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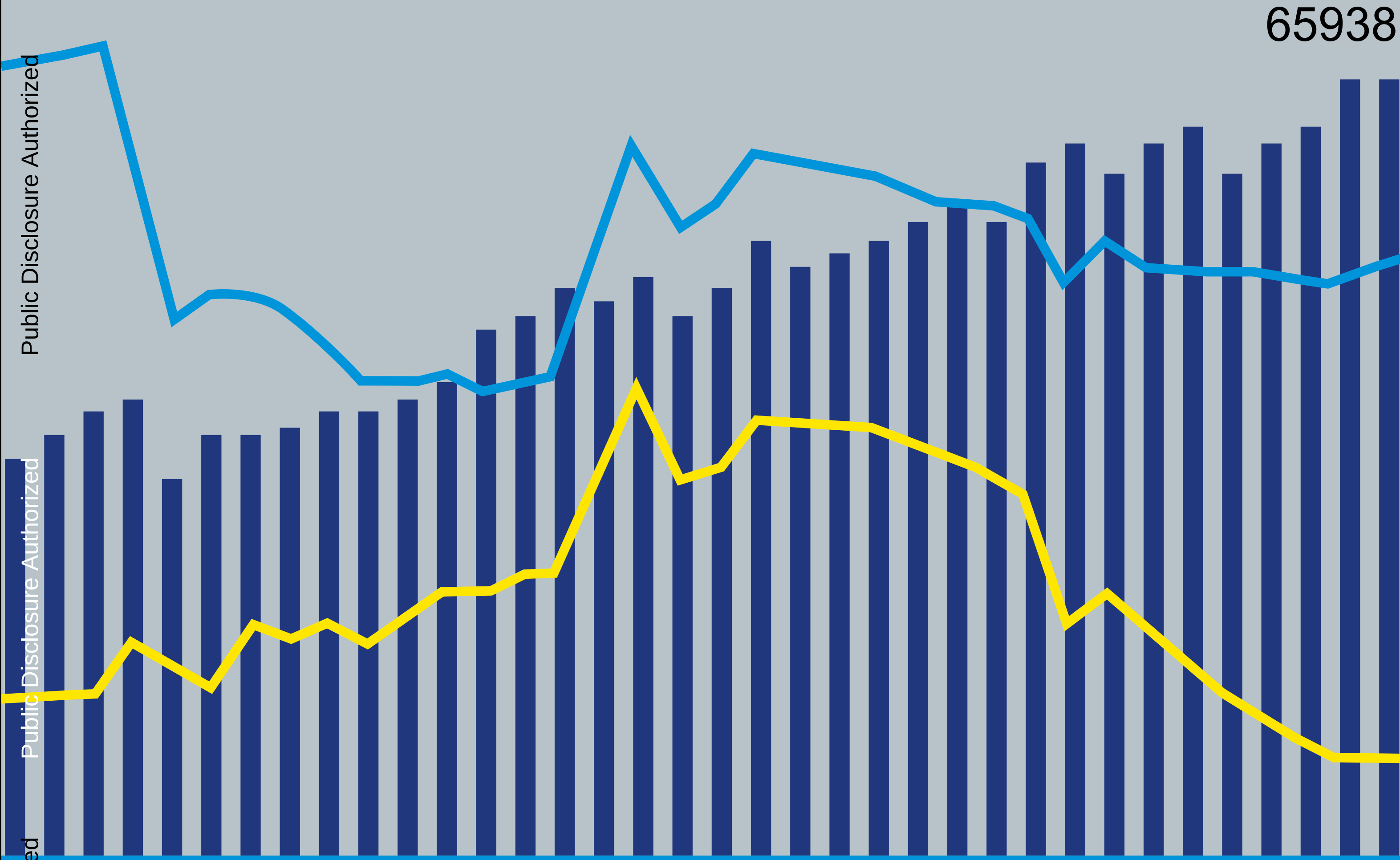

TAKING STOCK

An Update on Vietnam's Recent Economic Developments

PREPARED BY THE WORLD BANK

For the Annual Consultative Group Meeting for Vietnam

Hanoi, December 6, 2011

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GOVERNMENT FISCAL YEAR: JANUARY 1 TO DECEMBER 31

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ACRONYMS AND ABBREVIATIONS

ASEAN	Association of Southeast Asian Nations
BSA	Banking Supervision Agency
CAR	Capital Adequacy Ratio
CGE	Computable General Equilibrium
CPI	Consumer Price Index
FDI	Foreign Direct Investment
FSI	Financial Soundness Indicator
GDP	Gross Domestic Product
IFC	International Finance Corporation
IMF	International Monetary Fund
JSB	Joint Stock Commercial Bank
LIC	Low Income Country
NPL	Non-performing Loan
NPV	Net Present Value
ODA	Official Development Assistance
SBV	State Bank of Vietnam
SDR	Special Drawing Right
SOCB	State-owned Commercial Bank
SOE	State-owned Enterprise

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EXECUTIVE SUMMARY

Prospects for the global economy have become less certain in the second half of 2011, with significant increase in downside risks. Developing countries in East Asia are growing faster than developed countries, but they too are facing challenges due to a combination of reasons including: slower expansion in demand in developed countries; the impact of global uncertainty on investor sentiments; natural disasters; and the withdrawal of stimulus policies. Vietnam's growth slowed in 2011 compared to 2010, though it is still expected to reach around 5.8 percent.

Despite uneven implementation, the stabilization package (Resolution 11) has started to show results. Inflation peaked in August, and is now declining as a result of the tight monetary stance maintained throughout the year. The fiscal deficit is expected to decline in 2011 also, due more to good revenue performance than expenditure cuts. The intended adjustments to public investments and improvements in their efficiency have not yet materialized. Debates are ongoing on how to reform state-owned enterprises, though there is still lack of clarity on future policy in this area.

The external sector has remained relatively stable. The current account deficit declined in 2011, as export performance outpaced imports and remittances grew robustly. Both import and export values saw a dramatic rise, mostly because of higher commodities prices. External debt remains sustainable, as the current account deficit was more than covered through medium-term capital inflows that are largely non debt-creating (foreign direct investments) or contracted on concessional terms (official development aid). Foreign direct investment inflows continued at a steady pace, although new commitments declined. International reserves increased in the first half of the year while the Vietnamese dong benefitted from a period of relative calm. In the last quarter of the year, however, exchange rate fluctuations increased due to volatility in gold prices, deepening uncertainties and the seasonal increase in demand for foreign currency as the year end approaches.

The prolonged period of tight monetary policies in addition to recent external and domestic turbulence are putting pressure on the banking sector. Administrative measures are still pervasive and are creating additional burden on the banking system. Banks are reporting liquidity shortages, and capital adequacy continues to be an issue. The asset quality of bank portfolios remains an ongoing concern given the unusually high credit growth of the past years, high lending rates, and relatively weak risk management capacity in the banking sector. Authorities are taking a number of steps to address these concerns. An action plan for restructuring and consolidation of the banking sector is reportedly being drafted. The capacity of the Banking Supervision Agency (BSA) has been upgraded noticeably through technical assistance. An important step toward a more transparent banking system was made with the issuance of a circular enhancing information disclosure and communication of monetary policies by the State Bank of Vietnam.

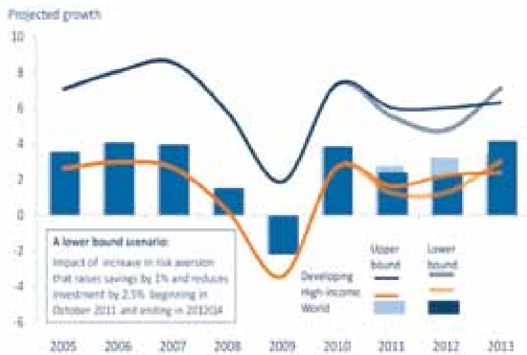
The stabilization package adopted by the Vietnamese authorities to deal with the effects of the global economic crisis was appropriate, although implementation was not uniform. Impacts from the stabilization package and continued turbulence in the global financial market are expected in 2012. The authorities could ease its reliance on monetary policy by accelerating the implementation of structural components under the stabilization package. Their effects tend to take longer to materialize, but they will ease the demand-side pressures and liquidity shortages affecting the corporate and banking sectors.

In the longer run, Vietnam's ambition to maintain high growth into the next decade will require as bold a set of reforms as the one adopted with Doi Moi. The challenge is arguably more difficult than the previous one, and few countries in the world have accomplished it. Vietnam is endowed with a young and hard-working labor force. This is a vital asset to meet the country's ambitious goals, if the country manages to equip itself with relevant skills, and match it with necessary capital. It also needs a level-playing field to maximize its potential. As people become more educated and production becomes more sophisticated, demands for predictability, trust and a level playing field will grow. Transparency is a critical element in this. Concentration of economic power in a small number of large firms undermines efforts at creating a level playing field. Large firms and industries that circumvent rules to their advantage are promoting corruption, and undermining efficiency, which damages the country's potential. The governance challenges are complex, but Vietnam's medium term outlook will be much better if they are addressed sooner rather than later.

GLOBAL ECONOMIC ENVIRONMENT

Prospects for the global economy have become much less certain in the second half of 2011, with increasing risk of a global growth slowdown. The debt crisis in Europe has intensified, and is likely to dampen consumer and business spending with negative consequences for global growth. As of September 2011, the growth forecasts ranged around 2.2 - 3.2 percent for 2012, but these projections are being adjusted down to take into account the effects of the turmoil on confidence levels. September forecasts predicted high income countries to grow at 1.2-2.2 percent and developing countries to grow at 4.8 – 6 percent (figure 1).

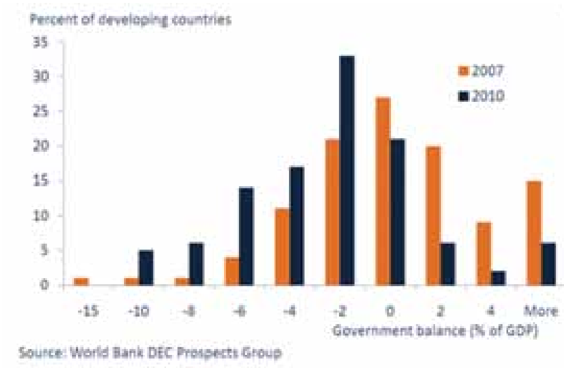
Figure 1: Uncertain prospects for global economy



Source: World Bank DEC Prospects Group

Even with robust growth rates, many developing countries are less well positioned now than in 2008 to respond to a renewed global growth slowdown. The fiscal positions of developing countries are healthier than those of high income economies, but they too have limited fiscal space to counteract a slowdown due to the stimulus policies implemented in 2008 and 2009. Before the crisis in 2007, well over half of developing countries recorded a fiscal surplus. The situation had reversed by 2009 - over sixty percent of developing countries went into fiscal deficit. More recently, over 40 percent of countries now have fiscal deficits that exceed 4 percent of GDP.

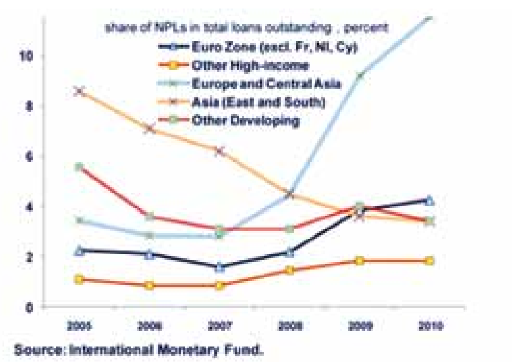
Figure 2: Fiscal position of developing countries since 2007



In 2010-2011, some economies undertook monetary policy tightening to control inflation caused in part by stimulus policies. Those that were successful in fighting inflation may have some scope for monetary policy easing, but others continue to face high inflation, or already have very low interest rates. On the positive side, many developing countries, especially in East Asia, have comfortable levels of international reserves and appreciating currencies. This gives them more options to deal with the impeding growth slowdown.

The banking sector is vulnerable to the global financial turmoil, either directly through the implications of the debt crisis, or indirectly through an economic slowdown (see the detailed discussion in the banking sector below). Particularly striking is the case of Europe and Central Asia, which saw a sharp increase in NPLs following growth slowdown in 2008 and 2009.

Figure 3: Share of NPLs in total loans outstanding



Lower demand has reduced the pressure on commodity prices; they are falling or stabilizing, albeit at a high level due to the rapid rise of 2010 and early 2011. The price of oil, however, remains high by historical standards (figure 4.1). Food prices are stabilizing. All countries will benefit from lower inflation and less volatility in the commodities market and food prices, though the net effect for producer countries may not always be positive.

Figure 4.1: Commodity prices have stabilized

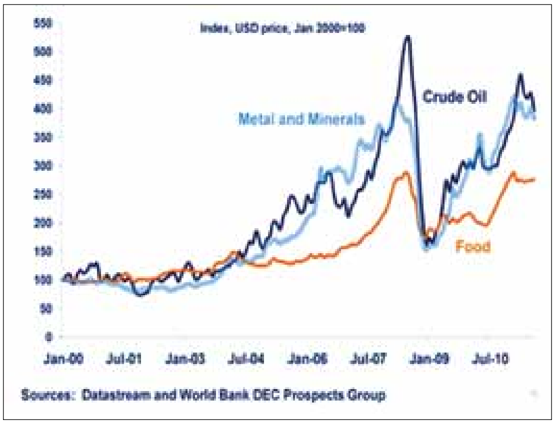
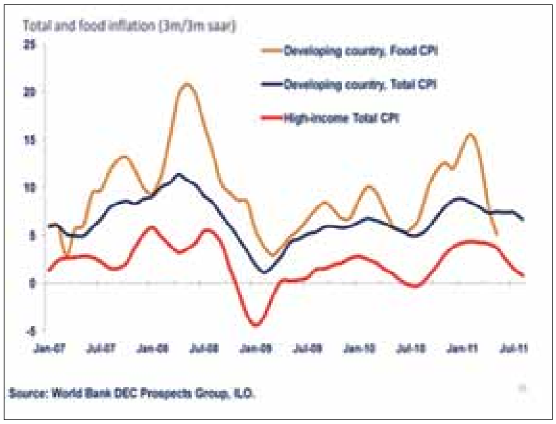


Figure 4.2: Food and headline inflation



Vietnam needs to prepare for a further slowdown of exports, trade and investment resulting from the above global developments. The situation in the financial sector may fuel an increase in NPLs, and put additional stress on banks. There is now limited scope for further stimulus. The global economic crisis has shown how vulnerable countries are to external shocks, and how fiscal positions can change quickly over a short period of time, from surplus to deficits financed by rapidly rising public debt. Vietnam is not immune to this, and external borrowing options are also becoming increasingly limited. There needs to be greater emphasis on efficiency of public investment, restructuring of SOEs, and other structural reforms even if this means some moderation in short-term growth.

REGIONAL ECONOMIC CONTEXT

Growth in developing East Asia moderated in 2011 due to a combination of reasons including: slower expansion in demand in developed countries; the impact of global uncertainty on investor sentiments; natural disasters; and the withdrawal of stimulus policies. Industrial production growth slowed, especially the parts and components exported by the major production networks to advanced economies. Growing intra-regional trade and domestic demand helped mitigate the slowdown. Mining industries are supported by growing domestic demand, and as a result, resource-rich countries are expected to grow faster than average. Real GDP in developing East Asia is projected to increase by 8.2 percent in 2011 and by 7.8 percent in 2012. China is expected to grow by 9.1 percent and 8.4 percent in 2011 and 2012, respectively, below the historic average of 10.5 percent during 2000-2007, but still well above the regional and global averages.

Table 1: Growth in East Asia Pacific

	2009	2010	2011/f	2012/f
East Asia	4.9	9.3	7.1	6.7
Developing East Asia	7.5	9.7	8.2	7.8
China	9.2	10.4	9.1	8.4
Indonesia	4.6	6.1	6.4	6.3
Malaysia	-1.6	7.2	4.3	4.9
Philippines	1.1	7.6	4.2	4.8
Thailand	-2.3	7.8	2.4	4.0
Vietnam	5.3	6.8	5.8	6.1
Developing EAP excl. China	1.3	7.0	4.7	5.3
Assumptions about the external environment:				
World	-2.4	4.0	2.7	2.8
High-income countries	-3.8	2.9	1.6	1.7
Other developing countries	-1.0	6.0	4.7	4.9

Source: World Bank

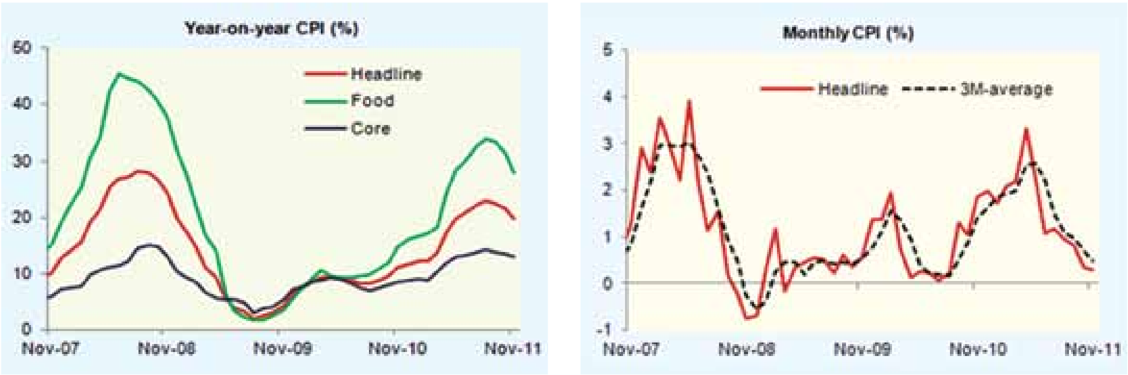
Therefore despite the slight moderation in growth, developing East Asia continues to provide strong trade and investment opportunities for Vietnam. The majority of FDI in Vietnam now comes from developing East Asia. This calls for continued efforts to invest in regional partnerships and regional infrastructure, which can potentially help to offset any effects from slowing demand in advanced economies.

RECENT ECONOMIC DEVELOPMENT IN VIETNAM

The stabilization package is starting to show results

The stabilization package adopted in early February in the form of Resolution 11, has started to bring down inflation. Monthly inflation in November eased to 0.39 percent from an average of 1.6 percent in the first ten months of 2011 (figure 5). Though year-on-year headline CPI is still high at 19.8 percent in November, inflation is clearly starting to ease. On a monthly basis, the three-month average headline inflation declined rapidly and dipped to 0.5 percent, after peaking at 2.6 percent in May 2011. Inflation is expected to fall below 19 percent by the end of the year.

Figure 5: Consumer price index



Note: core inflation excludes food, foodstuff and fuel
Source: GSO and WB estimate

Holding down the tight monetary stance

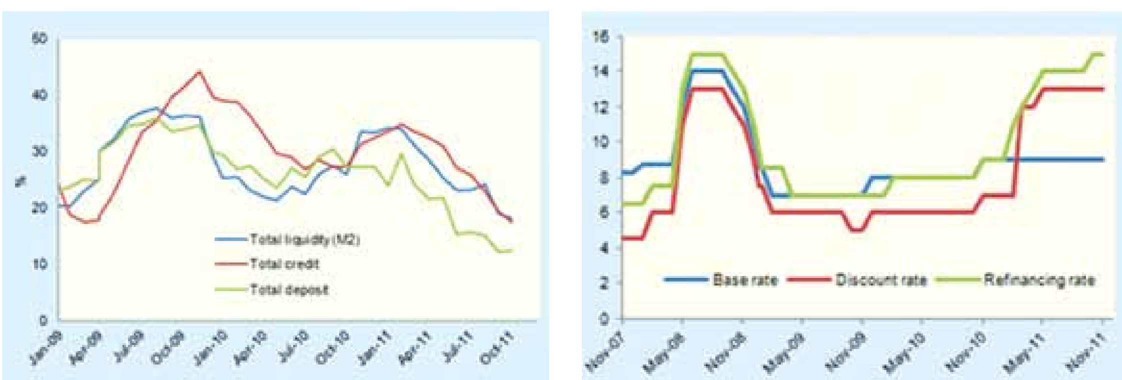
The State Bank of Vietnam (SBV) has adhered to a tight monetary stance since the stabilization package was adopted in February 2011. Rapid expansion of credit and money supply (M2) in preceding years, beyond what was necessary to support economic growth and ongoing monetization of the economy, is considered to have been one of the main drivers of inflation.

In 2010, total credit to the economy grew at 32.4 percent and M2 by 33.3 percent. For 2011, the SBV set targets for credit and money supply growth at less than 20 percent and 16 percent, respectively (figure 6). As of October 20, year-to-date growth of credit and M2 was 8.6 percent and 7.5 percent, respectively. The SBV estimates of credit and M2 growth for the year are at around 12 and 10 percent, respectively. These numbers reflect the monetary authorities' strong commitment to bring down inflation to single digit.

Vietnam's monetary policy is supplemented by an array of administrative measures, such as restrictions on foreign currency loans, different caps on dong and dollar deposit rates, and limits on foreign currency purchases. Whilst these measures may have helped to address macro instability in the short-term, they also had high compliance costs, potentially distorted incentives and interfered with market mechanisms. In the long run, such measures would reduce the effectiveness of monetary policy. Monetary policy has become more complex, requiring that the overall strategy and direction be communicated clearly and transparently. It otherwise creates uncertainty for banks and other market participants. For example, soon after Resolution 11 was adopted, SBV set an interest rate cap for Vietnamese dong and foreign currency deposits, and a ceiling for bank loans to non-productive sectors, mostly real estate and securities trading. In early September, the SBV advised lowering of lending rates and encouraged commercial banks to concentrate on providing credit for production, agriculture and rural development, export and import of essential goods, and for small and medium enterprises. It also imposed a strict ceiling rate of 14 percent on Vietnamese dong deposits. The monetary authorities have indicated that these administrative measures will be removed as soon as stability is restored in the market.

Figure 6: Key monetary aggregates

(year-on-year change in percent)



Source: SBV

GDP growth is lower but picking up speed

GDP growth is expected to be lower than projected at the beginning of the year, due to stabilization policies and the global financial crisis. In the first nine months of 2011, GDP grew by 5.8 percent compared to 6.5 percent in the same period of 2010 (Table 2). However, the year-on-year growth rate has accelerated every quarter, from 5.4 percent in the first quarter, 5.7 percent in the second quarter and 6.1 percent in the third quarter. The fourth quarter is historically the strongest quarter of the year in terms of output due to increased consumption and exports. The growth rate for the year is forecast to reach around 5.8 percent.

Table 2: Gross domestic product

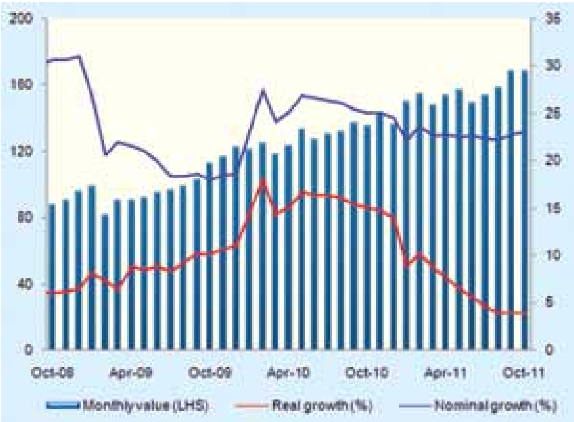
	Share	Change in percent			
	2010	2009	2010	9M-10	9M-11
Total GDP	100	5.3	6.8	6.5	5.8
Agriculture, forestry and fishery	20.6	1.8	2.8	3	2.4
Industry and construction	41.1	5.5	7.7	7.3	6.6
Industry	34.1	4.0	7.0	6.6	7
Construction	7.0	11.4	10.1	10.3	4.9
Services	38.3	6.6	7.5	7.3	6.2

Source: GSO

The breakdown of output by sectors shows that growth is reasonably well-balanced. Industry and services sectors grew robustly, contributing the most to overall growth. Growth in the construction sector decelerated to 4.9 percent. This is not a concern if it reflects corrections of overheating episodes in preceding years. On the other hand, it could be a cause of concern if the slowdown is driven mainly by liquidity constraints hitting all construction projects indiscriminately. Some projects have higher expected social and economic returns than others, and some projects are at very advanced stages requiring little more additional investments to complete. Even though the construction sector represents only 7 percent of GDP, its deceleration could have a large impact on the economy through secondary effects - the sector employs a large number of workers, including unskilled labor. It also has high domestic content in the form of cement and transportation.

The primary sector grew by 2.4 percent in the first nine months of 2011, despite periods of unfavorable weather. Favorable international commodity prices have contributed to a large increase in agro-food commodity export earnings. The Ministry of Agriculture and Rural Development has estimated that paddy rice production in the Mekong River Delta in 2011 will increase by nearly 1.3 tons compared to 2010 and reach the highest level ever. As a result, Vietnam's rice exports will likely exceed 7 million tons for the calendar year, equivalent to about one fourth of national production. In the coming years, improving product quality and food safety, adding value to primary commodities, and improving natural resources management could lead to higher incomes for farmers, and a significant contribution of the sector to overall economic growth, as it represents approximately 22 percent of the economy. Other commodities such as coffee, rubber and cashew nuts have seen their export earnings grow due mainly to the price effect (see the discussion in the export section).

Figure 7: Retail sales



Source: GSO

On the demand side, the picture is less robust. The retail sales index, a proxy for consumption and hence an indicator of consumer confidence, grew only by 3.9 percent in real terms (year on year), more slowly than real output. It shows a declining trend since the beginning of 2010, although it has stopped falling in recent months (Figure 7). Consumers are likely to be suffering from high inflation and volatility, especially in the prices of food. The non-state sector accounts for nearly 90 percent of total retail sales and services in Vietnam, and as such, it is one of the indicators to gauge the health of private sector activities.

Price effects buoyed exports

High commodity prices helped both oil and non-oil export value to increase by 34.6 percent, despite a moderate increase in volume due to the global economic slowdown. This performance is unlikely to be repeated in 2012 when international price of many commodities are expected to fall. The volume of Vietnamese exports could hold up relatively well as its exports face relatively inelastic demand.

In spite of production capacity constraints, the value of oil exports is still strong as a result of high prices so far this year. As of October, oil export volumes increased at an annualized rate of 6.7 percent, but earning from oil exports rose by 53.5 percent. The increase in the value of oil exports in the past few years was driven almost entirely by prices, rather than quantities. Oil revenues continue to be an important part of the state budget which is estimated to contribute around 15 percent of total budget revenues of 2011.

Table 3: Export value and growth

	Value (f.o.b, $bn)	Growth in %			
	2010	2009	2010	10M -10	10M -11
Total export earnings	72.2	- 8.9	26.4	23.3	34.6
Crude oil	5.0	-40.2	-20.0	-24.6	53.5
Non-oil	67.2	- 2.7	32.0	29.5	33.2
Rice	3.2	- 8.0	21.9	10.8	17.3
Other agricultural commodities	6.4	-13.1	35.1	29.9	52.4
Seafood	5.0	- 5.7	18.0	15.3	22.8
Coal	1.6	- 5.1	22.3	20.7	7.9
Garment	11.2	- 0.6	23.7	22.3	29.4
Footwear	5.1	- 14.7	26.0	24.8	25.8
Electronics & computers	3.6	4.7	29.9	28.0	8.7
Handicraft (including gold)	3.3	133.1	5.3	5.6	- 6.4
Wood products	3.4	- 8.2	32.3	36.2	16.2
Other	24.2	- 6.3	49.0	47.7	50.4

Source: GSO.

Non-oil exports grew by 33.2 percent in the first 10 months of the year compared to the same period last year, as other commodities also benefitted from high prices. Rice exports increased by 17.3 percent in the first ten months of 2011, helped by both the price and record high level of production. Value of coffee export jumped 59.2 percent, rubber increased 55.7 percent, and cashew nuts rose by 32.6 percent.

Figure 8: Price and value changes for key commodities

(Weighted average)

Note: Key commodities include crude oil, coal, rice, coffee and rubber.
Source: GSO and WB estimates

In the first ten months of 2011, exports from foreign enterprises increased 38.6 percent, outperforming domestic enterprises. These enterprises account for large shares in both exports (57 percent of total, including crude oil) and imports (45 percent of total). Foreign enterprises dominated manufactured exports, accounting for 90 percent of electric wires and cables, 96 percent of computers and accessories, 75.5 percent of footwear, 62 percent of furniture and 60 percent of garments.

The US continued to be the largest market for Vietnam's exports in 2011, accounting for nearly 18 percent of Vietnam's total exports (figure 9). The US market is the destination for half of garment exports, 35 percent of furniture exports and 30 percent of footwear exports from Vietnam. Total value of exports to the US increased by 19 percent (year on year). Other major markets for Vietnam's exports were EU, ASEAN, Japan, and China. Exports to Africa are still small, accounting for only 4.4 percent, but surging by 124 percent in value.

Figure 9: Principal export destinations

(share of total exports)

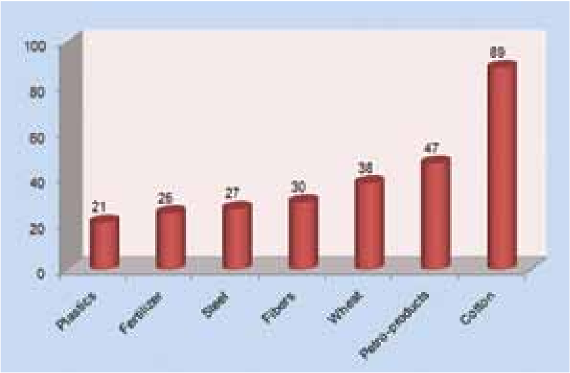
Source: GSO

Import prices were also high

The total value of imports was 27.2 percent higher in the first 10 months of 2011 compared to the same period in 2010. This was largely due to a sharp increase in import prices. Import growth may have been somewhat constrained by the import restrictions imposed by Ministry of Industry and Trade as part of the stabilization package. The rise in price was particularly severe in cotton, but also large in fuel and other inputs to production such as petroleum products, steel, plastics, fertilizer, fiber and wheat (see Figure 10).

Figure 10: Surge of import prices in 2011

(Average unit price change in percent, year-on-year)



Source: GSO

Food Price Surge and Poverty Incidence

Rising prices for exports and agricultural products brought higher income for producers in rural areas. The benefits are sufficiently large for some groups of the population to offset the adverse impact caused by slower growth and high inflation, resulting in overall poverty reduction in Vietnam. Between 2008 and 2010, the poverty incidence fell by 3.7 percentage points to 10.7 percent, measured by the national inflation-adjusted poverty line. The rates of reduction were similar in both urban and rural areas.

Box 1: The possible impacts of food price on poverty in Vietnam

The relationship between food price and poverty incidence has been examined by a recent study by Ivanic and Martin (2011). Using the VHLSS 2010 data in a CGE framework, the authors' simulation shows that a 10 percentage point increase in all food prices is likely to reduce poverty overall by around 0.5 percentage points in Vietnam. The impacts, however, differ significantly across different population strata. The benefits in terms of poverty reduction are large for households headed by farmers who account for 78 percent of the poor. In contrast, poverty incidence increases in the households headed by non-farmers, and also in those with female head as a result of a 10 percentage point increase in food prices. Poorest people tend not to benefit from increases in food prices as they are less likely to be net sellers of food. The estimated impacts also vary among geographical regions, according to the sectoral concentration of the region.

A striking result of the study is the seemingly non-monotonic relationship between food prices and overall poverty. While a moderate increase in food prices may benefit the net sellers of food and the poor as a whole, substantial rises in food prices can have adverse implications for poverty reduction because of its significant adverse impact on non-farm households.

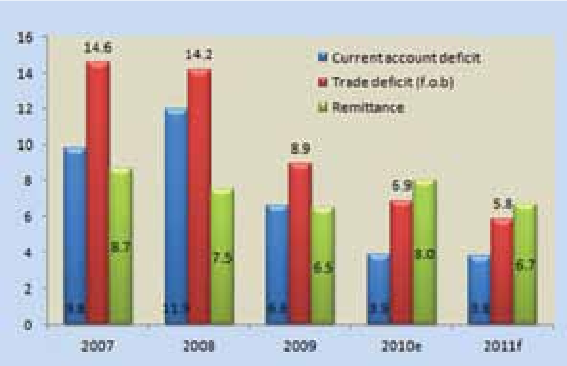
Source: Ivanic and Martin (2011), Implications of Food Price Changes for Poverty in Vietnam

Trade and current account deficit decreased

The current account deficit declined in the past three years, narrowing from 12 percent of GDP in 2008 to an estimated 3.8 percent of GDP in 2011. It has been helped by a large remittance flow from abroad, and the declining trade deficit (fob basis), which is expected to be around 6 percent of GDP by the end of this year. Vietnam is able to sustain the current account deficit, as net capital inflows, mainly in the form of foreign direct investment and ODA, are comfortably larger.

Figure 11: External balance

(percent of GDP)



Source: SBV, IMF, and World Bank estimates

Fragility in exchange rate continues

The Vietnamese dong enjoyed a period of relative stability after the government started implementing Resolution 11. The foreign exchange market appeared to stabilize after a large devaluation in February. The accompanying administrative measures, including a cap on dollar deposits and restrictions on lending in foreign currencies, probably helped in the short run, but pressures started to build due to pent-up demand. The State Bank of Vietnam purchased more than 6 billion US dollars between March and July of this year to increase the international reserves to about two months of imports.

However, the dong has started to depreciate against the US dollar again in recent months, despite robust capital inflows outpacing the current account deficit. The depreciation is attributed to weakening domestic confidence, which in turn is caused by volatile gold prices, continued inflationary expectations, and global economic turbulence. Under such circumstances, market participants tend to switch their holdings to hard currencies as they are perceived to be a safer store of value. In response, SBV has gradually weakened the dong reference exchange rate through a number of small adjustments, and intervened in the foreign exchange market in October. Pressures will rise further towards the year-end, as demand for foreign currencies will increase in the last months of the year, when settlements for imports and repayment of loans in foreign currencies tend to be bunched, though sharp fluctuations in the exchange rate is likely to be avoided.

Figure 12: Vietnam dong per US dollar exchange rate

New trends in foreign direct investment

Commitments for foreign direct investment decreased significantly in 2011, but disbursements have not slowed down since the global crisis started to unfold. Total committed FDI fell by 22 percent in the first ten months of 2011 compared to the same period last year.

Table 4: Foreign Direct Investment

(in million US dollars)

	10m-2010	10m-2011	change in %
Implemented capital	9,000	9,100	1.1
Registered capital	14,412	11,274	-21.8
Newly-registered	12,670	8,876	-29.9
Capital increase from existing projects	1,742	2,398	37.6
Number of projects			
Newly-registered	1,067	861	-19.3
Capital increase	367	264	-28.1
FDI's exports (excluding crude oil)	27,294	37,830	38.6
FDI's imports	29,643	38,892	31.2

Source: MPI

In an encouraging sign, foreign investors appeared to be shifting away from speculative real estate sector to manufacturing, which could contribute to a steady increase in employment and output.

Figure 13: Change in FDI commitment

(share of total)

Source: MPI

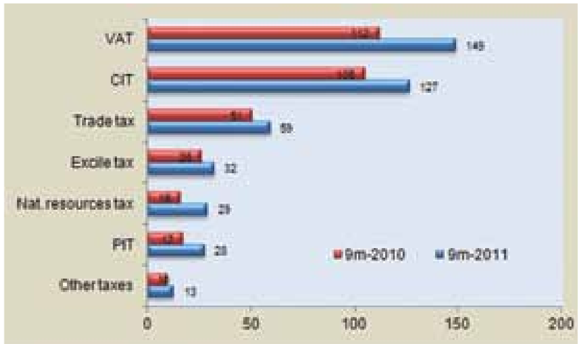
East Asian countries were the biggest foreign investors in Vietnam in the first 10 months of 2011. Hong Kong, SAR China is the largest investor with committed capital of US$ 2.9 billion, followed by Singapore ($1.4 billion), Japan ($0.9 billion), China ($0.6 billion) and Korea ($0.5 billion). In the longer term, Vietnam needs to address a number of issues to sustain its status as a truly attractive investment destination. One challenge for Vietnam is to upgrade its infrastructure, especially in areas such as power, transport and ports to which investors have often pointed as constraints. Skills of workers also need upgrading so that Vietnam could increase its value-added in the global production chain.

Lower fiscal deficit thanks to good revenue performance

The fiscal position remains manageable as a result of a significant improvement of the budget revenues in 2011. Total revenues are estimated to increase by 29.4 percent in the first nine months of 2011 compared to the same period last year: tax revenues increased by 29.8 percent, and non-tax revenues are up by 39.6 percent. High oil price has helped oil revenues to increase by 54 percent year-on-year.

Figure 14: State budget revenues by taxes

(in trillion of Vietnam dong)

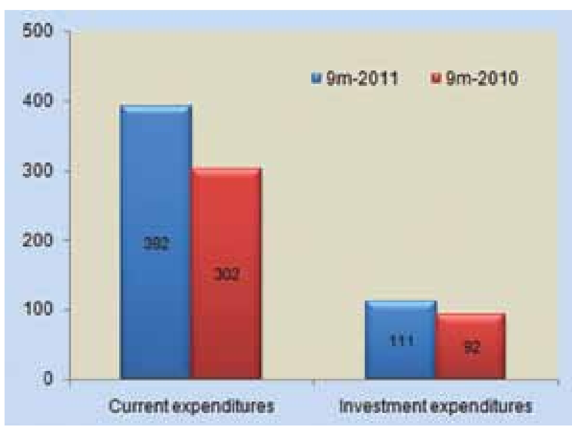


Source: MOF

The preliminary budget execution results for the first 9 months of 2011 show that expenditures grew rapidly, albeit at a lower rate of 27.9 percent compared to domestic revenues. In the first nine months of 2011, current and capital expenditures increased by 30.1 and 20.9 percent, respectively. These rates are in line with the original budget plan for 2011 (compared to original budget plan for 2010), but have not followed through on Resolution 11 commitments to cut investment expenditures by 80 trillion dong (around 3.2 percent of GDP) through cancellation of inefficient public investment projects and postponement of non urgent projects. There will be fiscal consolidation as the overall fiscal deficit is projected to be 3.9 percent of GDP in 2011, down from 6.4 percent in 2010, but more because of buoyant revenue rather than consolidation of expenditures (figure 15).

Figure 15: State budget expenditures

(in trillion of Vietnamese dong)



Source: MOF

Public debt has increased since the onset of the global crisis

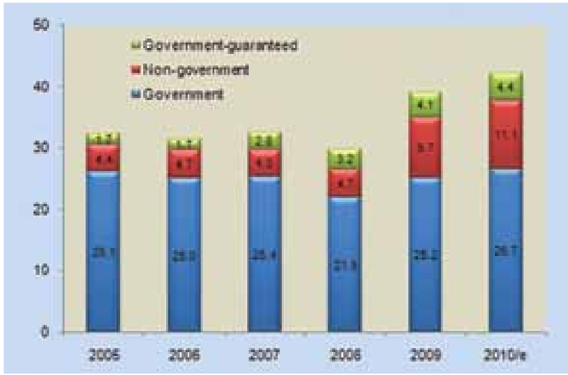
Vietnam's debt position has been historically strong but has deteriorated since the onset of the global crisis in late 2008. Public debt to GDP is estimated at 57 percent, which includes external and domestic government debt (46 percent), government guaranteed debt (11 percent), and local government debt (0.3 percent).

Vietnam's total external debt outstanding is estimated to have risen to 42 percent of GDP at the end of 2010, almost 10 percentage points higher compared to end of 2007. Most of Vietnam's government and government-guaranteed external debt is concessional with long maturities and a fairly diversified currency composition. As of end-2010, 39 percent of government and government-guaranteed external debt outstanding was in Japanese yen, 27 percent in Special drawing rights (SDRs), 22 percent in U.S. dollars, 9 percent in Euro, and 3 percent in other currencies. The government and government-guaranteed external debt stock at the end of 2009 was estimated at about 29.3 percent of GDP and is estimated to have increased to 31.1 percent of GDP in 2010.

Although external debt and debt service indicators remain below the applicable debt thresholds for debt sustainability, the global economic crisis has shown how quickly the situation can change for many developed and developing countries. Many developing countries entered the global economic crisis from a position of fiscal strength, thanks in large part to prudent policies in the early part of the last decade. However the rapid increase in discretionary fiscal stimulus has led to a build of public debt in both developed and developing countries. In industrial countries, government debt to GDP may reach 110 percent by 2015, an increase of almost 40 percentage points over pre-crisis levels. In Low Income Countries, in 2009-10 the NPV of public debt to GDP deteriorated by 5-7 percentage points compared with pre-crisis projections, and 40 percent of these LICs are already in debt distress or face a high risk of falling into debt distress *("Sovereign Debt and the Financial Crisis" – Carlos a. Primo Braga and Gallina A. Vincelette eds).*

Figure 16: Total external debt outstanding

(in percent of GDP)



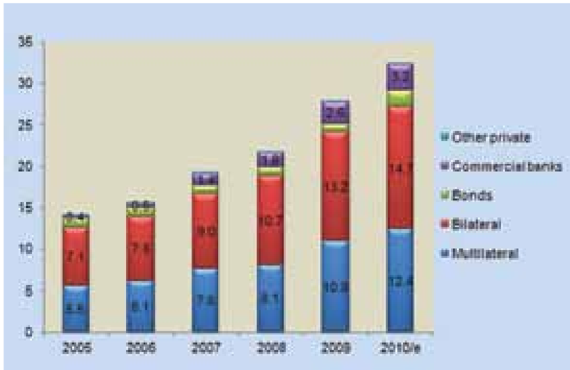
Source: MOF

Vietnam is not immune from risks of rapidly spiraling public debt. There are large sources of uncertainty and hence, unquantifiable risk, to debt sustainability emanating from implicit obligations, which are not captured under government and government-guaranteed debt statistics. "Non-government" external debt (e.g. borrowing by SOEs and private sector), which is not guaranteed by the government, has gone from 4.4 percent of GDP in 2005 to 11.1 percent in 2010.

The explicit obligation in the form of government-guaranteed external debt has risen from 1.7 percent to 4.4 percent of GDP between 2005 and 2010. Some of the more leveraged SOEs, in ship-building and the cement sector in particular, are reported to be experiencing problems servicing their debts. The government is well-aware of these risks, and is moving to strengthen monitoring and management of debt incurred by SOEs through tightening of regulations and revamping of the reporting regime. The focus should be on streamlining the reporting requirements, enhancing disclosure obligations, assessing the aggregate risks rather than scrutinizing individual borrowing decisions. There should also be more attention to improving corporate governance of SOEs in general and financial accountability in particular. These improvements would not only reduce the likelihood of debt problems arising from contingent liabilities, but also help transform SOEs into more competitive players.

Figure 17: Public external debt by sources

(in billion of US dollar)



Source: MOF

Banking sector showing signs of stress

Vietnam's banking sector has experienced difficulties due to adverse macroeconomic conditions, monetary tightening and growth slowdown. Total deposit growth rate at the end of third quarter reached 9.8 percent, but showed negative growth in September (-1.07 percent). Credit growth slowed down significantly to 8.14 percent by the end of the third quarter, primarily as a result of lower liquidity in the system and in response to SBV's policy actions. Reducing credit growth was necessary to fight inflation, but the resulting credit crunch has been difficult for banks and enterprises.

The asset quality of bank portfolios remains an ongoing concern given the unusually high credit growth of the past years, high lending rates, and relatively weak risk management capacity in the banking sector. According to official data, non-performing loans (NPL) increased from roughly 2 percent at year end-2010 to 3.2 percent at August-end 2011. NPLs are expected to increase in the coming months, as the difficult deleveraging process continues.

Exposure of the banking sector to loss-making SOEs and real estate is of particular concern. Loans to SOEs are estimated[1] at 27 percent of outstanding loans. Although credit extended by SOCBs to SOEs has declined in recent years as a share of total loans, it is likely to remain a source of vulnerability for the banking sector. The proposed changes to Decree 09/2009/ ND-CP on financial management of state enterprises and restrictions on SOEs' investments in other enterprises are welcome developments. A few small and medium-sized banks are exposed to risk related to real estate. This is reflected in the increasing number of SMEs

[1] World Bank estimates based on IMF data (March 2011).

closing,[2] and cases of firms (e.g. cement companies) being unable to honor loan repayments.

Capital adequacy continues to be an issue for not only smaller banks, but also the larger ones in both absolute amount and in terms of prudential ratios. In terms of absolute amounts, the deadline to increase the minimum charter capital to 3 trillion dong (about $143 million) by end 2010 was extended for one more year as quite a few banks were unable to meet this new requirement. In terms of capital adequacy ratio (CAR), the whole banking system was estimated to be above the 9 percent requirement. With rising NPLs and continued reporting of asset deterioration, the ratio may have weakened for some banks. Foreign strategic investors can bring much needed capital, expertise and skills to domestic banks, as in the cases of the International Finance Corporation in Vietinbank and additional equity injection to JSB Lien Viet Bank by Commonwealth Bank of Australia.

To address some of the above challenges, restructuring and consolidation of the banking sector is being discussed, and the government is reportedly working on an action plan. Many of the credit institutions are small, urban-based and have seen rapid growth in their loan portfolios. While the SBV has supported weaker banks through greater liquidity, it has hinted that some consolidation may be needed if the weaker banks are not able to comply with regulations.

The Government is making efforts to strengthen the supervisory and regulatory framework in the financial sector. Bank supervision has received support from development partners in the past year, and the capacity of the newly established Banking Supervision Agency (BSA) has improved noticeably. Nonetheless, regulation enforcement remains weak and the regulatory framework needs further enhancement in line with the Law on Credit Institution (2010). Reliance on administrative measures is still pervasive and will need to be gradually phased out in favor of more market-based mechanisms.

An important step towards higher transparency in banking system was made when the SBV issued Circular 35/2011/TT-NHNN on information disclosure and provision by the central bank. The effort to provide important information such as select financial soundness indicators (FSIs) on a regular and periodic basis is laudable, especially when the complicated and overlapping confidentiality regulations are still in effect. The circular is a good first step but more needs to be done to bring reporting and disclosure to international best practices and standards. In the coming years it would be important for SBV to further increase transparency through disclosure of more of the FSIs and other banking sector statistics (including at bank level) similar to practices of its peers and neighboring countries.

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2 According to the Ministry of Planning and Investment, for the first 9 months of 2011, 49,000 enterprises ceased operation (5,800 bankruptcy cases, 11,500 business discontinuation cases, 31,500 not being able to pay taxes). The estimate for the whole 2011 can be up to 10% of the total 600,000 enterprises.

MEDIUM-TERM ECONOMIC PROSPECTS

Vietnam's macroeconomic stability remains fragile and premature loosening of policies will risk repeating the recent pattern of recurring instability. Steadfast implementation of fiscal consolidation and structural elements of Resolution 11, including restructuring and reform of the state-owned enterprise and financial sectors should help Vietnam return to a more sustainable macroeconomic environment while laying the foundations for greater efficiency and productivity to drive medium and longer term growth. However, undertaking these deep, structural reforms will require strong leadership, diligent implementation, support from development partners, and some short-term pains. Vietnam must choose between a few difficult years of stabilization with better prospects for rapid growth versus a decade of mediocre growth amidst recurring instability.

The challenge of maintaining strong growth into the next decade will require as bold a set of reforms as the one adopted with Doi Moi. The challenge is arguably more difficult than the previous one, and few countries in the world have accomplished it within a short period of time. To this end, Vietnam must improve efficiency of resource allocation, and the State has a critical role to play, which sometimes means doing less than it does now. The State needs to relinquish the direct management of economic activities where no market failures exist, and concentrate more on its regulatory function and provision of a level playing field for the private sector. The State has a vital role in providing an environment conducive to deriving "more from less," that is, more worker and consumer welfare using less input and having less environmental impact.

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