TAKING STOCK

An Update on Vietnam's Recent Economic Developments

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ACRONYMS AND ABBREVIATIONS

ASEAN	Association of Southeast Asian Nations
CAR	Capital adequacy ratio
CIEM	Central Institute for Economic Management
FDI	Foreign Direct Investment
GDC	General Department of Customs
GDP	Gross Domestic Product
GSO	General Statistics Office
IAS	International Accounting
IFC	International Finance Corporation
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
MOF	Ministry of Finance
MPI	Ministry of Planning and Investment
NPL	Non-Performing Loan
SOCB	State-Owned Commercial Bank
VAS	Vietnamese Accounting Standards
VASS	Vietnam Academy of Social Sciences

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SUMMARY

Vietnam has navigated the global crisis better than many other countries. GDP grew by 5.3 percent in 2009, accelerating to 6.9 percent in the last quarter of the year. At 5.8 percent, the figure for the first quarter of 2010 was less impressive, but claims that growth has slowed down are most probably unwarranted. Exports declined in 2009, for the first time since the beginning of economic reforms, but their decline was smaller than in other countries of the region. By now export growth is converging back to the 30 percent annual growth rate observed before the crisis. Inflation, which had reached 19.9 percent in 2008 was down to 6.5 percent in 2009. While there were some worrying signs of inflation acceleration in late 2009 and early 2010, by now the monthly increase of the Consumer Price Index (CPI) is again moderate. And as in previous years, there were no banking crises despite the continuation of macroeconomic turbulence.

These positive outcomes owe much to the determination of the government to timely react to changing economic conditions. Over less than three years, the Vietnamese economy went from steady growth to overheating to stabilization to stimulus to rebalancing. As circumstances changed, it did not take long for government to adjust its policy stance. In some opportunities the change in course involved taking unorthodox measures, as when a compulsory bond was used to mop up excess liquidity and bring asset price bubbles to an end, or when an interest rate subsidy scheme allowed enterprises to quickly refinance debts they had contracted in excessively onerous terms. More recently, a sizeable stimulus package, combining tax rebates and exemptions with increased government spending and rapid credit growth succeeded at supporting domestic demand and sustaining economic growth. The success is all the more remarkable given that exports accounted for roughly 67 percent of GDP when the crisis hit.

Still, Vietnam could be doing better. Unorthodox measures worked, but they were costly and were often misunderstood by markets. The actual size of the budget deficit implied in the stimulus package was difficult to grasp, even for analysts with privileged access to government data. Duplications in the reporting of stimulus measures, uncertainty on which measures would have their cost falling on the budget, delays in the disclosure of budget implementation and lack of clarity on the resources available to finance the deficit amplified market uncertainty. The secrecy surrounding the level of international reserves created anxiety on the sustainability of the exchange rate policy. For most of 2009 markets were expecting a faster devaluation than was warranted. The errors and omissions of the balance of payments reached a stunning 13.1 percent of GDP, reflecting speculative foreign currency hoarding by domestic households and enterprises, including state-owned enterprises and Economic Groups. Unnecessary delays in adjusting interest rates resulted in protracted government struggling to stabilize the foreign exchange market. There has been no banking crisis, but two years of macroeconomic turbulence and policy shifts created risks for the banking system.

Meanwhile, countries which had not done as well as Vietnam in the aftermath of the global crisis were doing better in terms of attracting capital inflows. Compared to them, and in spite of the VN index growing by 57 percent in 2009, Vietnam did not receive any substantial portfolio inflows. Other countries in the region were experiencing currency appreciation as a result of their inflows, while Vietnam was struggling to prevent a faster depreciation of its own currency. And the country risk premium of Vietnam remains high compared to that countries whose overall performance in the aftermath of the crisis is certainly not better than that of Vietnam. Confidence in the dong is gradually returning, but it could have been reestablished earlier, had the government let interest rates in dong adjust to their market levels.

This gap between an above-average economic performance and a below-average appreciation by markets stresses the importance of strengthening macroeconomic management and improving communication on policy choices. Strengthened management should be reflected in a better capacity to forecast government revenue, more successful issuances of government bonds and the avoidance of unnecessary delays in adjusting interest rates. Better communication involves the disclosure of information currently kept confidential (as with the level of international reserves), of information presented in line with standard international practice (as in the case of the budget deficit, or the classification of banking sector loans) and of more frequent information (in particular, in relation to the execution of the government deficit). Better communication also requires a clear explanation of policy measures which are unorthodox or may be misunderstood by markets. The recent decision to push for a rapid decline in interest rates is a case in point. The desire for an early normalization of interest rates is understandable. But if pursued aggressively it could be easily interpreted as a return to aggressive stimulus policies, thus undermining the still frail confidence in the dong.

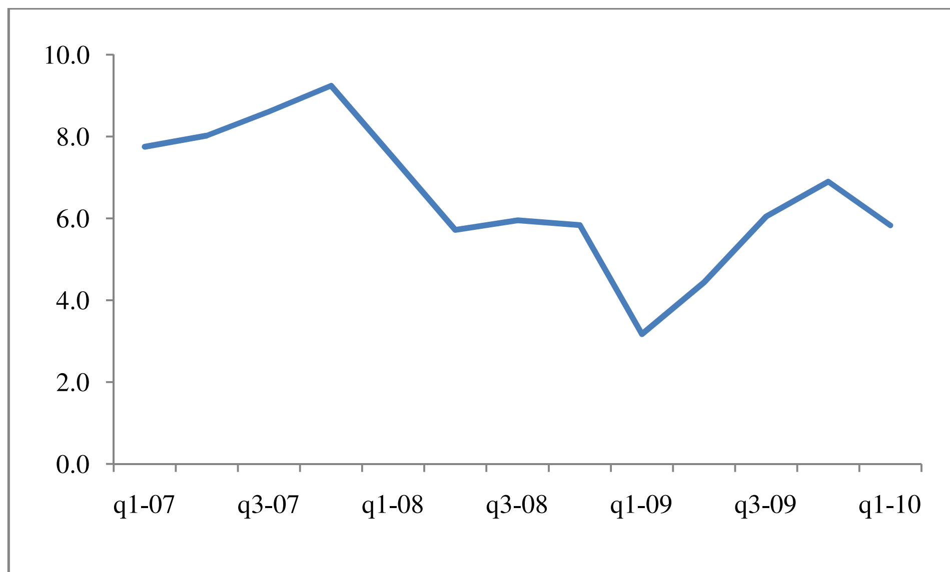
More generally, lack of clarity by markets forces the government to overshoot in its policy reactions. Because markets are not sure to understand what the government is up to, they need to see very strong action in order to be convinced that the right course of action has been taken. As a result, Vietnam has had to go through dramatic shifts in the policy stance as circumstances changed. The stabilization policies of 2008 effectively "killed" the real estate bubble and brought inflation rates to zero in just a few months, but such speed took a toll on economic activity. The stimulus policies of 2009 were equally strong and determined, but they ended up putting too much pressure on international reserves. With more information disclosure and better communication, policy shifts could perhaps be less extreme. Combined with stronger macroeconomic management, it should be possible for Vietnam to gradually free itself from the "stop-and-go" cycle that has characterized macroeconomic policies over the last three years.

EMERGING FROM THE CRISIS

In spite of the dismal growth forecasts made by many analysts and observers barely one year ago, so far Vietnam has navigated the global crisis relatively well compared to other countries in the region. By the last quarter of 2009, total GDP had expanded by 6.9 percent compared to the same period in 2008, when the crisis began (Figure 1). For the year 2009 as a whole, GDP growth reached an honorable 5.3 percent, below China's 8.7 percent and India's 7.4 percent, but above all of the other large economies in the region, including Indonesia (4.5 percent) and the Philippines (0.9 percent). For some of Vietnam's immediate neighbors the year 2009 was much tougher. GDP contracted by 1.7 percent in Malaysia, by 2.0 percent in Cambodia and by 2.3 percent in Thailand. Only smaller regional countries such as Laos and Papua New Guinea did better than Vietnam.

Figure 1: Quarterly GDP Growth

(Year on year, in percent)



Source: GSO

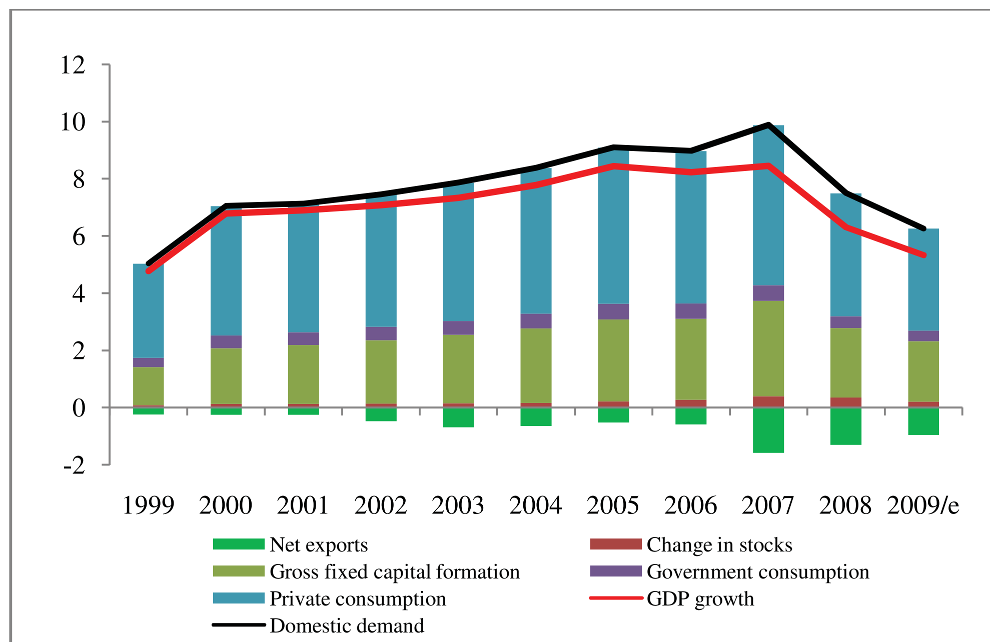
Other economic indicators were encouraging as well. The inflation rate was 6.5 percent for the year 2009 as a whole, down from 19.9 percent in 2008. Exports decreased by 9.7 percent compared to 2008, and this was the first decline since Doi Moi. However, the decline was smaller than in other countries in the region. In Thailand, merchandise exports declined by 13.6 percent, in Indonesia by 15.0 percent, in China by 15.9 percent, in Malaysia by 21.1 percent and in the Philippines by 21.9 percent. Moreover, Vietnamese imports contracted by an even sharper 14.7 percent, bringing the current account deficit down to about 7.8 percent of GDP, compared to 11.9 percent in 2008. And capital flows proved more

resilient than anticipated. Admittedly, FDI commitments fell from a record-high USD 71.7 billion in 2008 to USD 21.5 billion in 2009. However, implemented FDI is estimated to have declined by a more modest 13 percent.

A decomposition of GDP growth among its main contributors reveals the important role played by a determined government response in achieving this relative good performance. In 2009, the agricultural sector expanded by 1.8 percent, industry and construction by 5.5 percent and services by 6.6 percent. Construction led the rebound (11.4 percent) thanks to the impact of the government's stimulus measures. Total investment increased by about 15 percent compared to 2008 and accounted for about 42.7 percent of GDP. The state sector accounted for a third of the total. With imports of goods and services contracting substantially more than exports, the change in the trade balance contributed 0.35 percentage of points to the GDP growth of 2009 compared to 2008 (Figure 2). While this is a modest figure in absolute terms, the direction of the change is still positive. The fact that exports of goods and services account for about 67 percent of Vietnam's GDP had led many analysts and observers to expect a dramatically negative impact from foreign trade.

Figure 2: Contribution to GDP Growth

(Year on year, in percent)



Source: GSO and World Bank calculation

IS GROWTH SLOWING DOWN ?

As the government starts to withdraw its stimulus policies, and the global economy has not fully recovered yet, the question is whether the strong growth performance observed

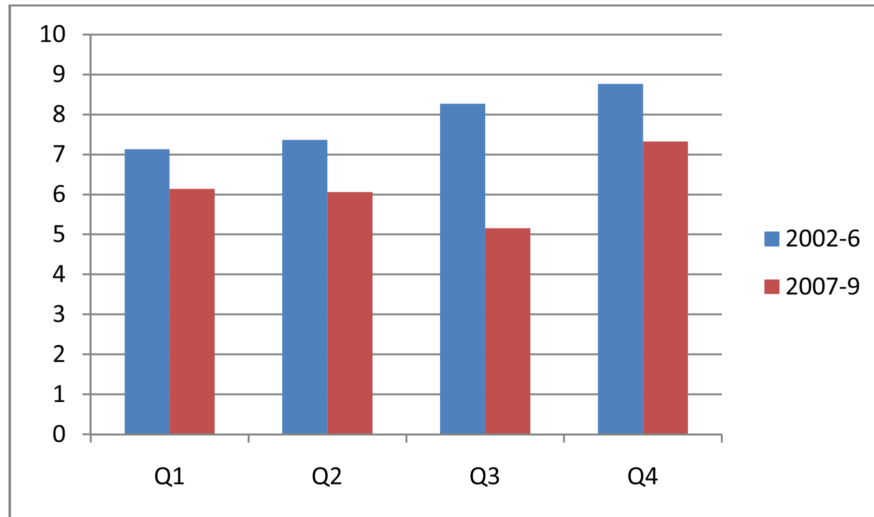
in 2009 will continue into 2010. In the first quarter of the year, GDP grew by 5.83 percent compared to the same period in 2009. Agriculture expanded by 3.4 percent, industry and construction by 5.65, and services by 6.64 percent. The sub-sectors with the highest growth rates during the first quarter were construction (7.13 percent), hotel and restaurants (7.82 percent) and financial services (7.86 percent). These are strong outcomes compared to where Vietnam was a year earlier. In the first quarter of 2009, GDP had expanded by only 3.1 percent, the lowest figure on record. Back then, the growth of industry and construction was only 1.7 percent and the growth of services 4.95 percent. Based on these outcomes, the government is still setting the growth target for the year 2010 as a whole at 6.5 percent.

Yet performance in the first quarter of 2010 is less impressive than it was in the last quarter of 2009, when GDP growth had reached 6.9 percent. This decline has led some analysts to conclude that Vietnam may be entering a phase of economic slowdown. And it is true that measured on a seasonally adjusted basis, GDP contracted by 1.3 percent between the last quarter of 2009 and the first quarter of 2010. However, seasonal adjustments are not highly reliable in Vietnam. No doubt that the first quarter always sees a decline in economic activity, due to the Tet break (the longest national holiday) and the slow return of migrants workers from the countryside afterwards. A seasonal adjustment "inflates" the GDP level of the first quarter to the level of a "normal" quarter, thus allowing comparisons with the (also adjusted) GDP level of previous quarters. The magnitude of the adjustment is estimated based on how far removed from the trend the GDP level of each quarter is. The problem is that Vietnam's growth path had a clear trend until 2007, but became much more erratic over the period with macroeconomic turbulence, when the path was affected by a sequence of stabilization, stimulus and re-balancing policies. This change is clear when comparing quarterly growth rates since 2007 with those observed up to 2006 (Figure 3). In addition to the change in macroeconomic conditions, there seems to be an underlying trend to capture more of a year's GDP in the fourth quarter of the year and less of it in the first quarter (Figure 4). This trend makes economic activity in the first quarter of the year look increasingly weak compared to the last quarter of the year.

Perhaps a more reliable assessment of whether growth is slowing down in Vietnam can be obtained from other indicators of economic activity. But most of those indicators point towards an acceleration of economic growth, more than a deceleration. In the first four months of the year industrial production increased by 13.5 percent compared to 2009. Retail sales, a proxy for domestic consumption, increased by 25 percent in nominal terms. This is substantially above the 19 percent observed during the same period in 2009, when the inflation rate was much higher. In the first quarter of the year, tourist entries increased by 36 percent from a year earlier. And electricity demand in Vietnam's two main cities surged by 30 percent during the month of May 2010. None of these indicators seems consistent with a decline in economic activity, but rather the opposite. On the other hand, these indicators are not sufficient to predict an acceleration of growth rates either, not to mention a return to the levels observed before the global crisis.

Figure 3: A Change in the Structure of Seasonality

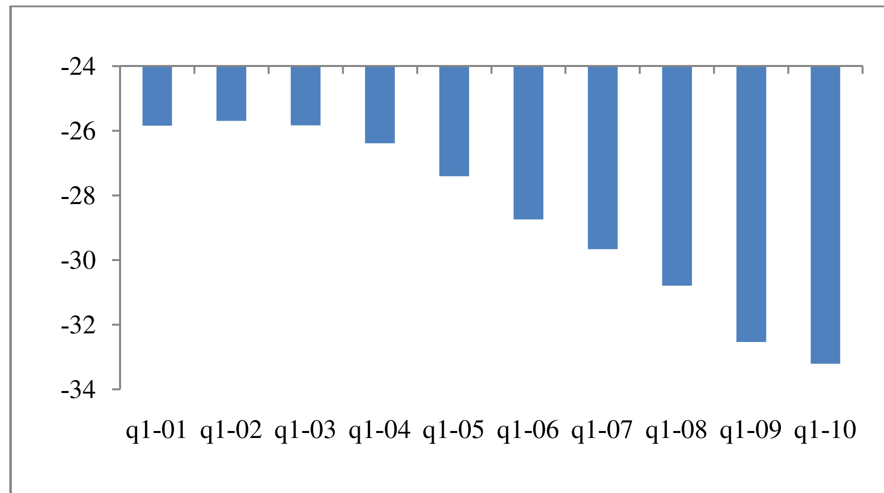
(Qi year T compared to Qi year T-1, in percent)



Source: GSO and World Bank calculation

Figure 4: A Shift in Reporting Towards the 4th Quarter

(Q1 year T compared to Q4 year T-1, in percent)



Source: GSO and World Bank calculation

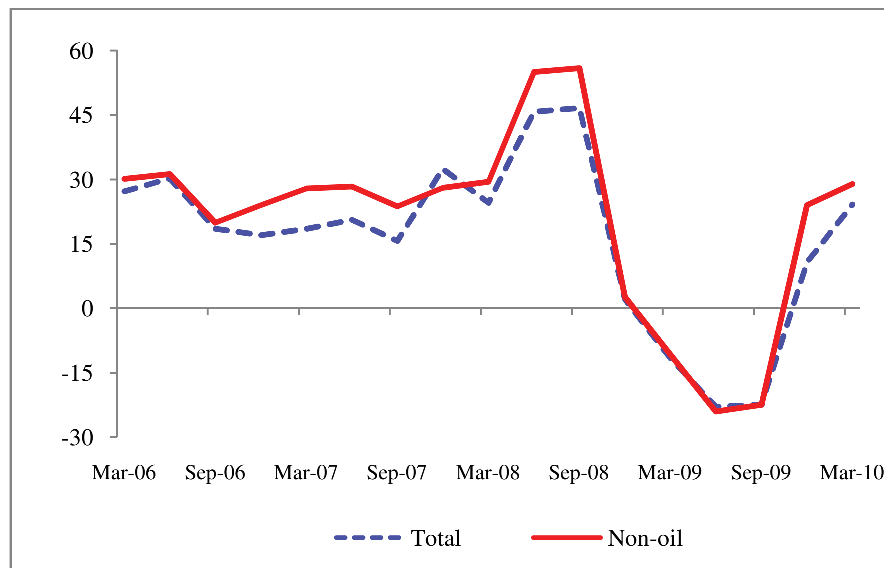
EXPORTS SURGING AGAIN

After the worst year on record in 2009, Vietnam's exports are now recovering. Total export earnings increased by 6.9 percent in the first four months of 2010. And the rate would be as high as 23.7 percent if gold re-exports were excluded (Figure 5). Foreign trade in gold is not strictly speaking a monetary phenomenon in Vietnam, as it is not related to purchases

or sales by the State Bank of Vietnam (SBV). Trade flows are mainly determined by portfolio decisions made by domestic agents, who hold their financial assets in a combination of dong-denominated assets, dollar-denominated assets and gold. Oil is another relatively volatile component of export earnings. If oil exports are excluded from the calculation, in addition to gold exports, the growth rate of earnings is currently going back to the vicinity of 30 percent, which was the trend before the global crisis.

Figure 5: Export Growth over Previous (Moving) Quarter

(Three months over previous three months, excluding gold, in percent)



Source: GDC and World Bank's calculation

This recovery of exports hides two very different trends by type of product. The recovery is strong in the case of key labor-intensive exports such as garments, footwear, electronics, seafood and furniture. In the first four months of 2010, garment exports rose by 16.4 percent (to about USD 3 billion) compared to the same period in the previous year. Garment exports to the US soared by 24 percent, and account now for 58 percent of total garment sales abroad. Exports of computers and electronic products increased by 35.8 percent and reached nearly USD 1 billion. The corresponding figure in the case of seafood was 19 percent (Table 1). There is also an increase in other non-commodity exports, which may be related to new investments coming on line.

On the other hand, there was a substantial decline in the volume of key commodity exports. Despite the substantial increase in the international price of oil in the early months of 2010, export earnings from oil export decreased by 13.5. This is because the export volume contracted by 49 percent as oil fields mature and the first refinery in Dung Quat started operations. Similarly, in the first four months of the year Vietnam exported about 2.17 million tons of rice, which amounts to only 87 percent of the volume exported during

the same period in 2009. Given the prospect of declining international prices of rice due to global oversupply, the government adopted a plan to stockpile of about 1 million tons, in the expectation of mitigating the impact of the decline on the domestic price of rice.

Table 1: Earnings from Key Export Items

	USD mn 2009	Growth rate (year on year, in percent)			
		2008	2009	4M-2009	4M-2010
Total export earnings	57,096	29.1	-8.9	1.4	6.9
Crude oil	6,195	22.0	-40.2	-43.7	-13.5
Non-oil	50,901	30.6	-2.7	12.3	9.4
Rice	2,664	94.3	-8.0	41.9	-0.3
Other agricultural commodities	4,771	17.2	-13.1	-12.4	10.7
Seafood	4,251	19.8	-5.7	-6.5	18.7
Coal	1,317	38.8	-5.1	-10.9	28.3
Garment	9,066	17.7	-0.6	1.1	16.4
Footwear	4,067	19.4	-14.7	-5.7	7.3
Electronics & computers	2,763	22.5	4.7	-8.5	35.8
Handicraft (including gold)	3,177	65.1	133.1	948.0	-89.7
Wood products	2,598	17.7	-8.2	-17.0	31.0
Exports excluding gold	*54,596*	*29.1*	*-12.9*	*-12.3*	*23.7*

Source: GDC

Figure 6: Key Commodity Exports

Weighted change in export value, price and quantity

Note: Key commodity exports include crude oil, coal, rice, coffee and rubber
Source: GDC and World Bank's calculation

However, earnings from commodity exports have been resilient thanks to higher international prices (Figure 6). In the first four months of 2010 the export price of rubber almost doubled compared to the same period last year. The export price of crude oil rose by 72 percent, the price of coal by 47 percent and the price of rice by 14 percent. Overall, the weighted change in the price of Vietnam's key commodity exports (namely: crude oil, coal, rice, coffee and rubber) was about 42 percent in the first four months of 2010. This increase almost exactly offset the weighted change in the export volume of those key commodities (44.6 percent).

IMPORTS SURGING EVEN FASTER

Table 2: Import Values for Key Items

	USD mn 2009	Growth rate (year on year, in percent)			
		2008	2009	4M-09	4M-10
Total import value	69,949	28.8	-13.3	-41.0	36.5
Petroleum products	6,255	42.2	-43.0	-57.3	30.0
Machinery and equipments	12,673	25.8	-9.4	-27.3	16.4
Computer and electronics	3,954	25.5	6.5	-21.0	40.8
Pharmaceuticals	1,097	22.9	26.9	23.3	16.2
Garment and footwear accessories	1,932	9.4	-18.0	-19.8	25.6
Iron & steel	5,361	31.5	-20.2	-67.7	14.1
Fertilizer	1,415	47.3	-3.9	-33.8	-25.4
Plastics	2,813	17.5	-4.5	-31.5	55.4
Fabrics	4,226	12.7	-5.2	-7.7	20.6
Chemicals	1,625	21.1	-8.5	-27.9	38.6
Chemical products	1,580	24.8	-1.5	-14.5	39.4
Automobiles (COMP/CKD/IKD)	3,071	57.2	3.8	-50.9	57.7
Yarns and fibers	811	4.6	4.6	-26.2	61.3
Pesticides	488	94.3	-34.3	-32.4	40.7
Cotton	392	74.7	-16.0	-54.0	180.9
Paper	771	25.5	2.3	-31.4	33.1

Source: GDC

Imports soared by 36.5 percent in the first four months of 2010, resulting in accumulated trade deficit of USD 4.6 billion. While concerns have been raised about this imbalance, the surge in imports seem to be related mainly to strong domestic investment demand by both domestic and foreign investors and to imports of intermediate products in

order to re-export. On the investment side, the import value of machinery and equipment, which accounts for 16 percent of total imports, expanded 16.4 percent from a year earlier. This is compared to a 9.4 percent decline in 2009. Similarly, imports of computers and electronic components increased by 41 percent. On the inputs side, imports of garment and footwear accessories soared by 25.6 percent, and imports of fabric by 20.6 percent (Table 2). The increase in the international price of oil also resulted in import values increasing by 30 percent, despite a 17 percent decline in import volumes.

While Vietnam's imports are not driven by FDI companies, in the short term the trade deficit would clearly be smaller without them. Foreign direct investors are net importers in the early stages of their project cycle. To the extent that these companies choose Vietnam as a platform to export to third countries, the relatively large trade deficit is not in itself a cause for concern. FDI imports may be substantial, but they tend to bring their own financing with them. Imports of consumption goods have been more of a source of concern, especially in times of overheating, when asset price bubbles make households feel wealthier and spend accordingly. For now, only the surge in imports of automobiles seems to fit this pattern. And since February 2010, the monthly trade deficit is on a downward trend.

TRENDS IN FOREIGN TRADE

Meanwhile, the overall regional profile of Vietnam's international trade is evolving. The recovery in export earnings reflects an improving economic environment among key partners, but there are also important differences across regions. Exports to the US grew by 22.4 percent in the first four months of 2010, compared to the same period in 2009. This comes after a period of absolute decline in 2009. Exports to key European markets and Japan expanded at a similar pace. But exports to countries in the region grew much more rapidly. Referring again to the first four months of 2010, exports to Indonesia grew by 116.9 percent, exports to Hong Kong (China) by 86.4 percent, exports to China by 43.7 percent, and exports to Korea by 39.4 percent. These different paces of market recovery are leading to a reorientation of Vietnam's exports towards the region, with China and countries in ASEAN increasing their share.

The faster growth of regional demand could contribute to some rebalancing of Vietnam's foreign trade insertion. At present, there is a clear difference between Western countries and developing Asia, with India, Japan and Russia occupying an intermediate position. Vietnam is clearly a net exporter to Western countries. The most extreme case is that of the US, which absorbs 19.8 percent of Vietnam's exports but accounts for only 4.5 percent of its imports (Table 3). At the other end, China accounts for only 9.5 percent of Vietnam's exports but supplies a striking 22.7 percent of its imports. And this imbalance is despite the recent acceleration in China's demand for Vietnamese goods.

Table 3: Trade Balance with Key Partners

(Figures are for the first four months of 2010and in US$ million)

	Exports to	Imports from	Trade balance
China	1,872	5,531	-3,659
Korea	101	2,601	-2,500
Taiwan (China)	405	2,104	-1,699
ASEAN	3,401	4,740	-1,339
India	235	653	-417
Japan	2,238	2,580	-342
Russia	162	337	-175
Australia	913	375	537
EU	3,352	1,847	1,505
US	3,906	1,088	2,818

Source: GDC

The trade balance of Vietnam basically determines its current account balance, as net imports of services and profits and returns on foreign investments are roughly offset by remittances. The latter held well in the aftermath of the global crisis. They reached an estimated USD 6 billion in 2009, and an estimated 1.5 billion in the first quarter of 2009. One possible explanation for this resilience is the fact that remittances do not depend on short-term migrant workers as much as they do on the overseas Vietnamese community. The possibility to secure labor export contracts for short-term migrants might have declined due to the global crisis. But there is anecdotal evidence that many overseas Vietnamese took advantage of the decline in real estate prices since the 2007 overheating to buy property.

RESILIENT CAPITAL INFLOWS

FDI inflows fell to USD7.4 billion in 2009, compared to 10.0 billion in 2008. But the decline was mostly due to the global crisis, and not to deterioration of Vietnam's overall attractiveness to investors. According to the World Investment Prospects Survey 2009-2011, released by the United Nations Conference on Trade and Development, Vietnam is one of the 15 most FDI-friendly countries in the world. Admittedly, the decline in FDI commitments was dramatic in 2009, but many of those commitments amount to taking an option (especially, on land) rather than to expressing a willingness to invest in the short-term. Even so, despite their low 2009 level, FDI commitments still amounted to 25 percent of GDP, which is remarkably high in international perspective.

As the world economy recovers, so do FDI inflows to Vietnam. In the first four months of 2010, some USD3.5 billion were disbursed, up 5.9 percent year on year. The

upward trend is expected to continue. In the first four months of 2009, more than half of FDI implementation was associated with the expansion of existing projects. But in the first four months of 2010, newly registered projects are taking the lead (Table 4). Among these newly registered projects, investments in services, manufacturing and high technology are gradually replacing hotels and real estate as key sectors.

Table 4: Foreign Direct Investment

	4M-2009 (US$ billions)	4M-2010 (US$ billions)	Change (percent)
Implemented capital	3.4	3,5	5.9
Registered capital	8.0	5.9	-25.7
Newly registered	3.5	5.6	58.5
Existing projects	4.4	0.3	-92.7

Source: MPI

As for other components of the capital account of the balance of payments, inflows of Official Development Assistance (ODA) increased as multilateral organizations and donor countries scaled up their support to Vietnam in response to the global crisis. About USD 2 billion in ODA were disbursed in 2009. ODA pledges at the December 2009 Consultative Group meeting reached a record USD 8 billion. But while most pledges translate into firm commitments, disbursements tend to be much lower as funding for ODA projects spreads over many years and their implementation tends to be slow in Vietnam.

On the other hand, portfolio investments have been negligible. After reaching USD 8.8 billion in 2007, they became slightly negative in 2008 (USD -0.6 billion) and only recovered marginally since then. Despite an increase in the VN Index by 57 percent in 2009, foreign investors only bought around USD 160 million in shares in the Ho Chi Minh City Stock Exchange.

THE BALANCE OF PAYMENTS

Vietnam's large trade deficit also results in a substantial current account deficit. In 2008, the deficit had reached 11.9 percent of GDP, above what is usually considered the safety threshold, namely 10 percent. In 2009, gold re-exports and administrative measures aimed at containing imports brought the current account deficit down to a more reassuring 8.0 percent of GDP. And it is expected to remain below the 10-percent threshold in 2010, despite the surge in imports, due to the ongoing recovery in exports (Table 5). However, the conventional safety threshold is more of a subjective barrier than a rigorous measure of

vulnerability. What really determines whether the current account deficit is sustainable is the size and composition of the capital account surplus.

Table 5: The Balance of Payments, 2007-10

(In percent of GDP)	2007	2008	2009 e/	2010 f/
Current account balance	-9.8	-11.9	-8.0	-9.1
Trade balance	-14.6	-14.2	-8.9	-9.5
Non-factor services	-1.3	-1.0	-1.2	-2.6
Investment income	-3.0	-4.9	-4.9	-3.8
Transfers	9.0	8.1	7.0	6.8
Capital account balance	23.7	13.4	12.3	11.7
FDI investment (net inflows)	9.2	10.0	7.4	7.3
Medium and long-term loans	2.9	1.1	4.8	2.4
Other capital (net)	2.8	2.9	-0.1	0.4
Portfolio investments	8.8	-0.6	0.1	1.5
Errors and omissions	0.5	-1.2	-13.1	0.0
Overall balance	14.3	0.3	-8.8	2.6

Source: SBV, IMF and World Bank.

From that perspective, Vietnam is doing well. For the last few years, the capital account surplus has exceeded the current account deficit, sometimes by a large margin. Moreover, in 2008 and 2009 most of the capital account surplus was associated with long-term inflows, not with short-term capital and portfolio investments.

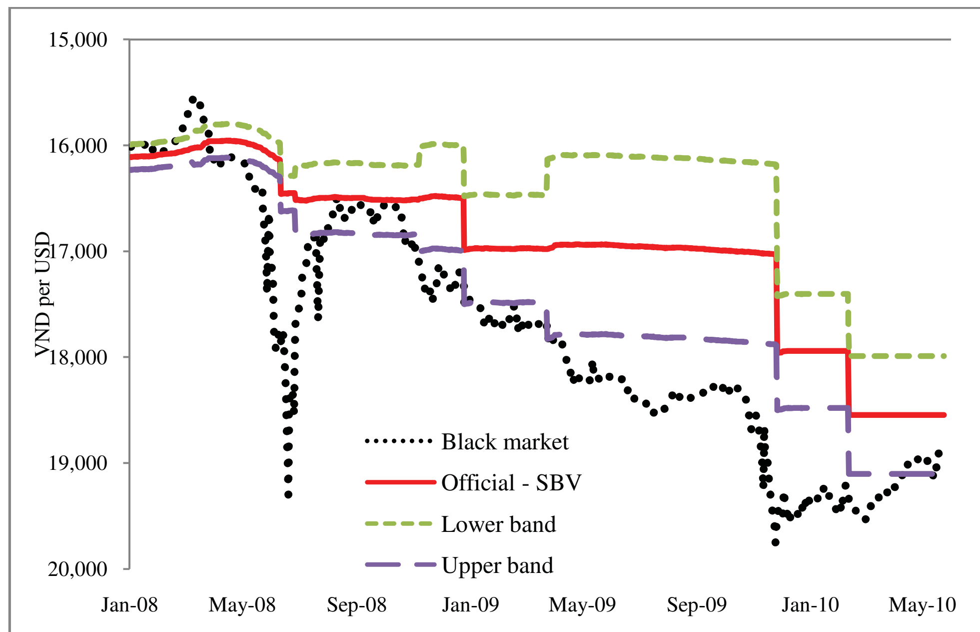
Yet international reserves declined substantially in 2009. This was not due to a shortage of dollars in Vietnam, but to a shortage of dollars under control of the SBV. The very sizeable errors and omissions of 2009, which reached an astounding 13.1 percent of GDP, reflect the hoarding of foreign currency by domestic agents. Both households and enterprises (including state-owned enterprises and economic groups) were expecting a faster devaluation of the dong during most of last year. Therefore, they preferred to shift the composition of their portfolios towards international assets, including dollars and gold. Some of the additional dollar holdings took the form of deposits in the banking system; some were held under more informal arrangements, or in accounts abroad.

AN EMBATTLED CURRENCY

Because of devaluation expectations, during 2009 and the first few months of 2010 the exchange rate in the parallel market was often out of the official floatation band (Figure

7). The gap with the upper end of the official band was never as wide as in May 2008, when there were fears that Vietnam could be “the next Thailand 1997”, but it lasted for much longer. The origin of the problem can be traced back to the shift from stabilization to stimulus, in the last quarter of 2008. At that point, an expansionary policy stance pushed interest rates in dong down. Meanwhile, the year 2008 had seen inflation escalating to 19.9 percent, but devaluation of the dong against the dollar only reaching about 9 percent. Low interest rates in dong, combined with the expectation of a devaluation aimed at restoring Vietnam’s competitiveness, made the option of holding dollars increasingly attractive.

Figure 7: Vietnam Dong/US Dollar Exchange Rate



Source: SBV

Devaluations of the central exchange rate and changes in the width of the floatation band did not succeed in restoring confidence in the dong (Table 6). The tightening of monetary policy that took place towards the end of 2009, when the government chose to rebalance the stimulus and growth objectives, was not sufficient either. As for the request to large Economic Groups to surrender their foreign exchange holdings, it provided dollar liquidity to the monetary authorities, but did not do anything to restore confidence in the dong. Only when the government finally accepted to liberalize interest rates in dong, in the first quarter of 2010, did the trend revert and the parallel exchange rate converge towards the official trading band.

Table 6: Exchange Rate Management

Adjustment of	Date	Trading band	Devaluation
Trading band	24-Dec-07	+/-0.75%	
Trading band	10-Mar-08	+/-1.0%	
Central exchange rate	11-Jun-08		2.0%
Trading band	27-Jun-08	+/-2.0%	
Trading band	7-Nov-08	+/-3.0%	
Central exchange rate	25-Dec-08		3.0%
Trading band	24-Mar-09	+/-5.0%	
Central exchange rate and trading band	25-Nov-09	+/-3.0%	5.4%
Central exchange rate	11-Feb-10	+/-3.0%	3.4%

Source: SBV

BANKING SECTOR VULNERABILITIES

Vietnam's banking sector weathered the global financial crisis better than market expectations. Timely monetary policy actions by SBV coupled with other measures introduced by the Government in the wake of the crisis helped the credit institutions navigate the turbulence. An interest subsidy program which was introduced in early 2009 as part of the government stimulus package also helped by allowing a rapid refinancing of (mainly short term) debts contracted at much higher interest rates in earlier periods. However, several challenges lie ahead for achieving full openness of the sector as per WTO commitments and for developing a resilient and stable financial system.

All the banks were able to meet the 2008 year-end target of VND 1 trillion for minimum capital requirement. However, meeting the requirement of VND 3 trillion by the end of 2010 is likely to be more demanding. As many as 20 banks are still short of that goal. The SBV has already asked the noncompliant banks to submit concrete plans to raise the required chartered capital or to provide a plan to terminate their legal status under the Vietnam's laws. As the banks race to meet the upcoming requirements, the will need to focus on asset quality management and tempered credit growth. Indeed, rapid credit increases could have a negative impact on asset quality and the share of non-performing loans (NPLs).

Most banks reported positive profit at the end of 2009. This has been achieved through increase in traditional credit activities as well as diversification into fee-based income generating activities. It should, however, be noted that the 2009 credit growth of 38 percent was significantly supported by the interest rate subsidy scheme and other support programs. In 2010, a lower target for credit growth (25 percent) and the phasing out of the stimulus program could adversely affect the profitability of banks. The new requirement for banks to increase their capital adequacy ratio (CAR) from the current 8 per cent to 9 per cent by the last quarter of 2010 will enhance the ability of banks to face difficulties in future, but it may put additional pressure on banking profitability. It

should be noted that SBV has recently issued another regulation on prudential ratio requirements which will enhance the banking data reporting requirements and provide SBV and the banks with better information for monitoring the banking sector.

The banks appear to have maintained asset quality, with the overall NPL share reported to be 1.9 per cent at the end of 2009 (2.08 percent in SOCBs and 1.77 per cent in joint stock banks). However, the reported NPLs are based on Vietnam Accounting Standards (VAS) and domestic regulation. If International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS) are applied this ratio is likely to be less encouraging. New regulations for loan loss classification and provisioning are in their final stages of approval. Although still based primarily on Basel I criteria, these regulations should bring classification and provisioning requirements closer to international practices. This is likely to impact both the reporting of NPLs as well as reported earnings (due to higher provisioning requirements).

The banking sector reform roadmap up to 2010 started implementation in 2006, but has been behind schedule. After the initial start of equitization of two SOCBs (Vietcombank in late 2007 and Vietinbank in late 2008) there had not been much progress. However, in February 2010 Vietinbank announced the sale of a stake to the Canadian Bank of Nova Scotia and the International Finance Corporation (IFC) in the third quarter this year. Once completed, Vietinbank will be the first SOCB to have a foreign strategic partner. The expected passage of the Law on Credit Institutions and the SBV Law in the current session of the National Assembly should also be a significant development. However, there has been little progress in relation to the Law on Deposit Insurance.

MONETARY TIGHTENING

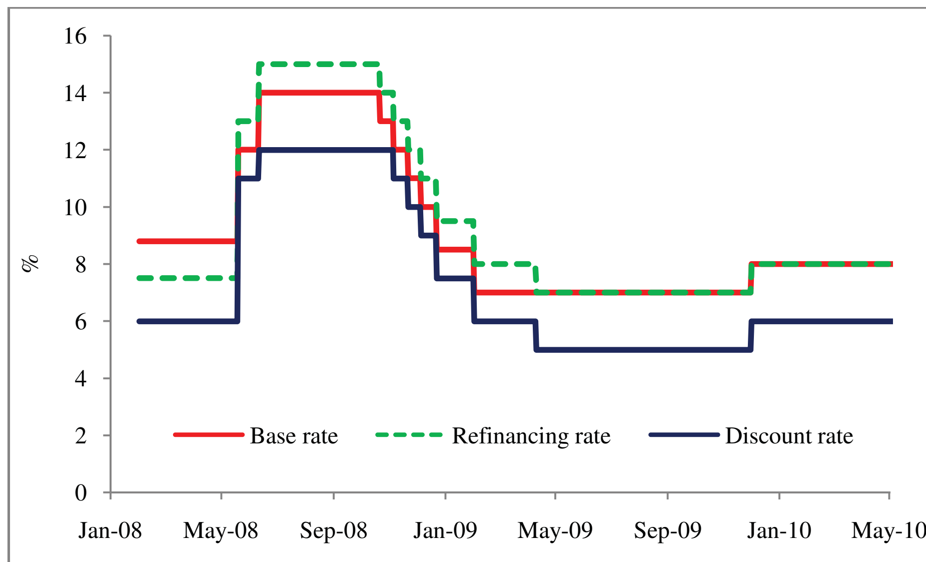
In the last quarter of 2009 there was a gradual shift in macroeconomic policy towards ensuring a balance between the growth and stability objectives. A spike in the domestic price of gold, and a widening gap between the parallel and the official exchange rates, made it obvious that the expansionary stance was not sustainable for much longer. Excessively low interest rates had also made government bond issuances unattractive. In spite of a substantial increase in fast disbursing ODA, and the drawdown of government deposits in the banking system, financing the budget deficit was becoming increasingly difficult.

On the monetary front, the new policy stance was reflected in a lower target for credit growth in 2010 (25 percent, as opposed to growth of 39.6 percent realized in 2009), the discontinuation of the short-term interest rate subsidy program, and an increase in policy rates, with the base rate and the refinancing rate going up from 7 to 8 percent (Figure 8).

However, policy rates do not play the same role in Vietnam as in other market economies. Decisions on the SBV on the liquidity to be provided to commercial banks and moral suasion (especially on state-owned commercial banks) often play a more important role. Thus, in the first quarter of 2010 the expansion of banking credit was brought down

drastically, in spite of the modest increase in policy rates. Between end-December 2009 and end-March 2010, outstanding credit grew by only 3.8 percent, which corresponds to an annualized rate of 15.2 percent, and this in a quarter when ample liquidity is usually provided to meet the higher money demand associated with the Lunar New Year. This dramatic reversal of the monetary policy stance marks one new phase in the "stop-and-go" process of the last three years, when Vietnam has gone from steady growth to stabilization policies to stimulus packages and back to a rebalancing of the growth and stability objectives (Figure 9).

Figure 8: Key Interest Rates

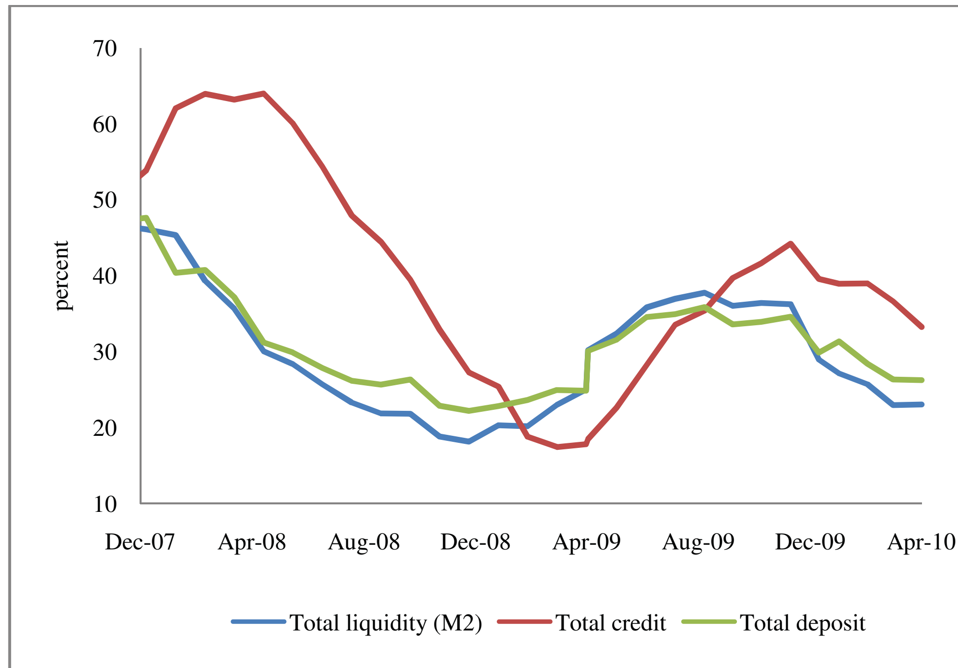


Source: SBV

The tightening of monetary policy clashed with the administrative cap on lending rates, imposed during the stabilization phase in 2008. The cap is set a 150 percent of the base rate. During the stabilization period, with the base rate at 14 percent, the cap allowed lending rates of 21 percent and provided a reasonable intermediation margin. In early 2010, with the base rate at 8 percent, commercial banks were not supposed to lend above 12 percent and this at a time when borrowers were willing to pay much more due to the shortage of liquidity. Fees and charges became common for bank loans, as did bonuses and authorizations for immediate withdrawals for bank deposits. The main problem is that the 150 percent cap had been introduced in the Civil Code, and therefore could only be abolished by another law. The expectation was that the amendment of the Law on Credit Institutions would be the only way to go around the cap, but it would not come into effect before January 2011 at the earliest. Confronted with this challenge, the SBV finally allowed commercial banks to provide loans on negotiated basis, in practice abolishing the cap.

Figure 9: Monetary Aggregates

(Year-on-year change in percent)



Source: SBV

FISCAL CONSOLIDATION

The overall budget deficit in 2009 reached 8.4 percent of GDP, an unusually high figure compared to both previous deficits in Vietnam and the deficits observed in other countries adopting aggressive stimulus policies (Table 8). However, this outcome is modest in relation to the predictions formulated earlier in the year. The adoption of the stimulus package was actually communicated in a way that generated much uncertainty as to how large the overall budget deficit could be. The budget plan for 2009, approved in November 2008, was already expansionary. In international terms, it could have resulted in an overall budget deficit in excess of 8 percent of GDP. Then, during the first and second quarters of 2009 a series of additional measures with potential fiscal implications were announced. Those measures were consolidated in a VND 143 trillion package (more than 8 percent of GDP) which seemed to be on top of the already expansionary budget plan for the year. In reality, the "143 trillion" package included substantial double counting. Some measures were already part of the budget plan for the year, others were listed twice (once as expenditures and once as finance for those expenditures) and yet others were not expected to fall on the budget, at least during the year 2009. However, even factoring in the double counting, towards mid-2009 it seemed as if the budget deficit could reach 12 percent of GDP.

Table 7: Government Budgetary Operations

(In percent of GDP)

	2007	2008	2009 e/	2010 f/
Total revenue and grants	28.7	28.1	26.7	26.9
Revenue (excluding grants)	28.1	27.6	26.3	26.7
Tax revenue	23.5	24.2	22.3	22.8
Oil revenues	6.9	6.0	3.6	3.6
Non-oil tax revenues	16.6	18.2	18.7	19.2
Non-tax and capital revenues	4.7	3.4	4.0	3.9
Grants	0.5	0.5	0.4	0.3
Official expenditure	29.4	29.2	31.7	28.6
Current	20.3	20.1	20.9	21.7
Development	9.1	9.2	10.9	7.0
Official fiscal balance	-0.7	-1.2	-5.1	-1.7
Other expenditures	1.2	2.5	3.9	3.8
Off-budget expenditure	1.5	1.8	2.8	2.4
ODA on-lending	-0.3	0.7	0.5	1.4
Overall expenditure	30.6	31.7	35.6	32.5
Overall fiscal balance	-1.9	-3.7	-8.4	-5.5
Interest rate subsidy scheme	0.0	0.0	0.6	0.4

Source: MOF, IMF and World Bank. Figures exclude the Vietnam Development Bank.

Budget execution differed substantially from the budget plan. Total budget expenditure was 16 percent higher, mainly due to development investment spending, which increased by an outstanding 60 percent. But total budget revenue was buoyant too, increasing by 13 percent compared to the original plan. And this was despite the tax rebates and deferrals adopted as part of the stimulus package. Value Added Tax and Corporate Income Tax combined yielded 7.1 percent more revenue than in 2008. Revenue from trade tax rose by 29 percent despite the decline in trade volumes. Fees and charges (including land rental) soared by 47 percent. The biggest contributors to the surge in revenue were the special consumption tax on imports and revenue from assignment of land-use rights. Last but not least, the limited success of bond issuances contained off-budget expenditure. A cutoff interest rate that was too low to attract buyers was instrumental in achieving this outcome.

The rebalancing of the macroeconomic policy stance observed since late 2009 is expected to lead to a smaller budget deficit in 2010; larger than in "normal" years, but substantially lower than in 2009. Based on the budget plan, the overall budget deficit could reach 5.5 percent of GDP. But the continuation of the surge in tax revenue observed since the end of 2009 could bring the figure further down. Whether this happens will critically

depend on how government will use the tax revenue windfall. Another important question concerns the optimal speed at which the fiscal stimulus should be withdrawn and the answer critically depends on the vigor of the global recovery.

SUSTAINABLE DEBT

The budget deficit does not translate mechanically into a one-for-one increase in public debt. For instance, in 2009 the overall budget deficit was 8.4 percent of GDP but the ratio of public debt to GDP increased by a more modest 5 percentage points. There are several reasons explaining this gap. Growth is the most obvious one. GDP expands between the beginning and the end of the year, which means that both the numerator and the denominator in the debt ratio are growing at the same time. A less obvious reason for the gap is real exchange rate appreciation. A large fraction of Vietnam's public debt is denominated in foreign currency. As domestic prices increase faster than the exchange rate, as they did in 2009, the debt ratio declines mechanically. Finally, the government can rely on non-debt finance, as it did in 2009, or can finance expenditures which are not part of the budget, as it may choose to do in 2010.

The large budget deficit of 2009 was partly financed by drawing down government deposits in the banking system. The unusually large size of these deposits, in international perspective, is due to the still decentralized cash management system of Vietnam which forces each spending unit to have its own safety cushion. In 2009, was would otherwise be considered a weakness in public financial management turned to the advantage of the government, which could tap about 2 percent of GDP from this source. However, to the extent that cash management remains decentralized, the government may choose to rebuild these deposits in 2010. Also, the cost of an important component of the stimulus package, namely the interest rate subsidy scheme, did not fall on the budget in 2009. This cost, estimated at about 1.0 percent of GDP, was borne by SBV. But sooner or later, either through lower SBV transfers to government or through its recapitalization, this cost is bound to fall on the budget. Therefore, non-debt finance helped contain the growth of public debt in 2009, but may accelerate it in 2010.

At the end of 2009, public debt accounted for about 49 percent of GDP. Two thirds of the debt was owed to external creditors and about one fourth was denominated in domestic currency. Public debt is likely to remain sustainable if the current economic recovery continues and the authorities revert to an overall fiscal deficit in the order of 3 to 4 percent of GDP over the next three years. Under the baseline scenario of an ongoing debt sustainability analysis by the International Monetary Fund, the Asian Development Bank and the World Bank the debt ratio is projected to increase to just above 50 percent of GDP in the second half of this decade before starting to decline again in the next decade. The large fiscal deficits in 2009 and 2010 would not affect the overall debt sustainability significantly, as long as the government reverts to the pre-crisis levels of deficit in a few years.

Even with recent borrowing being closer to market terms, nearly two-thirds of Vietnam's debt is on highly concessional terms. As a consequence, the ratio of debt service to exports is projected to remain at or below 5 percent until 2013. The stress tests for the current exercise are not yet completed, but the basic picture has not changed from the previous exercise conducted in 2009. The two main risks to debt sustainability are likely to continue to be a sudden depreciation of the dong and a surge in debt-creating flows. Both scenarios seem unlikely at present.

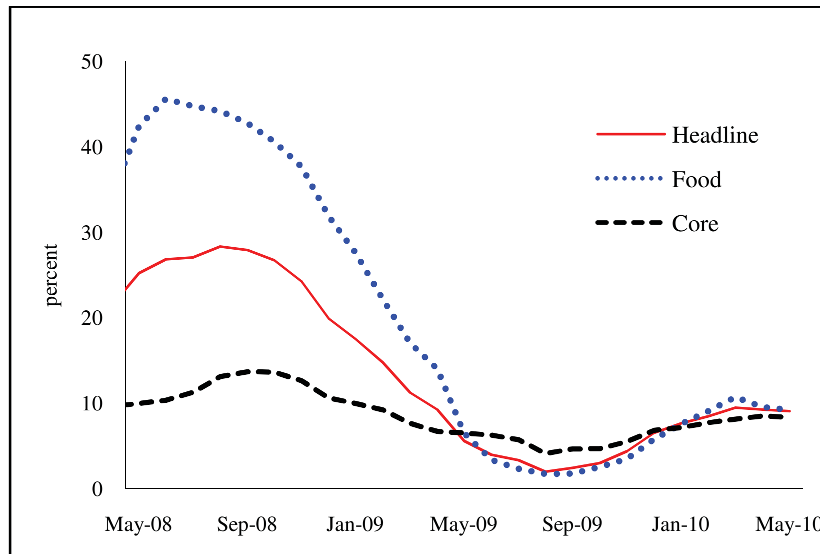
The external debt position of Vietnam remains robust too, with preliminary results from the debt sustainability assessment indicating that the risk of debt distress remains low, due to the high degree of concessionality and long maturity of the debt. At the end of 2009, total external debt (including private debt) represented about 34.4 percent of GDP, of which 30.4 percent was public external debt. The projected medium-term external debt ratios are higher than estimated one year ago due to the economic slowdown. But debt burden indicators are below the safety thresholds except under the most extreme stress tests, and even then only very briefly.

ACCELERATING INFLATION?

Prices were much more stable in 2009 than they had been in 2008. The Consumer Price Index (CPI) increased by 6.5 percent, compared to 19.9 percent in the previous year. Similarly, the GDP deflator rose by 6.0 percent, down from 22.1 percent in 2008. On these counts, inflation was not a matter for concern. However, the additional demand created by the stimulus package, the recovery in the international prices of commodities and the devaluation of the dong all exerted upward pressure on domestic prices. Those pressures became apparent by the end of 2009. The adjustment in the prices of electricity and gasoline, justified on public finance and efficiency grounds, added to the pressure. By end-March 2010 the CPI was already 9.6 percent higher than a year earlier, questioning the attainability of the 7 percent inflation target set by the National Assembly for 2010 (Figure 10).

However, the CPI increased by only 0.14 percent in April 2010, and by 0.27 percent in May. It is true that the second quarter of the year is usually characterized by lower inflation, especially compared to the seasonally high first quarter, when both the scarcity of food associated with the winter and the Lunar New Year push prices up. But the results of April and May are reassuring even after discounting seasonality. Moreover, even with core inflation remaining stable, the global oversupply of rice should help contain the price of Vietnam's main food staple, which weighs heavily on the CPI, both directly and indirectly (through substitution effects with other food items). In light of these developments, the inflation target set by the National Assembly may not be met but inflation should remain in the single digits during the year 2010.

Figure 10: Year-on-Year CPI



Source: GSO

WHICH DIRECTION NOW?

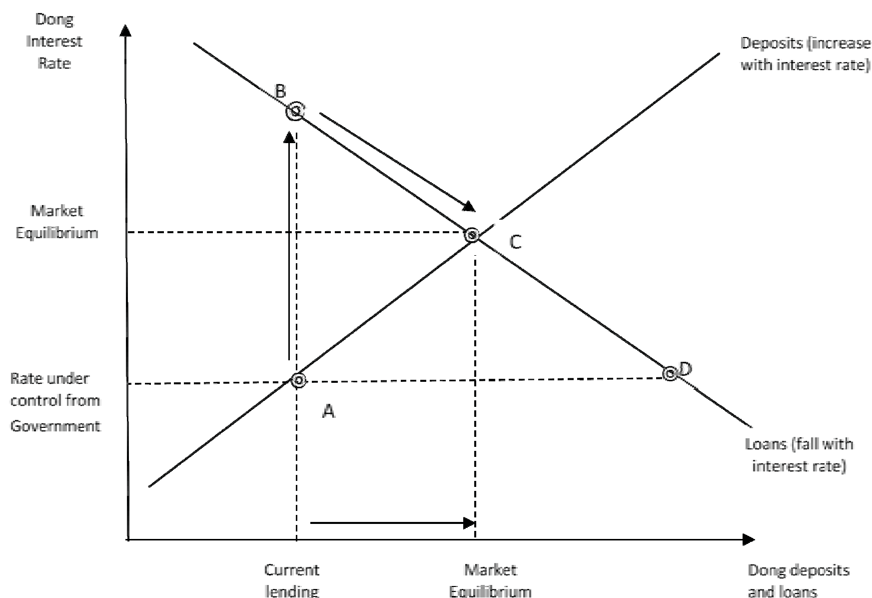
In a context of a tighter monetary policy, the removal of the cap on lending rates has led to a surge in the cost of credit. Because deposits in dong were not attractive while the cap was in force, banks did not have much liquidity and the demand for credit was simply rationed. With interest rate flexibility, the demand and supply for loans balance through higher interest rates. This surge of the cost of credit has become a concern by many, who see it as a potential threat to Vietnam's economic recovery. Given the recent deceleration of inflation, voices have been raised to rapidly expand liquidity and bring interest rates down. However, there are risks in going in this direction. Whether this recommendation is sound critically depends on the pace at which liquidity is to be expanded, and on the mechanisms to be used in order to do so.

Interest rates are bound to decline even if the government does not do anything about them. With dong deposits being substantially more attractive at present, domestic agents may reorient their portfolios away from gold and assets denominated in foreign currency. Dollar sales should contribute to bringing the parallel exchange rate deeper into the official floatation band, perhaps even crossing the central exchange rate in a not-too-distant future. The depreciation of the dollar should gradually dispel the fears of further devaluation of the dong and make the re-composition of portfolios towards dong-denominated assets even more attractive. This would be a time for the SBV to purchase the excess supply of dollars and provide dong liquidity in exchange. By doing so, SBV would start rebuilding the country's international reserves, and would provide the domestic currency for the banks to satisfy the

demand for lending. As dong liquidity increases, lending volumes would increase and interest rates would decrease.

In more analytical terms, the economy was in point A in Figure 11 when the cap on interest rates was still in force. At that time, the demand for credit at the prevailing (administered) interest rate, represented by point D, vastly exceeded the resources that commercial banks could mobilize. Interest rate liberalization shifted the equilibrium to point B, where liquidity is the same as before but the cost of credit is higher. However, the re-composition of domestic portfolios towards assets denominated in domestic currency should gradually increase the volume of dong deposits and reduce the interest rate. This is shown by the transition from point B to the final equilibrium in C. What many commentators are proposing at present can be interpreted as bypassing the over-shooting phase. In terms of Figure 11, this proposal amounts to moving as quickly as possible from point B to point C.

Figure 11: The Overshooting of Interest Rates

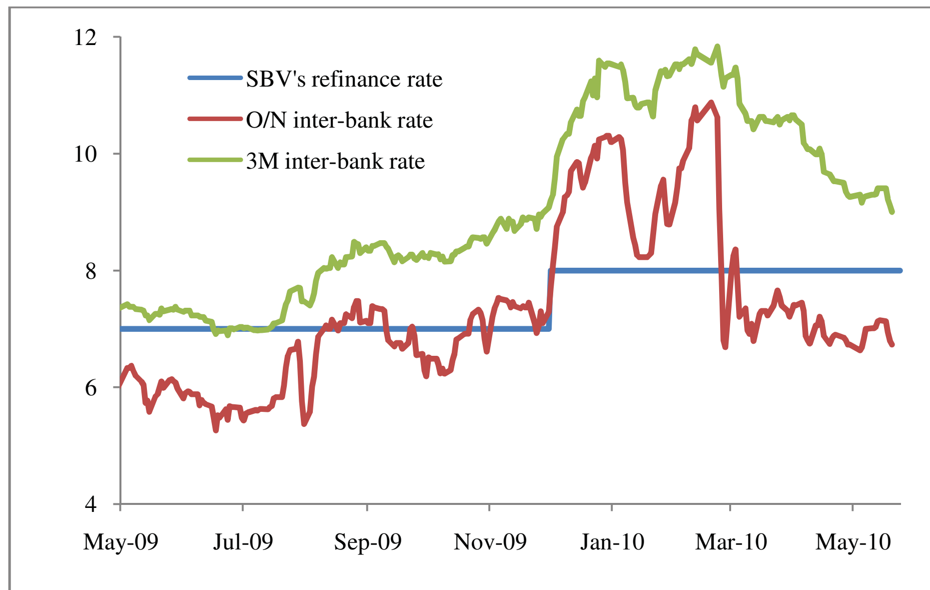


There is some evidence that this process is actually taking place. After having grown by only 3.8 percent in the first three months of the year, banking credit expanded by a cumulative 5.6 percent in April. It is also clear that the overnight interbank rate has eased considerably over these two months (Figure 12).

However, for this adjustment to work it has to be driven by the re-composition of the portfolios of domestic agents, and not by the expansion of liquidity by the SBV. Put differently, liquidity has to increase to satisfy the greater demand for dong-denominated assets by the public and to mop up the oversupply of dollars. If it were to increase before domestic agents are truly convinced to shift their portfolios from assets denominated in

foreign currency to assets denominated in domestic currency, the still frail confidence in the dong could be seriously damaged. Therefore, if the government is to embark in this direction, it will need to communicate very clearly under which circumstances it is providing more liquidity to the banking system. Failure to do so could undermine the progress accomplished since the rebalancing of the macroeconomic policy stance started.

Figure 12: Inter-bank Interest Rates



Source: SBV

PROSPECTS FOR 2010

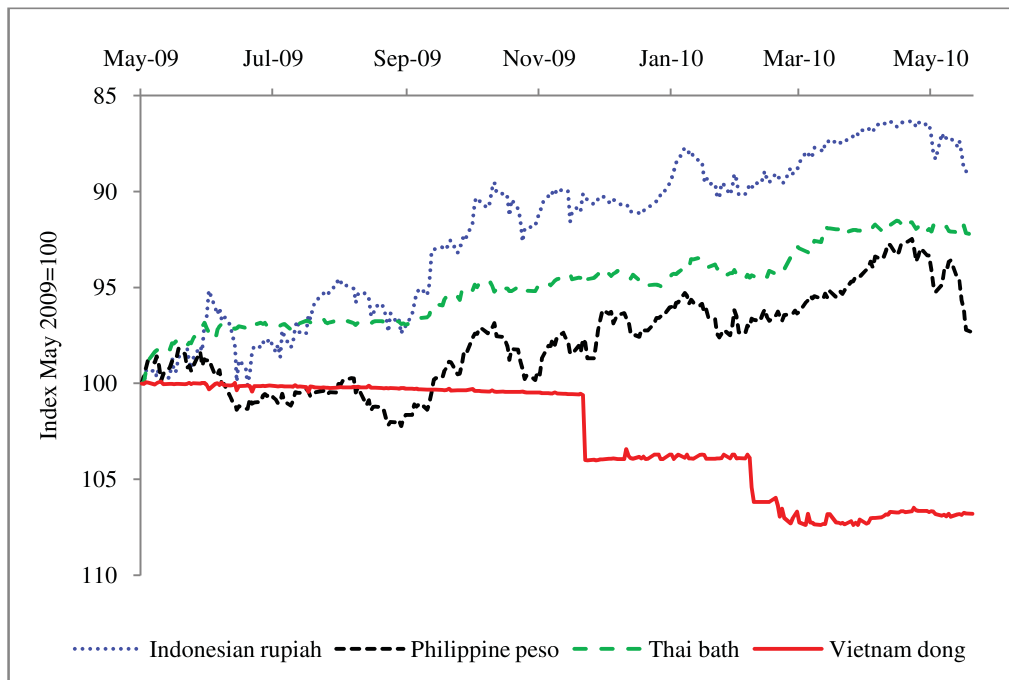
In the aftermath of the global crisis Vietnam did better than most other countries in the region. The growth rate of its GDP was among the highest and the decline of its exports among the lowest. Yet, despite Vietnam's performance being above average, perceptions about it and about the ability of its government to steer the economy in times of macroeconomic turbulence, seem to be below-average. Confidence is all the more important when important policy indicators (the budget deficit, the current account deficit, the inflation rate…) get close to conventional safety thresholds.

In international spheres, there are clear misconceptions on the objectives of the government, the extent of the macroeconomic risks it faces, or the motivations behind some of the specific policy measures it adopts (especially, when those measures are unorthodox). The lack of public information on the level of international reserves, differences with standard international practice in the way budget data are presented, and gaps between budget plans and budget outcomes provide support to these reservations.

Under these circumstances, it is not surprising that Vietnam did not benefit from the resurgence of international capital inflows experienced elsewhere. Elsewhere, those inflows resulted in currency appreciation, whereas Vietnam spent most of last year struggling with currency depreciation (Figure 13). Since May 2009, the Indonesian rupiah strengthened by 11.2 percent, the Thai bath by 7.7 percent and the Philippine peso by 2.7 percent. During that same period the dong lost 6.8 percent of its value.

Figure 13: Exchange Rate of Regional Currencies

(Domestic currency versus US dollar)

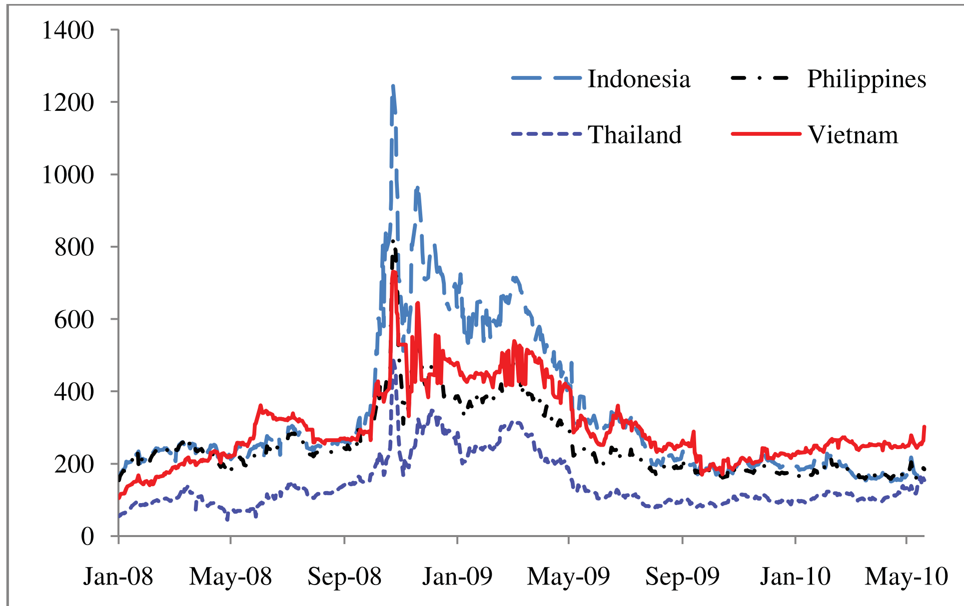


Source: World Bank

Poor perceptions are also affecting Vietnam's cost of borrowing. Compared to countries perceived as safe debtors, developing countries usually face a risk premium. The better the international image of macroeconomic management in the country, the lower is its premium and the cheaper is its cost of borrowing. Before the beginning of global turbulence, when macroeconomic trends in Vietnam were easy to predict, its country risk premium was relatively low; higher than for Thailand, but lower than for Indonesia or the Philippines. These days, Vietnam's country risk premium is the highest of the group (Figure 14). This is not necessarily due to fundamentals, as both the current account deficit and the inflation rate were higher back then than they are now.

Figure 14: Country Risk Premium of Regional Economies

(Five-year Credit Default Swaps)



Source: STRMG, World Bank

Analysts who are based in Vietnam and think they understand the macroeconomic situation end up devoting much time to "explain" it to outsiders. And this, in turn, suggests that government is still not doing as well at "explaining" its policies as it is doing at designing those policies and implementing them. If Vietnam had done a better job in this respect, it would be already benefitting from larger capital inflows and a lower cost of borrowing, both of which should boost economic growth. Similarly, it would be facing a greater abundance of foreign exchange and would be re-building its international reserves faster. As things go, Vietnam is bound to have a relatively good year, with a GDP growth rate of 6.5 percent or more and an inflation rate of around 9 percent. But improved macroeconomic management, enhanced information disclosure and a better "explanation" of economic policy decisions could make Vietnam's economic performance in 2010 even stronger.