of ‘Taking Stock’ – a semi-annual publication from the World Bank² – attempts to understand the recent macroeconomic changes in Vietnam like the ones discussed above. It documents changes to the macroeconomic outcomes and policies with a view to inform policy discussions in the country. The analysis is mostly retrospective in nature, though discussions on prospective challenges and outlook are also briefly mentioned. Developments in the global economy in general and in the EAP region in particular are juxtaposed against Vietnam’s own economic outcomes and policies to provide a more complete and nuanced picture of the issues.

II. Underpinning of the Recovery Process

4. Vietnam’s growth rate this year is likely to surprise on the upside. The Government has set a real GDP growth rate target of 6.5 percent for 2010. In the first nine months of this year, the economy has grown at a rate of 6.5 percent, compared to 6.3 percent and 4.6 percent in the same period in 2008 and 2009 respectively (see Annex 1). With both domestic and external demands appearing to be stronger in the fourth quarter this year than in the previous two years, the annual growth rate in 2010 is likely to surpass the 6.5 percent target. On a related front, 2010 is also the year when Vietnam’s nominal GDP will exceed US\$100 billion, coming on the heel of the 2009 achievement of per capita income exceeding US\$1,000.

5. The growth slowdown in 2008-09 and subsequent recovery in 2010 can be largely explained by what has been happening to Vietnam’s tradable sectors, i.e., manufacturing and commodities. As shown in the left panel of figure 2, the growth rate of industry and construction tumbled from 10.2 percent in 2007 to 6 percent in 2008 and further to 5.5 percent in 2009, after recovering to above 7 percent in 2010. Similarly, agricultural growth fell from 4.7 percent in 2008 to 1.8 percent in 2009 and then bounced back to 2.8 percent in 2010. These large swings in

² To read previous editions of ‘Taking Stock’, please see <http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/EASTASIAPACIFICEXT/VIETNAMEXTN/0,,contentMDK:22229235~menuPK:387571~pagePK:1497618~piPK:217854~theSitePK:387565,00.html>

growth rates have coincided with initial collapse and subsequent recovery in external demand – an indication that at least in the near-term, growth in Vietnam has been constrained more by lack of external demand than by supply side considerations.

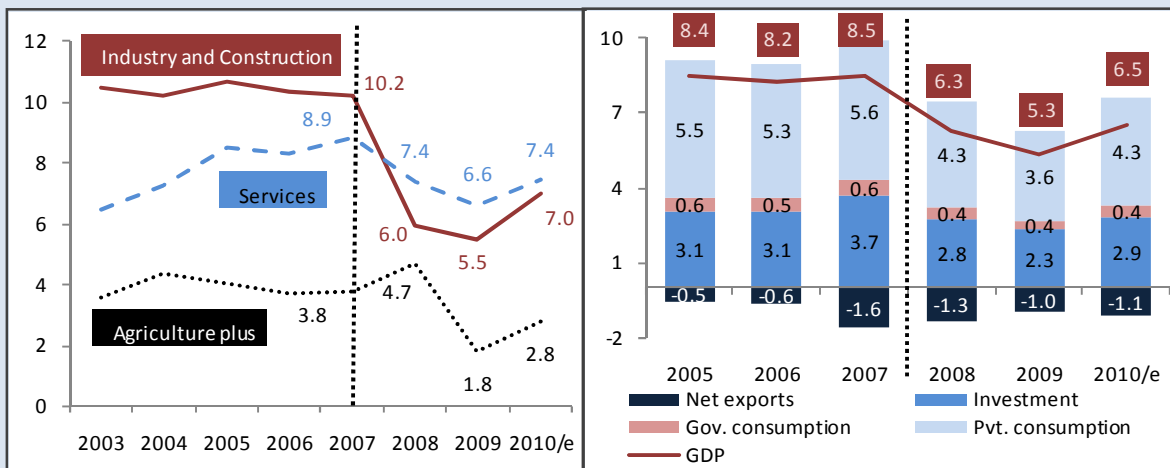
6. While agriculture and industry continue to recover at a robust pace, their growth rate remains significantly below the pre-crisis level. The value-added output in the combined agriculture, forestry and fisheries sector has expanded by 2.9 percent in the first nine months of 2010. Similarly, gross industrial output has increased 13.8 percent in the first eleven months – the turnover of the foreign invested sector has risen by 16.9 percent and domestic private sector has expanded by 14.5 percent, while that of state owned enterprises (SOEs) has grown 7.5 percent year-on-year. Despite the rapid recovery, there remains excess capacity or potential for higher production in selected sectors (e.g., fisheries, rice)³.

7. The growth slowdown in the service sector has been less visible and so has been its rebound. The sector recorded a growth rate of 7.2 percent in the first nine months of the year, due to the strong performance of retail trade, tourism, transportation and financial services. The retail sales and service index, an indicator of domestic consumption, grew by 25 percent (14.7 percent in real terms) in the first eleven months of 2010 compared with 18.5 percent in the same period of 2009. Retail and wholesale trade, which contributes about one-third of the value added in the services sector, expanded by 7.9 percent in the first three quarters of this year.

Figure 2: Contribution to growth - supply and demand side perspectives

Left Panel: Sectoral growth rates, in % (2003-2010)

Right Panel: Composition from the demand-side, in % (2005-10)



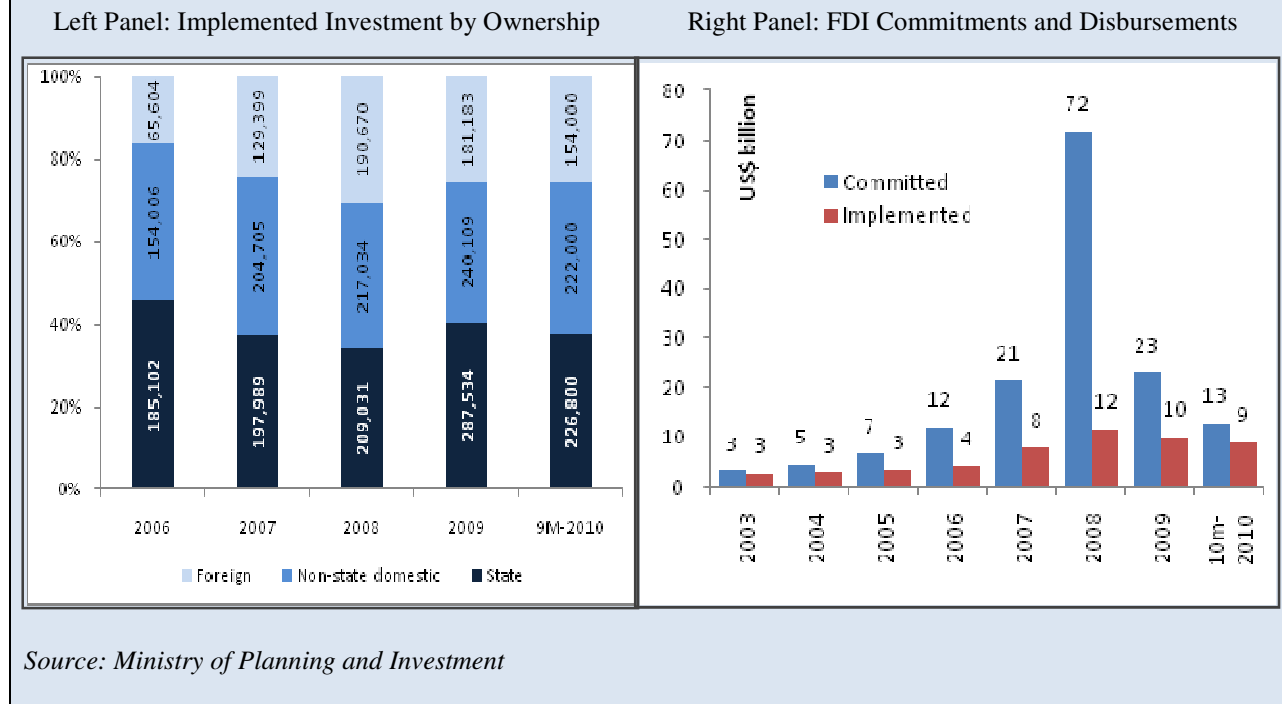
Source: General Statistics Office

Note: The estimate for 2010 is based on actual for Q1-Q3 and projection for the Q4.

³ There are however growing concerns about the long-term sustainability of commodity producing sectors in Vietnam, given their excessive reliance on natural resources and adverse consequences on the environment (see *Vietnam Development Report 2011*).

8. Private consumption and investment continue to be the major drivers of aggregate demand in the post-crisis period. The composition of aggregate demand has not undergone much shift in the post-crisis period as seen in the right panel of figure 2. With imports growing slower than exports, the contribution of net exports to overall growth has increased modestly. The large stimulus package – which took the form of low base (prime) rate, injection of liquidity through lower reserve requirements, interest rate subsidy, acceleration of public investment, reduction in corporate income tax, personal income tax and halving of VAT in selected items – seems to have provided the necessary buoyancy to private consumption and investment to grow at a healthy pace. Real government consumption has also grown rapidly in 2009 (7.6 percent) and 2010 (6.9 percent), though given its modest size relative to the overall economy, its contribution to growth has remained unchanged in the last two years.

9. The investment rate continues to be very high, raising some concerns about its quality and sustainability. Total investment rose by 19.8 percent in the first nine months of 2010. For the entire year, the government's estimate of implemented investment, which is different from the standard national accounts measure of gross capital formation, is expected to cross 40 percent of GDP. A breakdown of implemented investment shows that investment by the non-state domestic sector increased by nearly 17 percent in 2010 and now accounts for about 37 percent of total investment (see left panel, figure-3). The Ministry of Planning and Investment (MPI) reported 61 thousand new business registrations in the first nine months of 2010 with an invested capital of about 418 trillion dong, or 28 percent higher than the same period of last year. The fact that Vietnam is registering only 6-7 percent growth while investing 42 percent of its GDP – the incremental capital output ratio is closer to 7 compared to 4-5 for China and India – has become a matter of considerable concern for the authorities. Raising the productivity of capital has thus emerged as one of the key themes in the Socio-Economic Development Strategy for 2011-20.

Figure 3: Level and composition of investment

10. Though foreign direct investment continues to remain large, there are concerns about the future commitments⁴. By end of October 2010, commitment by foreign investors to Vietnam amounted to nearly \$13 billion compared to \$23 billion in 2009 and \$72 billion in 2008 (right panel, figure 3). During the same period (January-October), implemented capital increased by 7 percent, from \$8.4 billion to \$9 billion. Some of the slowdown in foreign capital can be attributed to weak global environment and continued excess capacity in certain sectors. Domestic factors like power shortage, scarcity of skilled professionals and macroeconomic instabilities are also beginning to affect investment sentiments, if not the actual decisions. However, recent improvement in Vietnam's ranking in the 'doing business' indicator does indicate that the country still remains a fairly attractive place for business from a global perspective⁵.

⁴ Committed investment captures the registered investment in the investor's 'expression of interest', while implemented investment refers to realized investment on the ground.

⁵ For details, see Doing Business Report, 2011, The World Bank.

III. Strong Revival in International Trade

A. Resilience of Non-oil Exports

11. Despite a moderation in the growth of global trade in recent months and reduced volume of oil exports because of domestic production problems, Vietnam's total exports in 2010 will exceed its previous peak by nearly \$10 billion⁶. After Vietnam's exports declined by 8.9 percent in 2009⁷ – the first time since *Doi Moi* that export growth was negative – the situation has turned around rapidly during 2010. Total exports are expected to exceed \$70 billion this year, registering an annual growth rate of around 24 percent (left panel, figure 4). This impressive performance is in spite of a significant decline in crude oil exports, driven by production capacity constraints as well as by a decline in global oil prices. As of November, the volume of oil exports had decreased by 44.2 percent in annual terms, causing export value to fall by 22.6 percent.

12. The rebound of non-oil exports has been both strong and broad-based. In 2010, non-oil exports are expected to reach \$66 billion – doubling in value since Vietnam's accession to WTO four years ago. This strong performance has been evenly spread across sectors and commodities. The top ten export items in 2010 are going to be pretty much identical to what they were in 2009 (see right panel, figure 4) – garments, footwear, oil, seafood, electronics and computers, wood products, handicrafts, rice, coal, other agriculture commodities – indicating an uniform across the board growth in the export basket. The fact that the 'other' category, which includes all items not mentioned above, is expected to register a 47 percent growth in 2010, higher than any other category, implies continued diversification of Vietnam's export basket at the margin. Thus lesser known export items such as pre-fabricated steel, transportation parts, plastic products are beginning to witness increased demand, creating opportunities for scaling-up in the future.

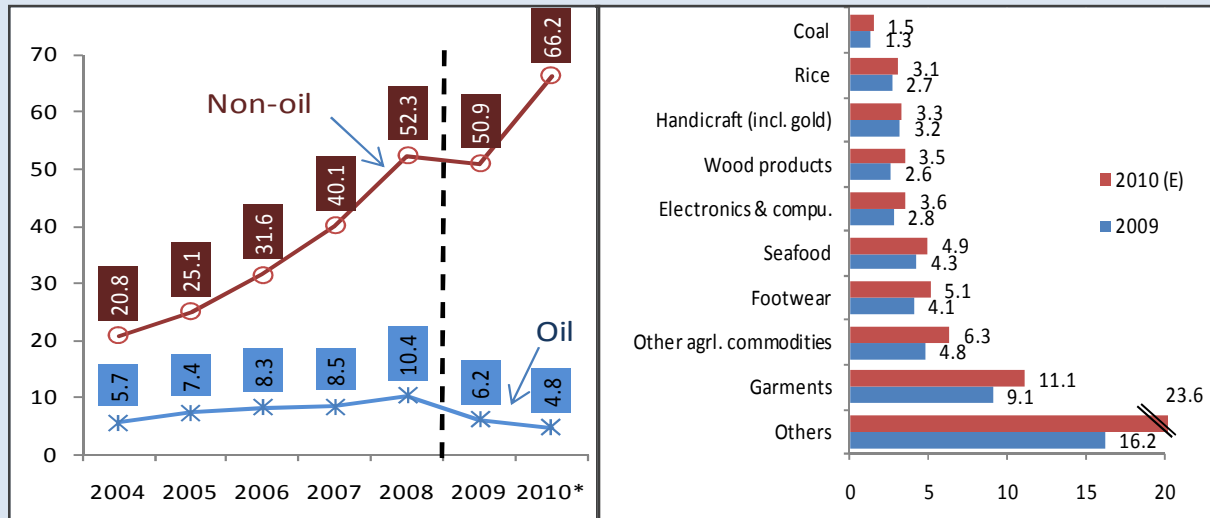
⁶ While reporting trade data we use the GOV convention of reporting exports in f.o.b. terms and imports in c.i.f. terms. But while reporting current account and balance of payment data we report imports in f.o.b. terms, as is done by the IMF.

⁷ And the decline would be larger if the sizeable gold exports of 2009 were not included in the figures.

Figure 4: Vietnam's exports performance (goods)

Left Panel: Trend in oil and non-oil exports
(in US\$ billions)

Right Panel: Non-oil exports at a more disaggregated
level (in US\$ billions)



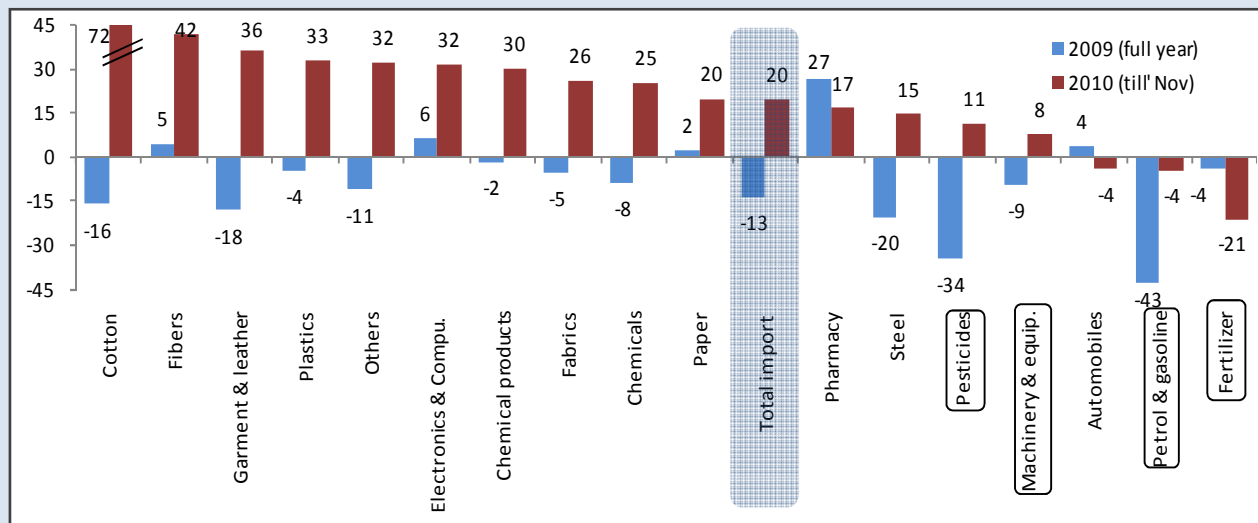
Source: General Statistics Office

Note: The estimate for 2010 is based on actual for Jan-Nov period and projection for Dec.

B. Reasonably Strong Growth in Imports

13. Imports are growing rapidly, albeit at a slower pace than their historical average and somewhat slower than exports. Imports are expected to grow by around 20 percent in 2010 compared with a negative growth rate of 13 percent in 2009. The import growth is driven by an increasing demand and by the input needs associated with export recovery. Imports for some of the raw materials and intermediate inputs for manufacturing exports, such as cotton, fabrics, garment and footwear accessories, have experienced very high growth rates (see figure 5).

14. At the same time, imports of capital goods and inputs for agriculture – machinery and equipment, steel, fertilizers and pesticides – are showing weak or negative growth (see figure 5). The slow growth of machinery and equipment imports could be a reflection of many potential developments: phasing out of the stimulus package, excess capacity in the tradable sectors, postponement of some of the investment decisions due to ongoing macroeconomic uncertainties and/or declining import contents of investment. On the other hand, the slowdown in import of fertilizers and pesticides may reflect the commissioning of some of the domestic plants and replacement of imports with domestic production.

Figure 5: Growth in non-oil imports at a disaggregated level

Source: General Statistics Office

C. Direction of Trade

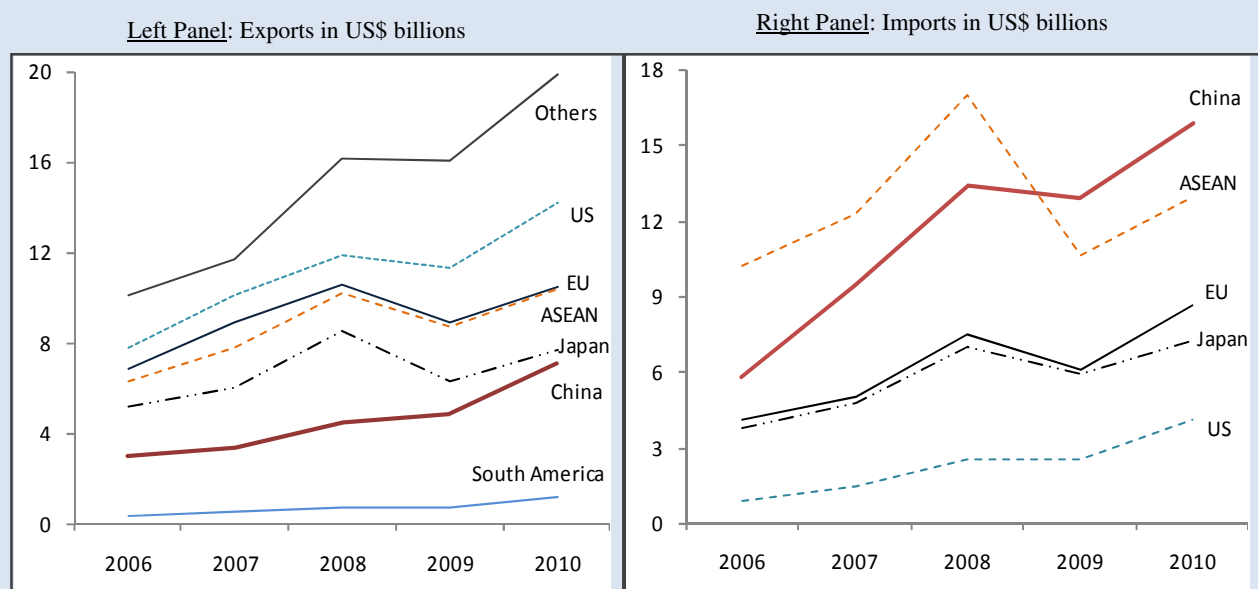
15. In 2010, China is likely to emerge as Vietnam's largest trading partner, overtaking the ASEAN countries (as a group). In the first 10 months of 2010, Vietnam's trade with China amounted to \$21.25 billion compared to \$21.3 billion with the ASEAN region. But as trade with China is growing at a much faster rate than with that of the ASEAN block, we expect China to emerge as Vietnam's number one trading partner by the end of 2010. China's share in Vietnam's total imports has risen from around 13 percent in 2004 to nearly 24 percent in 2010. During the same period, Vietnam's exports to China have also doubled – from \$2.7 billion in 2004 to \$5.4 billion in 2010.

16. Unlike many countries in the EAP region that have been sending an increasingly larger share of their exports to China, Vietnam continues to rely on industrialized countries for the majority of its exports. Among trade partners, the United States continues to remain Vietnam's biggest export market, accounting for more than a fifth of Vietnam's total exports. It is followed by EU, ASEAN, Japan and China. Overall, industrial countries account for nearly two-thirds of Vietnamese exports. Though there has been some diversification of its export base, Vietnam still remains significantly exposed to economic downturns in the developed world. In recent years, it has been making efforts to foray into the developing world, especially countries like Brazil, India, Mexico, South Africa, Turkey and UAE, which have yielded encouraging results.

17. While Vietnam's key export markets are the developed countries, its main import sources are China and other East Asian countries. This explains why Vietnam continues to post trade

surplus with the developed countries, while at the same time runs large trade deficit with trading partners in the region. This could imply either of the two things. One, Vietnam is yet to be linked to the global production networks that end in the EAP/ASEAN region. Second, there are some global production networks, especially those involving low-cost, labor intensive products like garments and footwear, whose final stage is in Vietnam. This provides an important opportunity for Vietnam to strengthen the global supply chains ending up in its own territory as well as to use regional trade agreements such as ASEAN to become part of global production network passing through the region, including China.

Figure 6: Direction of Trade – New Markets and New Trading Partners



Source: Government Statistics Office

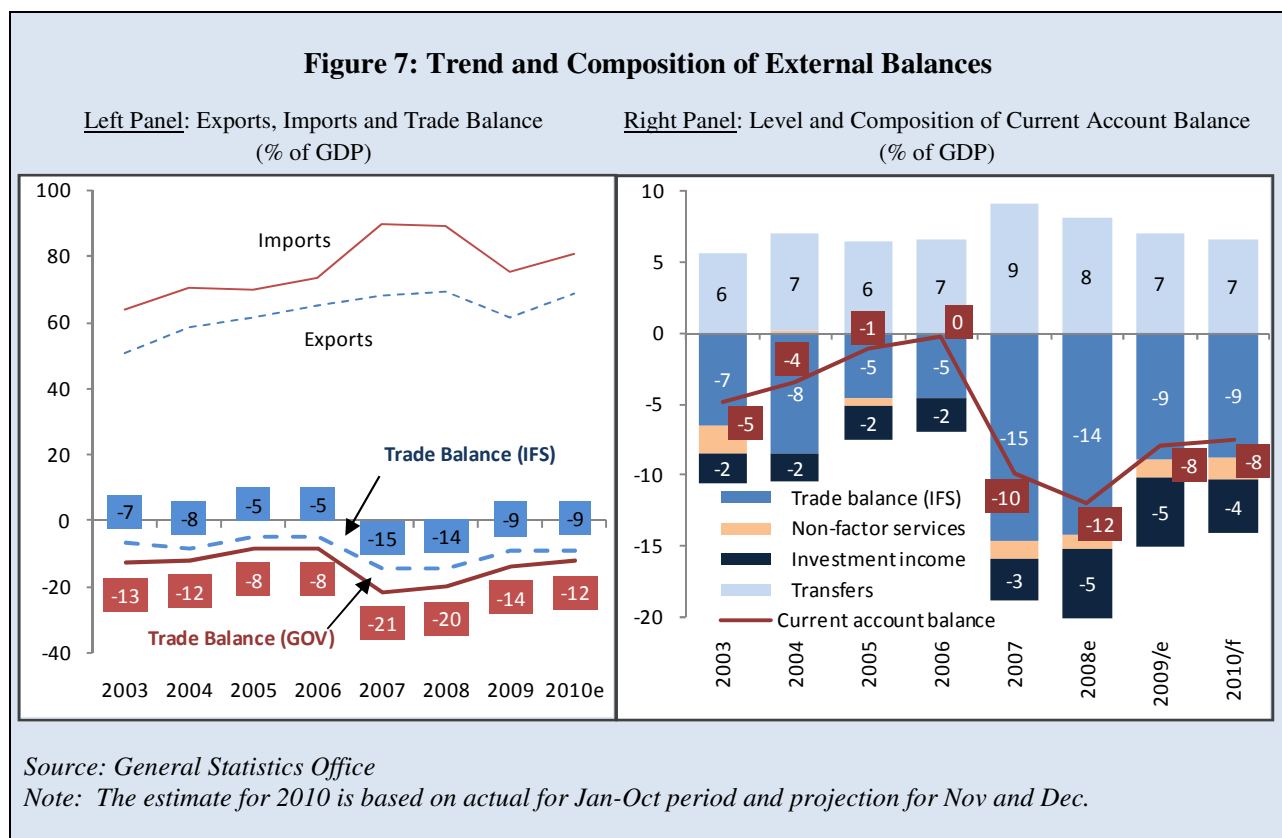
Note: The estimate for 2010 is based on actual for Jan-Oct period and projection for Nov and Dec.

IV. Moderation of the External Balances

18. After rising sharply following Vietnam's accession to WTO, the trade deficit, relative to the size of the economy, has declined in the past two years. The trade deficit to GDP ratio peaked in 2007 at 21.3 percent (GOV's definition). It fell modestly to 19.9 percent in 2008 and then declined sharply to 13.8 percent in 2009 (left panel, figure 7). In 2010, with exports growing considerably faster than imports, the trade deficit is expected to continue to shrink to around 12 percent of GDP. In absolute numbers, the decline will be much more modest – from \$12.9 billion in 2009 to \$12.4 billion in 2010. If one uses the International Financial Statistics (IFS) definition to estimate the trade deficit (which uses f.o.b. value of imports instead of c.i.f.

value as done by GOV), the size of trade deficit will be considerably smaller as shown in the left panel of figure 7.

19. Reflecting the downward trend in the trade deficit, the current account deficit (CAD) has also started to decline in the post-crisis period. High trade deficit, combined with increased payment on investment income (due to repatriation of profits by some of the foreign oil companies) led to a sharp rise in CAD in pre-crisis period. From a minor level of CAD of 0.3 percent in 2006, it shot up to 9.8 percent in 2007 and then to a peak level of 11.9 percent in 2008 (right panel, figure 7). This trend was reversed after the onset of the global economic crisis, with CAD falling to 8 percent of GDP in 2009 and is likely to fall further to 7.5 percent of GDP in 2010⁸.



20. The persistently high level of CAD in recent years has led some observers to worry about the structural nature of this deficit. There are indeed some structural changes underway in Vietnam that would affect the sustainable level of CAD. First, with Vietnam becoming a middle income country, private transfers, mainly official development assistance, are unlikely to

⁸ In estimating the current account deficit, we exclude trade in gold, since gold trade has been volatile over this period and distort the underlying imbalances.

increase as rapidly as in the past⁹. Second, domestic production of crude oil seems to have reached a plateau and will decline in outer years, reducing the volume of oil exports¹⁰. Third, with a growing stock of FDI, one would expect higher level of investment payments in future years. There also seems to be lower appetite for sovereign debt in the global credit market and rapid shifts in the global risk environment. So while Vietnam can continue to fund its CAD in the short to medium term through external private capital and official development assistance, it needs to lower the CAD to more sustainable level in the medium to longer term to help build confidence in the prospects of the economy.

V. Foreign Exchange Pressure Intensifies

21. Vietnam's currency, the dong, has been under pressure for the last three years and has lost nearly one-third of its value against US dollar during this period. As shown in the left panel of figure-8, the dong has often been trading outside the upper bound set by State Bank of Vietnam (SBV) for most of the time, starting in early 2008. Whenever the deviation between the official and free (parallel) market has persisted for a while, the authorities have responded by either depreciating the currency and/or changing the width of the band. While this strategy worked initially, it also led to expectations of future depreciations and greater uncertainty in the market. And the gradual but steady decline in the level of international reserves with the monetary authorities has added to uncertainty. Currently, the dong is trading in the parallel market around 9 percent above the upper bound, which is high, but below the 16 percent premium that prevailed in June 2008 and 10 percent premium reached during November 2009 (left panel, figure 8).

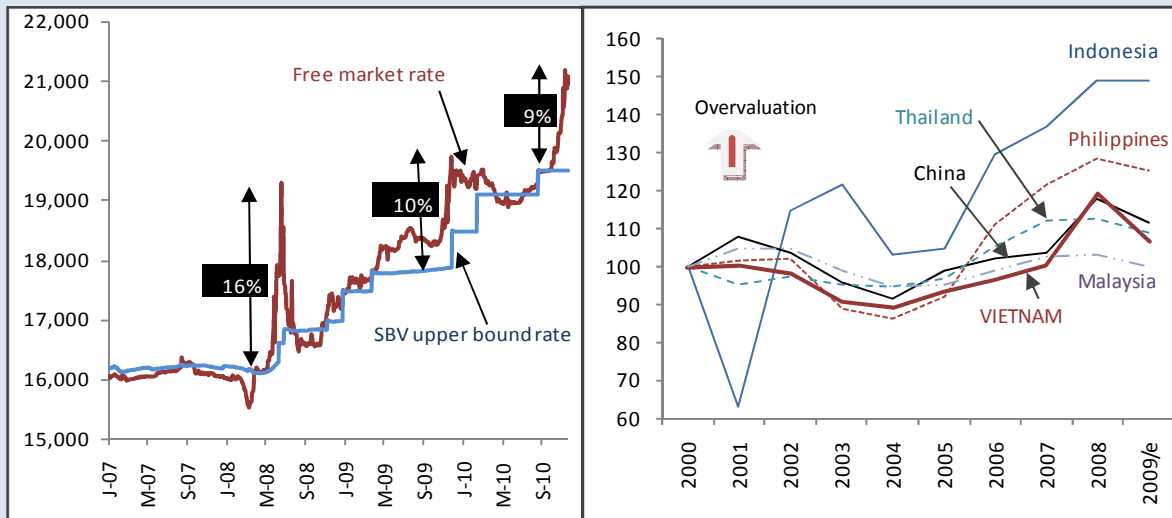
⁹ There are however important nuances to this broader trend in declining ODA. For example, since Vietnam has become a middle income country, it can now access both concessional credits (IDA) and less-concessional loans (IBRD) from the World Bank, and thereby seeing higher ODA in the short-term. However as it becomes more prosperous and more credit worthy, Vietnam will eventually lose its access to IDA and see a reduction in ODA from the World Bank.

¹⁰ This has encouraged Perto Vietnam (PVN) to explore investment opportunities abroad.

Figure 8: Movements in Nominal and Real Effective Exchange Rate

Left Panel: Nominal exchange rate between VND and USD (Deviation between official and parallel market)

Right Panel: Real Effective Exchange Rate* (Indexed to 100 in 2000)



Source: Government Statistics Office

Note: A increase in REER implies overvaluation of the currency and a decline implies undervaluation

22. Why is the dong under so much pressure? One of the potential explanations offered is that it is overvalued. However, the evidence on this front remains inconclusive. As shown in the right panel of figure-8, the extent of appreciation of Vietnam's real effective exchange rate (REER) between 2000 and 2009 is not significantly different from many of its Asian peers¹¹. In fact countries like Indonesia and Philippines, with higher level of appreciation, have not experienced pressure on their currencies anything close to what Vietnam has been undergoing. Moreover, the extent of appreciation of the dong should not have changed much in 2010, as it has already depreciated by nearly 9-10 percent against the US dollar and nearly 15-25 percent against the currencies of key countries in the ASEAN region (in the parallel market), while annual inflation rate has been around 11 percent. So clearly, mere devaluation of dong without addressing some of the underlying causes of the problem is unlikely to be an effective solution.

23. A second possible explanation offered is the high level of CAD. The fact that the two have coincided – high level of CAD and a depreciating currency – has led observers to point to large CAD as the key problem. Vietnam indeed has a large CAD compared to many of its peers in the EAP region (8-12 percent of GDP). At the same time it also has had a very large capital

¹¹ REER captures the real exchange rate of a country after taking into account the inflation differential across its trading partners. It is measured as a weighted average of bilateral real exchange rates, with each bilateral real exchange rate measured as a ratio of $\frac{E \times P^*}{P}$, where E is the bilateral exchange rate, P* is the CPI in the foreign country and P is the CPI in the home country for which REER is being estimated. Please note that REER plotted in figure 8 is the reciprocal of the above of the formula.

account surplus (KAS), around 10-14 percent of GDP. From this perspective, running a large CAD should not have posed a problem for Vietnam. And many countries in their initial stage of development do register large CAD, often financed from official donor assistance and remittances.

24. But given the high level of dollarization and a permissible domestic capital account convertible regime in Vietnam, the KAS has not always been used to finance the CAD or to build reserves. Instead, a large amount of hard currency is either being held off-shore or outside the banking system. This is reflected in an extremely large size of “Errors and Omissions (E&O)” in the balance of payments account¹². To this extent the foreign exchange problem in Vietnam is not only the result of weak macroeconomic fundamentals (high inflation, low reserves, high CAD, etc.), but also the product of an erosion of confidence among market participants in the government’s ability to address those weaknesses.

25. The reason for weak macroeconomic fundamentals and erosion of confidence can be traced to a number of cyclical and structural in the economy. The cyclical nature of the problem is to do with the monetary policy stance as discussed in Section-VIII. Effective monetary policies, anchored to an inflation objective that is comparable with rest of ASEAN countries, and better articulation of these policies along with improved disclosure of macroeconomic and financial statistics will help to address the foreign exchange problem in the short-term. A durable and medium-term solution to Vietnam’s currency problem would, however, involve addressing some of the structural issues, such as improving the efficiency of investment, raising the competitiveness of the economy, further consolidation of the fiscal accounts and completing its transition to a market economy¹³.

VI. Will Inflation Accelerate Further?

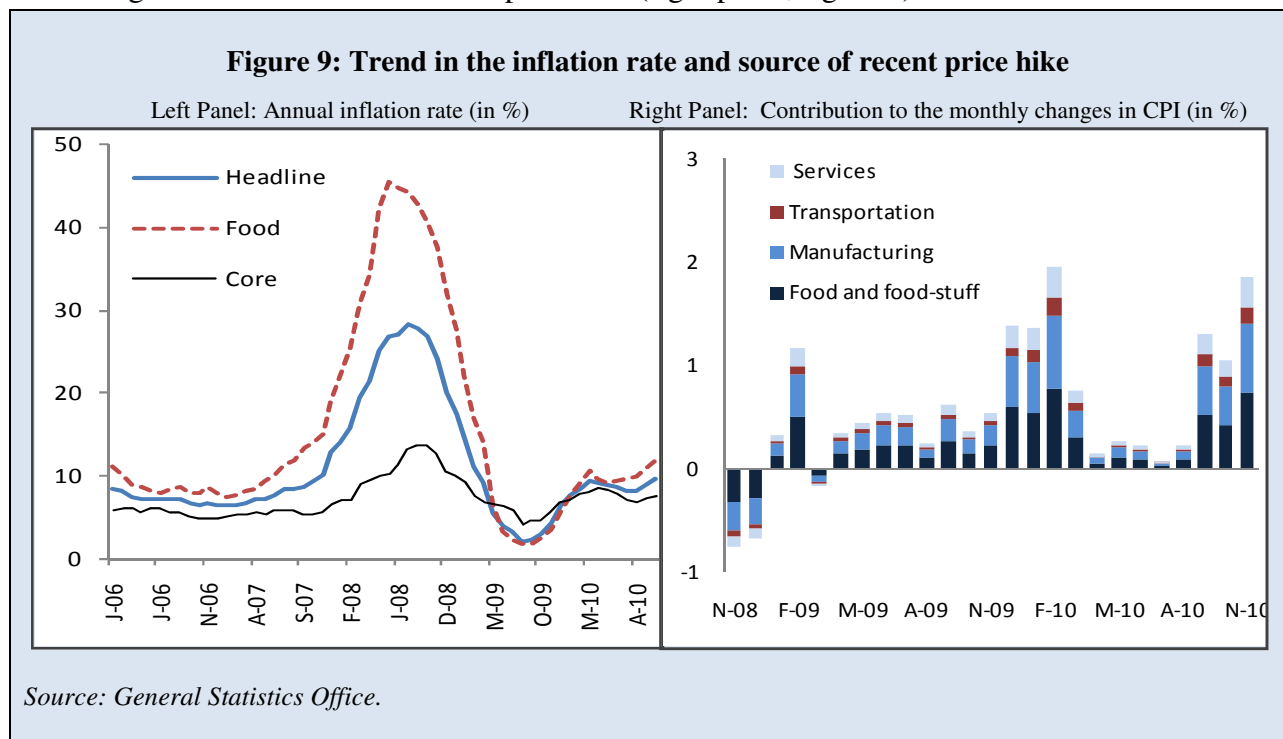
26. A higher than expected inflation rate during October and November of this year has rekindled the debate on the appropriate response to curb inflationary pressures in the economy. At the end of November, the annual inflation rate stood at 11.1 percent, while the inflation rate for the first 11 months of the year stood at 9.6 percent. The annual food price inflation is running at 14.8 percent, the highest level since April 2009. Historically, prices tend to go up during November-February period on account of higher export activities as well as the Lunar

¹² Errors and Omissions were nearly 12.2 percent of GDP in 2009 and are estimated to have reached around 5.9 percent of GDP in the first ten months of 2010.

¹³ Vietnam invests nearly 42 percent of its GDP, while its domestic saving rate is around 32-34 percent. This implies that the country relies on foreign savings to the extent of 8-10 percent a year, which by definition is (almost) equivalent to the size of its CAD. Therefore, unless the efficiency of the investment program is increased, Vietnam’s growth prospects will remain tied to the sentiments of the global economy. Similarly, raising the competitiveness of the economy would yield higher level of growth at the same level of investment and thereby ensure the sustainability of the high growth path.

New Year celebrations and therefore we expect the inflation rate for 2010 to reach closer 10.5 percent – considerably higher than the 8 percent inflation target set by the National Assembly (left panel, figure 9).

27. Rising prices of commodities and manufacturing products remain the key drivers of the recent hike in the inflation rate. Given Vietnam's open economy (trade to GDP ratio is nearly 150 percent) and a depreciating currency, the impact of rising global commodity prices has been amplified and the price of internationally tradable goods has increased. The global nature of the current inflation problem is reflected in the fact that many countries around the world have witnessed higher than expected inflation rates in recent months (e.g., China, India, and Indonesia). The domestic food prices in Vietnam have also increased due to supply shocks, including severe floods in the central provinces (right panel, figure 9).



28. Vietnam's inflation debate should, however, also be viewed from a historical perspective that shows that Vietnam has had higher inflation rate than many of its neighbors. For example, the average inflation rate in Vietnam in the last one decade is 8.8 percent compared to 2.7 percent in Thailand and 5.1 percent in Philippines. This, to some extent, may reflect the inherent bias in Vietnam's policymaking objective, which puts greater weight on achieving a higher growth target than on maintaining macroeconomic stability. Such a policy bias is then manifested through a more accommodating and variable monetary policy regime, as discussed later. And when faced with a higher than expected inflation rate, the government has resorted to administrative mechanisms – such as price controls and price stabilization funds – to keep inflation under check, though these mechanisms have been used infrequently and in extreme

circumstances¹⁴. As the Vietnamese economy becomes more complex and more integrated into the world economy, there will be a need to use more market-friendly policies to achieve the price stability objective, including greater use of competition policy and monetary policy.

29. Unlike the inflationary episode of 2007-08, the recent rise in inflation has not been associated with similar inflation in all asset classes. The stock market continues to underperform the broader economy, with VN Index yielding a negative 8.8 percent return during the first 11 months of the current year. Vietnam's stock market remains one of the worst-performing stock markets in the region. Portfolio flows were a meager \$128 million in 2009 and \$600 million in the first 11 months of 2010¹⁵, compared to nearly \$6.2 billion received during 2007. There is no reliable data to measure the national trend in real estate prices, though anecdotal evidence does point to a significant rise in real estate prices during this year. There has also been a surge in demand for gold and domestic gold prices in Vietnam have stayed higher and increased faster than the world prices after taking into account the transportation costs and relevant duties.

VII. Developments in the Banking Sector

30. After a period of rapid growth and expansion, Vietnam's banking sector is passing through a relatively challenging period. Credit growth has slowed down to 22.5 percent in the first ten months of 2010 (relative to 45.6 percent growth during 2009), though may exceed the 25 percent for the year due to usual spurt in lending in the last few months of the year. In terms of composition, the foreign currency loan growth has accelerated to 52 percent, while dong loan growth has risen at a more modest rate of 14.6 percent during the first ten months of this year¹⁶. Such an imbalance in credit growth is due to increase in dong lending rates (typically in the range of 14-18 percent per annum) compared to dollar loans (in the range of 6-8 percent per annum). This happened following the phasing out of the interest rate subsidy program and the removal of interest rate caps on dong lending (for medium and long-term loans in February and then short-term loans in April). However with dong depreciating by nearly 9 percent this year, the strategy to borrow in dollar has *ex-post* proven to be a costly proposition for many firms.

31. Total deposits in the banking system have grown in line with credit growth to reach 22.8 percent by the end of October. However, banks are finding it increasingly difficult to maintain their deposit growth and maturity structure in face of a depreciating currency. There are concerns that dong deposits are being converted into gold and dollars and there may also be a shift from medium and long-term dong deposits to short-term ones. There is also intense competition among banks to attract more deposits and the inter-bank interest rate has seen wide fluctuations in recent months.

¹⁴ See MOF's Circular 122/2010/TT-BTC dated August 12, 2010.

¹⁵ This does not include the \$1 billion sovereign bond issuance in 2010.

¹⁶ Source: National Financial Supervisory Committee and SBV.

32. According to SBV official data, the non-performing loan (NPL) ratio of the banking system has reached 2.4 percent in August 2010, compared with 2.5 percent in March 2010 and 1.9 percent at the end of 2009. In spite of a relatively low NPL ratio, the asset quality of bank portfolios remains an ongoing concern given the unusually high credit growth of the past years and developing, but relatively weak, risk management capacity in the banking sector. The size of NPL is expected to increase for a number of banks with significant exposure to the loss-making Vietnam Shipbuilding Industry Group (Vinashin). Furthermore, if international standards (IAS/IFRS) are applied, the NPL ratio of the banking sector is expected to be significantly higher. A new Circular (being drafted by SBV) replacing the current Decision 493 on loan classification and provisioning is expected to bring Vietnam's practice closer to international norms and would provide a more accurate reflection of the quality of overall bank portfolio.

33. The profitability of the banking system is likely to come under pressure this year. While a few smaller banks claim to have almost achieved their yearly profit target by end October, other banks are still struggling to meet the higher Capital Adequacy Requirements (up from 8 to 9 percent) effective since October 2010 and the higher minimum capital requirements effective next year. With fierce competition among banks for fund mobilization in the last quarter – pushing deposit rate upwards – interest income is being squeezed significantly, thereby affecting the profitability of the bank sector.

VIII. Policy Response: Growth versus Stabilization

A. *Monetary Policy*

34. In recent years, the monetary authorities have found it exceedingly difficult to balance the competing mandate given to them to support recovery and stabilize prices at the same time. Prior to the 2007, with a stable macroeconomic environment, Vietnam's authorities did not face the usual growth-inflation trade off, thereby creating a built-in bias for an accommodative monetary policy that supported rapid growth. But with Vietnam increasingly integrated with the global economy and the global economy itself going through a boom-bust cycle in recent years, macroeconomic management has reemerged as a central policy issue in many countries. This has also meant that Vietnamese authorities are adjusting to this new world economic order, and are being forced to constantly readjust and fine-tune domestic policies. Unfortunately, this has resulted in an erratic monetary policy stance, which some observers have characterized as a 'stop-go' problem.

35. With the economy on a recovery path by late 2009, the authorities adopted a tightened policy stance and shifted its priority from growth to stabilization. In November 2009, the policy interest rate was raised by 100 basis points, exchange rate was devalued by 5.5 percent and

interest subsidy scheme for short-term loans were phased out (more on this in the next subsection). But with growth slowing down to 5.8 percent in 2010 (Q1) and increasing complaints from private sector about high borrowing cost, the policy stance was reversed again by mid-2010 to give greater emphasis to growth. The authorities encouraged the banks to lower lending and deposit rates and brought down the short-term interest rates to 7 percent through large open market operations.

36. The accommodating stance continued through the third quarter of 2010 even though inflation started to creep up again. To curb price rise, the government, opted to implement a series of administrative measures. But as inflation began to accelerate further, SBV issued Decision 2619/QD-NHNN in early November to raise the base (prime) rate by 100 basis points – bringing it to 9 percent level. It also raised the recapitalization and discount rate by 1 percentage point to 9 and 7 percent, respectively. However, with interbank market rate rising to 18-20 percent in the aftermath of the base rate hike, SBV stepped in to supply the necessary liquidity and calm the interbank market. Despite a higher than expected inflation rate in November, it has decided to keep the base (prime) rate at 9 percent through the remainder of this year.

37. Given the rise in inflation rate and continued instability in the foreign exchange market, there is a need for the government to send an unambiguous and consistent message about its commitment to achieve and maintain macroeconomic stability in the near-term. This needs to be followed with necessary policy actions and regular disclosure of key macroeconomic and financial information to build credibility and trust among the market participants. With greater regional integration, there is an increasing need for monetary policy to be anchored to an inflation target which is comparable with the rest of the ASEAN countries. There is also a need to ensure consistency across various monetary policy targets – interest rate, domestic credit, money supply, etc. – and not yield to the temptation of hastily changing direction of monetary policy instruments and perpetuate the stop-go problem. The recent effort to improve the working of SBV, through a recently approved SBV law (see the next-sub section), is a step in the right direction, which needs to be nurtured and strengthened.

B. Policy Changes in the Banking Sector

38. A number of important changes in the policies and regulations announced in 2010 are expected to fundamentally reshape the working environment of the banking sector. These changes include the removal of interest caps, the revised banking laws (namely Law on the State Bank of Vietnam – SBV Law and Law on Credit Institutions –LCI), regulation on prudential ratios, higher minimum capital requirement for banks (VND3 trillion) and a forthcoming revised regulation on loan classification and provisioning.

39. The SBV Law is expected to improve the accountability, mandate and autonomy of SBV in undertaking monetary policy. The LCI is seen as enhancing the autonomy, safety and soundness of credit institutions. The removal of the interest rate caps and the issuance of Circular 13 (replacing Decision 457) on prudential ratios are expected to significantly affect the operation of the credit institutions. On one hand, credit institutions now have greater flexibility in setting interest rates, but on the other hand, are subject to the tighter prudential ratios, most notably the significantly higher CAR (i.e. 9 percent as of October 01, 2010) while facing stricter requirements on the amount of funds eligible for lending activities (although Circular 19 did lighten this requirement to some extent). The prudential requirements are expected to be further enhanced after the Circular revising Decision 493 on loan classification and provisioning is in place, possibly by end-2010. With tighter loan classification, resulting in higher reported NPL ratio and provisioning, credit institutions will face greater challenges in meeting the CAR as well as the other ratios. While the revised regulations might adversely affect the profitability of the banking sector in the short run, they will contribute to the safety, stability and soundness of the financial sector in the medium-term.

C. Fiscal Policy and Debt Situation

40. With significantly higher than expected revenue outturn and expenditure on check, the government is on course to achieve a lower fiscal deficit than planned. According to the Ministry of Finance, total budget revenues in the first 9 months of 2010 increased 34.4 percent compared to the same period last year. Meanwhile, total budget expenditure (excluding off-balance spending) is estimated to have increased by 21.5 percent, with current and investment expenditure increasing by 23.1 percent and 16.6 percent respectively. The fiscal deficit, which was budgeted to be 6.1 percent of GDP, is expected to decline to 5.9 percent of GDP in 2010 (using MOF definition)¹⁷.

41. The total government debt (including the guarantees) is expected to increase to 51.3 percent of GDP at the end of 2010 from 49 percent of in 2009. More than 60 percent of government's debt is external debt (i.e., 31.2 percent of GDP), a large part of which is Official Development Assistance in concessional terms. This also explains the relatively low level of debt servicing cost of Vietnam compared to other developing countries. The rest debt, amounting to 20.1 percent of GDP, is domestic currency debt.

42. While the level of government debt relative to the size of economy may not be large in Vietnam, the level of public sector debt – government plus the state-owned enterprises (SOEs) – is significantly larger. But domestic debts of SOEs are not guaranteed by the Government and hence not included in the standard debt sustainability analysis. Instead of being part of public

¹⁷ Accounting for off-budget activities and using international definition, the overall fiscal deficit, which was budgeted to be around 7.6 percent of GDP, is expected to decline to 6.1 percent of GDP in 2010.

sector debt, they should be considered as part of the government's 'contingent liabilities'¹⁸. In Vietnam, a large part of the SOE domestic liabilities are in the form of bank loans. The data from the 'monetary survey' shows that banking sector outstanding credit to SOEs was 33 percent of GDP at the end of 2009. Similarly, outstanding bonds issued by SOEs stood at nearly 3.2 percent of GDP at the end of 2009¹⁹. Thus the estimated gross liabilities of SOE sector at the end of 2009 are likely to be as large as 36.2 percent of GDP.

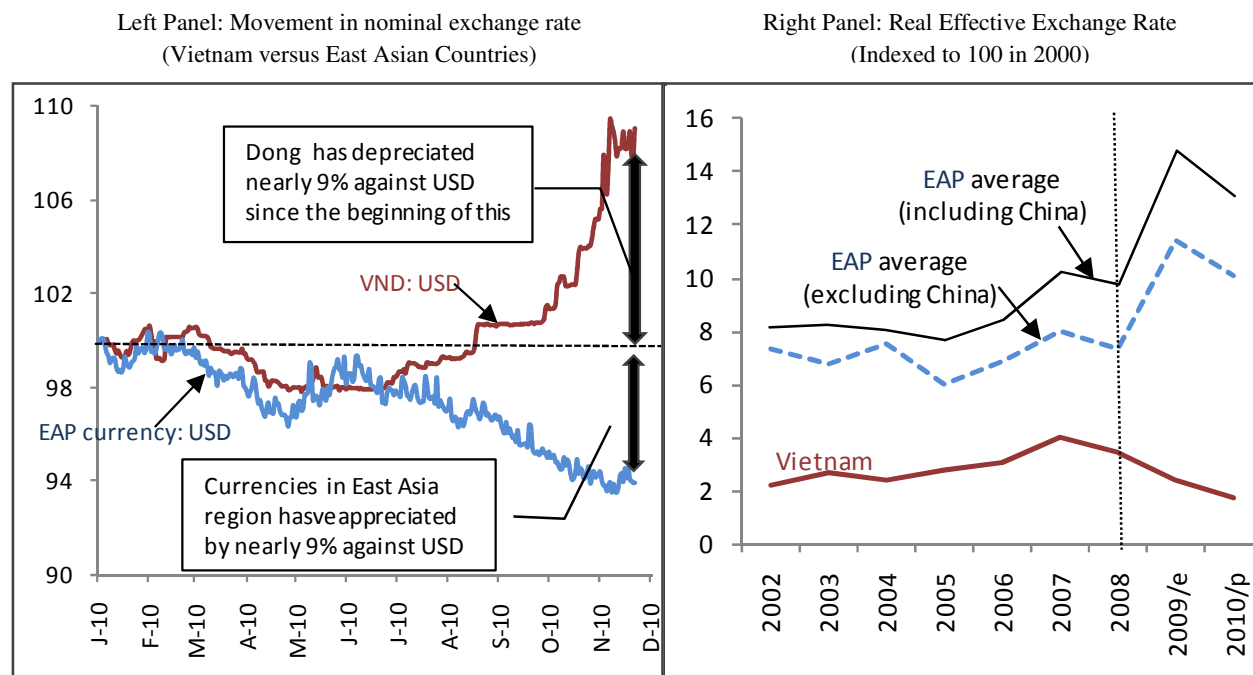
43. Going forward, there is a need to consolidate the fiscal accounts further and gradually bring down the fiscal deficit to the level prevailing prior to pre-crisis period (around 3 percent of GDP) and consistent with a sustainable level of debt. This process can be facilitated by reining on expenditure, improving efficiency of public investment and scaling up the existing medium-term budget framework being piloted in various line ministries to the national level. Collecting reliable and up-to-date information on contingent liabilities (mostly in the SOE sector) and assessing their fiscal risks – there are already some initiatives on this underway in MOF – should also be a priority. And by articulating these changes and reforms taking place in the government to the market participants and providing them with regular and up-to-date information on fiscal and debt situation would help raise confidence, lower risks and help Vietnam to raise capital at a lower cost.

¹⁸ Contingent liabilities are a moral obligation or expected burden for the government not in the legal sense, but based on public expectations and political pressures.

¹⁹ We assume that nearly one-half of the total outstanding non-government and non-corporate bond at the end of December 2009 (6.5% of GDP) has been issued by the SOEs.

ANNEX

Figure 1A: Macroeconomic problems facing Vietnam are considerably different from those faced by other countries in the regions



Source: East Asia and Pacific Update, The World Bank

Table 1A: Gross Domestic Products

	2008	2009	9M-08	9M-09	9M-10
Total GDP	6.3	5.3	6.3	4.6	6.5
Agriculture, forestry & fishery	4.7	1.8	4.3	1.6	2.9
Industry & construction	6.0	5.5	6.1	4.6	7.3
Industry	8.0	4.0	7.7	3.4	6.6
Manufacturing	9.8	2.8	10.5	2.0	8.3
Construction	0.0	11.4	-0.3	10.0	10.3
Services	7.4	6.6	7.3	5.9	7.2
Retail trade	6.3	5.3	6.3	4.6	7.9

Source: General Statistics Office

Table 2A: Export Value and Growth

	Value (\$bn) 2009	Growth (in percent)		
		2008	2009	11M-10
Total export earnings	57.1	29.1	-8.9	24.4
Crude oil	6.2	22.0	-40.2	-22.6
Non-oil	50.9	30.6	-2.7	30.3
Rice	2.7	94.3	-8.0	15.8
Other agricultural commodities	4.8	17.2	-13.1	33.0
Seafood	4.3	19.8	-5.7	16.3
Coal	1.3	38.8	-5.1	12.2
Garment	9.1	17.7	-0.6	22.6
Footwear	4.1	19.4	-14.7	25.3
Electronics & computers	2.8	22.5	4.7	28.5
Handicraft (including gold)	3.2	65.1	133.1	4.1
Wood products	2.6	17.7	-8.2	33.1
Other	16.2	44.3	-6.3	47.2

Source: General Statistics Office

Table 3A: Import Value and Growth

	Value (\$bn) 2009	Growth (in percent)		
		2008	2009	11M-10
Total import value	69.9	28.8	-13.3	19.8
Petrol and gasoline	6.3	42.2	-43.0	-4.3
Machinery and equipments	12.7	25.8	-9.4	7.6
Garment and leather materials	1.9	9.4	-18.0	36.4
Computer and electronics	4.0	25.5	6.5	31.5
Steel	5.4	31.5	-20.2	14.7
Fertilizer	1.4	47.3	-3.9	-21.3
Plastics	2.8	17.5	-4.5	33.0
Fabrics	4.2	12.7	-5.2	26.1
Chemicals	1.6	21.1	-8.5	25.3
Chemical products	1.6	24.8	-1.5	30.2
Pharmacy	1.1	22.9	26.9	16.6
Fibers	0.8	4.6	4.6	41.7
Pesticides	0.5	94.3	-34.3	11.4
Cotton	0.4	74.7	-16.0	71.8
Paper	0.8	25.5	2.3	19.9
Automobiles	3.1	57.2	3.8	-3.9
Other	21.5	28.2	-11.0	32.1

Source: General Statistics Office

Table 4A: State Budget Outturns

	2010 (<i>plan</i>)	9m-2009 (<i>est.</i>)	9m-2010 (<i>est.</i>)	9m change (%)
Revenues and grant	462	288	388	34.4
Taxes and fees	433	266	356	33.5
Capital revenues	24	18	28	55.9
Grant	5	4	4	1.4
Expenditures (excludes principal payment)	522	324	394	21.5
Expenditures on investment development	126	79	92	16.6
Current expenditures	396	245	302	23.1
Fiscal balance	-60	-36	-6	
Principal payment	45	26	41	60.8

Source: Ministry of Finance, figures in VND trillion.