TAKING STOCK

An Update on Vietnam’s Economic Developments and Reforms

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CURRENCY EXCHANGE RATE: US$ = VND 15,880
GOVERNMENT FISCAL YEAR: January 1 to December 31

ACRONYMS AND ABBREVIATIONS

CHI  Compulsory Health Insurance
CPI  Consumer Price Index
DAF  Development Assistance Fund
DATC  Debt and Asset Trading Company
FDI  Foreign Direct Investment
GCs  General Corporations
GDC  General Department of Customs
GSO  General Statistic Office
HCFP  Health Care Fund for the Poor
IAS  International Accounting Standards
JRS  Judicial Reform Strategy
LSDS  Legal System Development Strategy
NPL  Non Performing Loan
MPI  Ministry of Planning and Investment
MOH  Ministry of Health
MOET  Ministry of Education and Training
MONRE  Ministry of Natural Resources and Environment
MOF  Ministry of Finance
MOLISA  Ministry of Labor, Invalid and Social Affairs
MTEF  Medium-Term Expenditure Framework
NSCERD  National Steering Committee for Enterprise Reform and Development
SBV  State Bank of Vietnam
SEDP  Socio-Economic Development Plan
SCIC  State Capital Investment Corporation
SOCB  State Owned Commercial Bank
SPS  Sanitary and Phytosanitary Standards
TRIPS  Trade Related Intellectual Property Rights
TRIMS  Trade Related Investment Measures
VBARD  Vietnam Bank for Agriculture and Rural Development
VDGs  Vietnam Development Goals
VHLSS  Vietnam Household Living Standard Survey
VSS  Vietnam Social Security
WTO  World Trade Organization
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PART I

RECENT ECONOMIC DEVELOPMENTS
The pace of Vietnam’s economic growth has increased in each of the past three years, and is expected to surpass 8 percent in 2005. This strong performance has been accompanied by a continuation of Vietnam’s remarkable success in reducing poverty, which by now has declined to under 20 percent. Even though macroeconomic policymaking has been complicated by supply shocks, external and internal balances have been maintained at manageable levels. Rising international commodity prices while benefiting exports, raised the import bill, and added to inflationary pressures. But these prices have begun to soften towards the end of 2005. In October, Vietnam successfully issued its first international bond on relatively favorable terms. Policy challenges in coming months relate to the quality of credit, and managing the risk of continued inflation.

GDP growth to surpass 8 percent

GDP is estimated to have risen by 8.1 percent y-o-y in the first nine months of 2005 owing to a strong pick-up in economic activity in the second and third quarters (Table 1). In the third quarter, GDP grew by nearly 9 percent y-o-y. The government expects GDP to rise by 8.4 percent for the entire year, slightly below its original target of 8.5 percent.

GDP originating in the industrial sector recorded a rise of 10 percent, with the manufacturing sub-sector growing by 11 percent. Construction activity picked up especially in the third quarter to record a nine-month increase of 8.9 percent y-o-y. Performance of the services sector strengthened considerably in the latter two quarters. The main areas of expansion included retail trade, and sub-sectors related to tourism such as hotels, restaurants and transport.

Table 1: GDP Growth by Sector

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>3M-05</th>
<th>6M-05</th>
<th>9M-05</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total GDP</td>
<td>6.8</td>
<td>6.8</td>
<td>7.0</td>
<td>7.2</td>
<td>7.7</td>
<td>7.2</td>
<td>7.6</td>
<td>8.1</td>
</tr>
<tr>
<td>Agriculture, forestry &amp; fishery</td>
<td>4.6</td>
<td>2.8</td>
<td>4.1</td>
<td>3.2</td>
<td>3.5</td>
<td>4.1</td>
<td>4.2</td>
<td>4.1</td>
</tr>
<tr>
<td>Industry &amp; construction</td>
<td>10.1</td>
<td>10.3</td>
<td>9.4</td>
<td>10.3</td>
<td>10.2</td>
<td>8.5</td>
<td>9.5</td>
<td>10.0</td>
</tr>
<tr>
<td>Industry</td>
<td>10.8</td>
<td>9.8</td>
<td>9.1</td>
<td>10.3</td>
<td>10.5</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>o/w Manufacturing</td>
<td>11.7</td>
<td>11.4</td>
<td>11.6</td>
<td>11.5</td>
<td>10.1</td>
<td>10.3</td>
<td>11.4</td>
<td>11.0</td>
</tr>
<tr>
<td>Construction</td>
<td>7.5</td>
<td>12.8</td>
<td>10.6</td>
<td>10.6</td>
<td>9.0</td>
<td>8.0</td>
<td>8.1</td>
<td>8.9</td>
</tr>
<tr>
<td>Services</td>
<td>5.3</td>
<td>6.1</td>
<td>6.5</td>
<td>6.6</td>
<td>7.5</td>
<td>7.0</td>
<td>7.6</td>
<td>8.2</td>
</tr>
</tbody>
</table>

Source: GSO.
Note: In percent per year for annual data, and percent y-o-y for three, six, and nine months of 2005.

Industrial performance, as measured by the value of turnover, rose by 16.7 percent y-o-y in the first 10 months. Value of turnover of the private sector rose 24.5 percent, followed by the foreign invested sector at 18.4 percent and the state sector at 9.1 percent.

In the first nine months, agricultural production expanded by 4.1 percent despite a resurgence of avian influenza and drought conditions in parts of the country. It is estimated that in 2004 the direct impact of avian influenza amounted to about 0.12 percent of GDP.
This represents the net effect of the negative impacts on the poultry sector compensated to some extent by the increase in substitute livestock production. The impacts, however, are unequal as income from poultry and eggs is more important among the poorest part of the population. As the winter season approaches, the chances of a new, large outbreak of avian influenza become higher. There are also concerns that the H5N1 virus, which for now is transmitted mainly from bird to bird, and only on a very limited scale from birds to humans, could mutate and be transmitted from humans to humans, raising the prospect of a global influenza pandemic. As last year, the government’s strategy relies on bird culling and movement control. But it now also includes a revised “compensation framework” for farmers, enhanced bio-security, and a large scale vaccination campaign of domestic poultry and ducks.

Indicators of domestic consumption and investment have been robust. The retail sales index rose by 20 percent y-o-y during January to October 2005. New business registrations in 2005 are estimated to reach 38,000, an increase of about 3.3 percent over the previous year. The average capital of these new enterprises is around 170 thousand dollars. While this is still quite small, it has shown an appreciable increase of about 33 percent in 2005 compared with 2004. Overall, the ratio of investment to GDP is expected to attain 38.2 percent in 2005.

After achieving a seven-year high of 4.2 billion dollars in 2004, FDI commitments improved further to 4.6 billion dollars by end-October. These include 2.98 billion dollars of new commitments and 1.6 billion dollars for capital expansion by existing firms. FDI disbursements, including domestic borrowing by joint ventures, reached 2.78 billion dollars implying an increase of 17.5 percent y-o-y. FDI commitments are projected to exceed 5 billion dollars by year end, while disbursements are likely to rise to nearly 3 billion dollars (Figure 1).

**Figure 1: FDI Commitments and Disbursements**

![Bar Chart](image)

*Source: GSO and MPI.*

**Exports benefit from higher prices**

In the first ten months of 2005, exports grew by 21.9 percent y-o-y in value terms. As in 2004, crude oil was the leading export. Strong prices led to crude oil exports
Recent Economic Developments

increasing by 33.5 percent y-o-y in value terms, despite a fall in volume of 7.2 percent. Exports of other main commodities such as rice, coffee, rubber and coal have also benefited from increased prices in 2005 (Figure 2). While rice exports profited from higher prices they have been adversely affected by the damage caused by floods and Typhoon Damrey in the last quarter of the year. In order to ensure food security the government announced, in October, that it will not allow any further rice shipments. In the first 10 months of 2005 the quantity of rice exports was up 30 percent, while their value soared nearly 50 percent.

**Figure 2: Commodity Exports – Value and Price Increase**

![Chart showing commodity exports and price increase from 2002 to 2005](chart)

*Source: GSO and GDC.*

*Note: Commodities are crude oil, rubber, rice, coffee, and coal*

**Table 2: Export Structure and Growth**

<table>
<thead>
<tr>
<th>Value ($mn) 2004</th>
<th>Share (%)</th>
<th>Growth (% p.a.)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2003</td>
<td>2004</td>
</tr>
<tr>
<td>Total export earnings</td>
<td>26,503</td>
<td>100.0</td>
</tr>
<tr>
<td>Crude oil</td>
<td>5,671</td>
<td>18.9</td>
</tr>
<tr>
<td>Non-oil</td>
<td>20,832</td>
<td>81.1</td>
</tr>
<tr>
<td>Garments</td>
<td>4,386</td>
<td>18.3</td>
</tr>
<tr>
<td>Footwear</td>
<td>2,692</td>
<td>11.2</td>
</tr>
<tr>
<td>Seafood</td>
<td>2,401</td>
<td>10.9</td>
</tr>
<tr>
<td>Agricultural goods (excl. rice)</td>
<td>2,128</td>
<td>7.6</td>
</tr>
<tr>
<td>Wood products</td>
<td>1,139</td>
<td>2.8</td>
</tr>
<tr>
<td>Electronics &amp; computers</td>
<td>1,075</td>
<td>3.3</td>
</tr>
<tr>
<td>Rice</td>
<td>950</td>
<td>3.6</td>
</tr>
<tr>
<td>Handicrafts</td>
<td>426</td>
<td>1.8</td>
</tr>
<tr>
<td>Coal</td>
<td>355</td>
<td>0.9</td>
</tr>
<tr>
<td>Other</td>
<td>5,281</td>
<td>20.6</td>
</tr>
</tbody>
</table>

*Source: GDC and GSO.*

*Note: Growth for ten months of 2005 is year on year.*
The main manufactured export, garments, after being flat in the first half of 2005, recovered in the third quarter to grow by 7.2 percent y-o-y in the first ten months. An examination of destination data for the first nine months of 2005 reveals that garment exports to the US fell by 2.8 percent y-o-y, slowed to 5.2 percent in the EU, but experienced robust growth in the Japanese market (Table 3). The expiry of the Agreement on Textiles and Clothing marked the onset of quota free trade in the garments sector for WTO member countries. Vietnam, not currently a WTO member, continued to face quotas in the US market which accounts for over 50 percent of its garment exports. Garment exports have been impacted both by increased international competition, as well as by problems with domestic allocation of quotas. Since July, however, the introduction of an “automatic regime” for granting quotas is said to have eased exporters’ concerns.

Table 3: Destination and Growth of Selected Exports

<table>
<thead>
<tr>
<th></th>
<th>Footwear 2004</th>
<th>Seafood 2004</th>
<th>Garments 2004</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>9M-05</td>
<td>9M-05</td>
<td>9M-05</td>
</tr>
<tr>
<td>Japan</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Share</td>
<td>2.6</td>
<td>3.2</td>
<td>31.1</td>
</tr>
<tr>
<td>Growth</td>
<td>14.5</td>
<td>36.3</td>
<td>18.2</td>
</tr>
<tr>
<td>US</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Share</td>
<td>15.4</td>
<td>20.4</td>
<td>25.0</td>
</tr>
<tr>
<td>Growth</td>
<td>47.0</td>
<td>50.3</td>
<td>-22.7</td>
</tr>
<tr>
<td>EU</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Share</td>
<td>65.5</td>
<td>35.7</td>
<td>10.7</td>
</tr>
<tr>
<td>Growth</td>
<td>10.5</td>
<td>-4.8</td>
<td>57.1</td>
</tr>
<tr>
<td>Total export growth</td>
<td>18.7</td>
<td>12.3</td>
<td>9.2</td>
</tr>
</tbody>
</table>

Source: GSO and GDC.
Note: Share in percent. Growth rates in percent per year.

Vietnam’s exports are once again facing an uncertain environment due to anti-dumping actions. The items currently under threat are footwear, bicycles, and wood products. Bicycles have already been hit with antidumping tariffs of 34 percent in the EU. In July, the EU also started an anti-dumping probe against footwear imports from Vietnam. The EU footwear industry claimed that imported leather shoes from Vietnam were being sold at below-market prices. Between 2002 and the first quarter of 2005, footwear imports from Vietnam rose by 79 percent, while prices fell by 30 percent, allegedly harming the local industry. Depending on the product, antidumping suits have typically also included countries such as China, Thailand and India, in addition to Vietnam. However, given that Vietnam’s exports are less diversified than these countries, the impact on Vietnam has been greater.

Import growth slows

Over the first ten months of 2005 imports grew 18.3 percent y-o-y in value terms (Table 4). Compared with the first half of the year, imports appear to be slowing in the second half, and import growth over the entire year may further decrease. Part of the slowdown could be explained in terms of a recent softening of international commodity prices.
which were a key driver of the import bill in 2004 (Figure 3). In addition, imports of machinery which had picked up in the first four months of the year have since slowed, recording a growth of less than 2 percent in the first ten months of 2005.

### Table 4: Import Structure and Growth

<table>
<thead>
<tr>
<th></th>
<th>Value ($mn)</th>
<th>Share (%)</th>
<th>Growth (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2004</td>
<td>2003</td>
<td>2004</td>
</tr>
<tr>
<td>Total import value</td>
<td>31,954</td>
<td>100.0</td>
<td>100.0</td>
</tr>
<tr>
<td>Petroleum products</td>
<td>3,574</td>
<td>9.6</td>
<td>11.2</td>
</tr>
<tr>
<td>Final Goods</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Machinery and equipment</td>
<td>5,249</td>
<td>21.2</td>
<td>16.4</td>
</tr>
<tr>
<td>Computer and electronics</td>
<td>1,343</td>
<td>3.9</td>
<td>4.2</td>
</tr>
<tr>
<td>Pharmaceuticals</td>
<td>510</td>
<td>1.5</td>
<td>1.6</td>
</tr>
<tr>
<td>Intermediate and raw materials</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Garment and leather materials</td>
<td>2,253</td>
<td>8.1</td>
<td>7.0</td>
</tr>
<tr>
<td>Steel</td>
<td>2,573</td>
<td>6.6</td>
<td>8.1</td>
</tr>
<tr>
<td>Fabrics</td>
<td>1,927</td>
<td>5.4</td>
<td>6.0</td>
</tr>
<tr>
<td>Plastics</td>
<td>1,191</td>
<td>3.0</td>
<td>3.7</td>
</tr>
<tr>
<td>Fertilizer</td>
<td>824</td>
<td>2.5</td>
<td>2.6</td>
</tr>
<tr>
<td>Chemical products</td>
<td>706</td>
<td>2.3</td>
<td>2.2</td>
</tr>
<tr>
<td>Chemicals</td>
<td>683</td>
<td>2.0</td>
<td>2.1</td>
</tr>
<tr>
<td>Automobiles (CKD/IKD)</td>
<td>647</td>
<td>3.6</td>
<td>2.0</td>
</tr>
<tr>
<td>Fibers</td>
<td>339</td>
<td>1.2</td>
<td>1.1</td>
</tr>
<tr>
<td>Paper</td>
<td>248</td>
<td>0.9</td>
<td>0.8</td>
</tr>
<tr>
<td>Pesticides</td>
<td>210</td>
<td>0.6</td>
<td>0.7</td>
</tr>
<tr>
<td>Cotton</td>
<td>190</td>
<td>0.4</td>
<td>0.6</td>
</tr>
<tr>
<td>Other</td>
<td>9,489</td>
<td>27.2</td>
<td>29.7</td>
</tr>
</tbody>
</table>

*Source: GDC and GSO. Note: The ten-month growth is rate is year on year.*

### Figure 3: Key Commodity Imports – Value and Price Increase

*Source: GSO and GDC. Commodities are petroleum products, clinker, plastics, fertilizer, paper, cotton, fiber, steel.*
**External deficits narrow**

The trade deficit began to narrow in the second half of 2005 after having increased in the first half. Under current trends, the trade deficit (f.o.b basis), is likely to narrow to between 3 to 3.5 percent of GDP in 2005 compared with 5.2 percent in 2004. On the services side, tourism earnings are expected to surpass 3 billion dollars in 2005 compared with about 2.6 billion dollars in 2004. This year, the total number of foreign visitors is estimated to reach 3.4 million, compared with 2.9 million in 2004, and an increase in average spending per visitor is also anticipated. With overseas remittances likely to range from 3.5 to 4 billion dollars, the current account deficit is estimated to narrow to under 3 percent of GDP from 3.8 percent in 2004 (Figure 4).

![Figure 4: Trade and Current Account Balances](source: IMF and World Bank.)

The deficit is mainly financed through ODA and non-debt-creating FDI inflows. Data from MPI reveal that in the first ten months of the year, over 1.3 billion dollars of ODA was disbursed, of which about 1.2 billion dollars was in concessional loans. Foreign exchange reserves have risen from 7 billion dollars at end-2004 to 8.3 billion dollars in May 2005, representing around 12 weeks of imports of goods and non-factor services.

**Vietnam debuts in international bond market**

Vietnam successfully issued its first international bond in October, 2005. Initially, the government had decided to raise 500 million dollars, but given a stronger than expected market interest, the amount was increased to 750 million dollars. The ten-year dollar-denominated bonds were priced at 98.223 percent with a coupon of 6.875 percent to yield 7.125 percent. This was 256.4 basis points above comparable ten-year US Treasuries. The spread obtained by Vietnam is higher than that for countries such as China and Malaysia, but is appreciably lower than those for Indonesia and Philippines, and some Latin American countries (Figure 5). The outcome of the bond issuance is considered favorable given Vietnam’s level of economic development, and the fact that this was a first time
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offering. It may also be noted that the issue took place in a time period when spreads on emerging market bonds had in general been declining. The proceeds from the bonds will be passed on to Vinashin, the shipbuilding SOE. Vinashin is reported to have secured large export orders which justify the foreign currency borrowing. Moreover, commercial banks are unable to lend to Vinashin on a long-term basis, given the short-term nature of their deposits. The bonds are to be traded on the securities exchange in Singapore. The yield on the bonds is expected to serve as a benchmark for Vietnamese corporations who have expressed an interest in tapping the international market.

Figure 5: Bond Spreads over US Treasuries

![Bond Spreads over US Treasuries](image)


**Buoyant revenues and higher expenditure**

Oil-related revenue is expected to exceed its budgeted amount by over 40 percent, and overall revenue is likely to surpass its target by about 15 percent reaching around 25 percent of GDP. With private businesses showing robust performance, budgetary revenues from the sector are estimated to increase by 28 percent in 2005.

Rising oil prices have had an upward impact on the expenditure side as well. Since domestic oil price adjustments have lagged behind international prices, the government has had to compensate domestic oil distribution companies. Such expenditure is estimated to have attained 0.5 percent of GDP in 2004. In the first six months of 2005 compensatory payments to oil distributors are estimated at 6.4 trillion dong or 1.7 percent of GDP, but they are likely to come down in the second half as oil prices have recently softened. Another factor leading to higher expenditures is the recently announced increase in government salaries and social insurance payments. The estimated cost to the budget is 4.1 trillion dong or around 0.5 percent of annual GDP in 2005, and an additional 13 trillion dong will be required in 2006. Capital expenditure which accounts for about a third of total expenditure picked up in the second half of 2005. By October, about 90 percent of the
budgeted amount had been spent, and it is likely that capital expenditure will exceed the target set for 2005.

Overall, the budget deficit (excluding on-lending) is expected to range between 1 to 1.5 percent of GDP. This is below the planned level of 2.3 percent of GDP in 2005, but higher than the level of 0.8 percent attained in 2004. To obtain a fuller picture of fiscal needs it is important to add on-lending of both ODA as well as of domestically raised resources through DAF. For 2005, these are estimated at 1.2 percent and 0.6 percent of GDP respectively (Figure 6). Public debt related to budgetary operations currently stands at about 32 percent of GDP. Including off-budget items and DAF on-lending raises the debt-GDP ratio to around 41 percent. About two-thirds of the debt is highly concessional ODA, and debt servicing is considered very manageable.

**Figure 6: Budget Deficit and On-lending**

![Bar chart showing budget deficit and on-lending]  
*Source: MOF and World Bank.*

**Infrastructure bonds face mobilization and disbursement problems**

The government has planned to step up off-budget infrastructure investment that has been financed through the issuance of domestic bonds. Earlier plans to issue bonds worth 4 billion dollars till 2010 could be revised upwards by as much as 75 percent. The stock of infrastructure bonds currently stands at about 2.5 percent of GDP. While the enhanced spending program is justifiable on the basis of infrastructure requirements, its implementation needs to be accompanied by improvements in project evaluation and moving the expenditure on-budget. The target for such bond issuance in 2005 stood at 10.5-11 trillion dongs.

But in recent months the government has faced difficulties in raising capital through bond issuance. Part of the reason relates to a relatively low interest rate: Commercial

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1 The government’s definition of the budget deficit is non-standard in that it includes amortization payments and carry-over of revenues and expenditures. According to this definition the budget deficit is estimated at 4.9 percent of GDP in 2004 and 4.86 in 2005 against a target of 5 percent in both years.
banks offer as much as 9.5 percent per annum for a three-year term deposit while the most recent three- and five- year government bonds carried rates of 8.15 percent and 8.75 percent respectively. In addition, with Ho Chi Minh City and Hanoi also offering infrastructure bonds for sale the central government issues have been subjected to some competition.

There have also been problems with disbursing the funds raised through bonds over 2003-05. It is expected that 16 trillion dong or only 75 percent of the planned disbursements will occur by the end of 2005. Slow disbursements have been blamed on complex investment procedures, site clearance, and poor supervision.

**Non-food inflation creeps upwards**

The supply side-shocks that sparked inflation in 2004 have not fully abated or have recurred. These shocks are the outbreak of avian influenza, poor weather conditions, and hardened international prices of key imports such as oil, fertilizer, cement and steel. Inflation had trended downwards from 10.3 percent y-o-y in October 2004, to around 7.3 percent y-o-y in August 2005, but ticked up to 8.3 percent in October (Figure 7). The government’s original target of 6.5 percent y-o-y for end-2005 will thus be missed. Food price inflation which stood at 18.6 percent in October 2004, has come down to 10.9 percent a year later, but the prices of non-food items have crept upwards from 4.7 percent to 6.7 percent.

![Figure 7: Growth in Consumer Price Index](chart.png)

*Source: GSO.*

Throughout the year, while policy makers have reiterated their desire to meet their GDP growth target of 8.5 percent, they have been mindful of its potential inflationary impacts, especially as international commodity prices remained high. Central bank announcements have suggested a reluctance to apply strong monetary restraints to rein in the supply shock-induced inflation as it may entail an unduly high cost in terms of foregone
output. During the recent phase of inflation, the government has not allowed the power, coal and cement sectors to raise their prices, in order to not exacerbate the impact of the supply shocks. However, it appears likely that these sectors would be allowed to increase their prices next year. In the coming months, food prices will also face upward pressures from the usual high demand period around the Tet festival, as well as to some extent from the recently announced increased in public sector salaries.

**Credit growth slows slightly**

After having climbed to 42 percent y-o-y in December 2004, the pace of credit growth slowed to 37 percent in July 2005 (Figure 8). The slowdown is mainly attributable to a decline in credit growth to SOEs from around 36 percent in December 2004, to 28 percent in June 2005. In 2004, lending in foreign currency rose by 60 percent compared with 38 percent for loans denominated in domestic currency. Expectations of a slow depreciation of the dong combined with lower interest rates on foreign currency lending, appears to have made such borrowing more attractive. While US dollar lending rates have risen in 2005, so have domestic rates, and the spread between the two has not changed appreciably. With exchange rate expectations remaining unchanged, foreign currency borrowing has retained its attractiveness. To the extent that such lending may be going to borrowers who do not have foreign currency earnings or have unhedged exposures, the banks would be taking on additional risk. The lending rate normally charged for foreign currency loans is the Singapore Inter-bank Offer Rate (SIBOR) plus two percent.

![Figure 8: Credit and Money Supply Growth](image)

*Source: IMF.*

Domestic interest rates on bank deposits have faced upward pressure due to both inflation as well as increases in US interest rates as bankers perceive that depositors will switch to US dollar deposits if dong rates are left unchanged. Interest rates on one year dong deposits currently range between 8.4 percent and 8.76 percent.
The main concern with fast expanding credit has been its quality. In recent months the central bank has particularly highlighted risks related to property loans. With real estate transactions coming to a virtual halt in recent months, there have been concerns about the ability of builders to service their loans. The other risk that the central bank has emphasized relates to the so-called “rate race” between banks for attracting deposits. As higher deposit rates translate into higher lending rates, an assessment of the repayment capacity of borrowers needs even more attention. Credit quality has been hard to assess as banks, till recently, were required to report NPLs based on standards that were significantly weaker than internationally acceptable ones. The central bank’s Decision 493 of April, 2005 raised the classification and reporting on NPLs to international standards. The first reports are expected to be available at the end of 2005.

**Poverty continues on downward trend**

Data collected through the Vietnam Household Living Standard Survey (VHLSS) in 2004 shows a continuation of rapid poverty reduction in Vietnam. The general poverty rate has fallen from 58.1 percent in 1993 to 19.5 percent in 2004, implying an average decline of 3.5 percentage points per year (Figure 9). The proportion of poor people therefore is now a little more than one-third of what it was 11 years ago. While different definitions of poverty lines provide different poverty rates, the downward trend is preserved in all cases (Box 1).

**Figure 9: Poverty Trends**

The data also suggest that poverty reduction has accelerated in the past two years. This acceleration may simply be a quirk of the data. The household survey for 2002 was much larger in scale, but was conducted with less supervision and training of enumerators than the surveys done in 1993, 1998, and 2004. It is not unlikely that the 2002 survey might
have somewhat underestimated consumption expenditure and thus overestimated poverty. This would not impact the poverty rate for 2004, but would imply that the line connecting the 1993 rate with the 2004 rate is straighter. But the acceleration in poverty reduction could also reflect a real trend as it is consistent with several other developments over this time. The faster reduction in poverty is consistent with the acceleration in economic growth during 2002-2004 compared with the period 1998-2002. The sharper reduction in poverty might also reflect the increasing size of budget transfers to poorer provinces, especially since tax-revenue sharing arrangements and equalization grants were introduced in this period. The public investment program, with its greater emphasis in remote areas during the current five-year plan, might have contributed as well. Rural infrastructure development has benefited farmers by increasing their access to markets. The proportion of the people living within 2 km of an all weather road increased to about 83 percent compared with 76 percent two years ago. Last but not least, rapid poverty reduction in rural areas in recent years is likely to be related to a rise in the world market prices of agricultural export commodities such as coffee and rice, which are important sources of income for many of the rural poor.

**Box 1: Poverty Measurement**

The poverty rate is defined as the proportion of the population whose consumption expenditure, including food and non-food items, is not sufficient to ensure an intake of 2,100 calories per day. The general poverty rate presented here is based on such a minimum needs consumption basket derived from 1993 VLSS data. By adjusting the prices of each of the individual goods that constitute this basket one can ‘update’ the poverty line to 1998, 2002 and 2004 and use it to provide a set of comparable poverty rates over these years. But this approach, while consistent and acceptable, is deficient in that the food basket from 1993 is somewhat out of date as consumption patterns are likely to have changed.

The Government of Vietnam has recently adopted a new poverty line which is based on an update of this consumption basket. Prime Minister’s decision 170/2005/QD-TTg proposed a poverty line for 2005 of 200,000 dong per capita per month for rural areas and 260,000 dong per capita per month for urban areas. These lines are somewhat higher than the ones used for the present analysis, even when deflated back to 2004 and 2002, and thus lead to a somewhat higher national poverty rate: 23.1 percent for 2004 and 32.4 percent for 2002.

The above poverty rates use household consumption expenditure to measure whether a person is above or below the poverty line. An alternative approach would be to use income, instead of consumption expenditure, and classify people as poor when their income is lower than the poverty line. When this latter method is employed in conjunction with the new 2005 poverty line from the Prime Minister’s decision, the national poverty rate in 2004 is 18.1 percent and 23 percent in 2002 (see GSO press release of August 1, 2005).

Poverty reduction continues to be widespread across the country. In the past six years, rural poverty has decreased at 3.4 percentage points per year which is faster than for the country as a whole (3.0 percentage points per year). With rural poverty now at 25 percent, compared to 4 percent for urban areas, poverty in Vietnam remains overwhelmingly rural.
While there has been progress across all eight regions, the poverty rate remains much higher in some (Table 5). The North West stands out as being particularly poor, with 59 percent of the population living in poverty. Though only 3 percent of the total population lives in the North West, it accounts for 9 percent of the poor. The Central Highlands and the North Central Coast both have around one-third of their populations living in poverty, though both regions have made reasonable progress during the past eleven years and have more than halved the numbers in poverty since 1993.

### Table 5: Poverty Rate Across Regions

<table>
<thead>
<tr>
<th>Region</th>
<th>1993</th>
<th>1998</th>
<th>2002</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>North East</td>
<td>86.1</td>
<td>62.0</td>
<td>38.4</td>
<td>29.4</td>
</tr>
<tr>
<td>North West</td>
<td>81.0</td>
<td>73.4</td>
<td>68.0</td>
<td>58.6</td>
</tr>
<tr>
<td>Red River Delta</td>
<td>62.7</td>
<td>29.3</td>
<td>22.4</td>
<td>12.1</td>
</tr>
<tr>
<td>North Central Coast</td>
<td>74.5</td>
<td>48.1</td>
<td>43.9</td>
<td>31.9</td>
</tr>
<tr>
<td>South Central Coast</td>
<td>47.2</td>
<td>34.5</td>
<td>25.2</td>
<td>19.0</td>
</tr>
<tr>
<td>Central Highlands</td>
<td>70.0</td>
<td>52.4</td>
<td>51.8</td>
<td>33.1</td>
</tr>
<tr>
<td>South East</td>
<td>37.0</td>
<td>12.2</td>
<td>10.6</td>
<td>5.4</td>
</tr>
<tr>
<td>Mekong Delta</td>
<td>47.1</td>
<td>36.9</td>
<td>23.4</td>
<td>15.9</td>
</tr>
<tr>
<td><strong>All of Vietnam</strong></td>
<td><strong>58.1</strong></td>
<td><strong>37.4</strong></td>
<td><strong>28.9</strong></td>
<td><strong>19.5</strong></td>
</tr>
</tbody>
</table>

*Source: GSO.*

*Note: Percentage of people below the poverty line.*

About one-third of all poor people in Vietnam live in the densely-populated Mekong and Red River delta regions, even though their poverty rates are lower than the national average. The poverty gap, which measures the average distance between the actual consumption of the poor and the consumption needed to get out of poverty, reveals that poverty is shallow in the delta regions. This means that a large number of people are clustered a small distance below the poverty line. Poverty is at its deepest in regions where the incidence of poverty is high. The poverty gap in the North West is 19.1, or nine times larger than in the Red River Delta.

Measures used to track inequality, such as the Gini index or the ratio of expenditures of the poorest and richest quintiles of the population, suggest that there has been little or no increase in inequality over the last two years. The Gini index, at 0.37, has not changed since 2002. The ratio that compares the consumption expenditures of the richest and poorest quintiles of the population has increased very slightly between 2002 and 2004. In 2002, the share of expenditures made by the richest twenty percent of the population was 6.03 times the expenditures made by the poorest twenty percent. In 2004, this ratio stands at 6.27.
These impressive achievements in reducing poverty without striking increases in inequality sit alongside slower progress for an important sub-group of the population: ethnic minorities. Figure 10 shows that poverty for both Kinh and ethnic minority populations has fallen steadily over the period from 1993 to 2004. Progress has been more rapid for the Kinh and Chinese populations, however. In 2004, 14 percent of the Kinh and Chinese people were living in poverty, while 61 percent of ethnic minorities were still below the poverty line. Though ethnic minorities account for only 13 percent of the total population, they now constitute 39 percent of the poor. Their poverty is also deeper than the poverty of other groups. The poverty gap for ethnic minorities is 19.2, while that for poor Kinh people is only 2.6.

**Figure 10: Poverty among Kinh and Ethnic Minority Populations**

Source: GSO.
PART II
DEVELOPMENT POLICIES
Vietnam’s transition to a market economy has become linked closely with its efforts towards WTO accession. Substantial progress has been achieved on this front, but Vietnam’s initial goal of WTO membership by end-2005 will not be met. The number of SOEs continues to be transformed at a steady rate and the average size of equitized SOEs is also increasing. One remaining challenge is to speed up the transformation of the General Corporations. A roadmap for the reform of SBV and the banking system has been prepared, and two state owned banks are to begin their equitization process next year. Ensuring that the steps outlined in the banking reform program are implemented in a timely fashion will require a determined effort at the highest levels of government.

In the social sectors, Vietnam continues to make progress towards achieving the MDGs, but other challenges are emerging. In the education sector, progress is visible in attaining Fundamental School Quality Levels, including in poor areas. As the sector becomes increasingly diversified and decentralized, its governance has become more complex, and demands a greater focus from policymakers. In the health sector, greater emphasis is needed to address non-communicable diseases as well as new ones such as avian influenza and HIV/AIDS. A new decree has been prepared to help Vietnam move towards its goal of Universal Health Insurance. Efforts are needed to fully understand the cost implications of this strategy, and ensuring that the requisite supply response of health services will be forthcoming.

The government has recently drafted its Socio-Economic Development Plan (SEDP) 2006-10 through a broad consultative process including stakeholders at both national and subnational levels. The draft SEDP focuses on development outcomes, and sees an increasing role for the private sector in helping Vietnam attain middle-income status. Having received feedback from various stakeholders, the government is now strengthening the draft through revisions that include: mainstreaming poverty by widening the approach to beyond targeted programs alone, establishing a clearer connection between SEDP objectives and the allocation of budget resources, and better linking the plan's objectives with monitorable indicators and programs. Public finance reforms are focusing on budget formulation within a medium term framework and strengthening the management of state assets. The mechanisms for financing fast expanding demands for municipal infrastructure are being improved through better regulations for provincial infrastructure funds. The new law on anticorruption, and implementation of the recently approved legal and judicial system strategies, hold the promise of strengthening and modernizing the institutions for governing a market economy.

A. Transition to a Market Economy

International Integration

Vietnam’s WTO membership negotiations took a substantial step forward with the detailed discussion on 15 September 2005 of the first revision of the Working Party Report, a document that is a core part of the process. But Vietnam will not be able to wrap up accession by the Hong Kong Ministerial Conference in December 2005 as originally
targeted by the government. The main reason is that Vietnam has been unable to successfully conclude bilateral negotiations with all partners, notably the US. For non-
conditional accession, Vietnam would need to be provided Permanent Normal Trade Relations (PNTR) status, but the schedule for its consideration and potential approval by the US congress is not yet clear (Box 2). Reportedly, the US would like Vietnam to open up its telecommunication and financial sectors more than it has offered. US business groups have also complained against restrictions on trading and distribution that have prevented US firms from entering or selling in Vietnam's market. They would also like to see Vietnam improve its track record on implementing provisions of their existing bilateral trade agreement (BTA). Vietnam on the other hand has hinted that some of these constitute “WTO-plus” requirements, and should not be expected of a country at its level of development.

Thus far, Vietnam has concluded 11 multilateral negotiation sessions and has also completed bilateral negotiations with 22 out of 28 partners requiring bilateral talks, including major trade partners such as the European Union, Japan, China, the Republic of Korea and Singapore. Bilateral negotiations with the United States, Australia, New Zealand, Mexico and the Dominican Republic have not been concluded. The multilateral discussion of the revised working party draft revealed issues requiring further clarification, in particular, trading rights and the functioning and status of state trading enterprises, considered by the US as “a central issue” in the negotiation. Areas of concern also included subsidies, the investment regime and the taxation policies.

The seventh session of the National Assembly, held in May and June 2005, passed 15 laws which were seen to be important for WTO accession. These included the amended Civil Code, the amended Commercial Law, the Law on State Auditing, the Law on signing of, Accession to and Implementation of International Treaties, the amended Customs Law, the amended Law on Export and Import Duties, the amended Mineral Law and the amended Law on Complaints and Denunciations. The National Assembly also speeded up its legislation program in an attempt to achieve the goal of promulgating within 2005 important laws concerning WTO membership. The agenda of the October-November session, includes discussing and possibly adopting 14 Laws, including the Law on Intellectual Property, the Law on Electronic Transactions, the Enterprise Law, the Investment Law, the amended Law on Value Added Tax, the amended Law on Special Consumption Tax.

Vietnam up till now has committed to implement upon accession the following agreements: TRIPS (intellectual property), TRIMs (investment measures), CVA (Customs Valuation Agreement), TBT (technical barriers to trade), SPS (sanitary and phytosanitary measures), ILP (import licensing provisions), A/D & C/V (anti-dumping), and ROO (rules of origin). With regard to the SCM (subsidies and countervailing measures) Vietnam has requested that it be eligible for special and differential treatment that is available to countries at a comparable level of development.

The amended laws on special consumption tax (SCT) and VAT will ensure that there will no longer be discrimination between imported products and locally-made ones as required under WTO rules. The affected commodities include passenger cars, cigarettes,
alcohol, beer, cotton, and unprocessed forestry and seafood. For instance, under current rules, filter-tipped cigarettes using imported materials carry a SCT of 65 per cent, while the ones using local inputs are taxed at only 45 per cent. The equality will be achieved through an upward adjustment of tax rates. In the case of passenger cars, local producers currently enjoy a preferential tax treatment lasting up to 2007. But the new law will introduce an equal tax rate next year, with lower rates for imports but higher ones for domestically produced vehicles.

Preferential credit currently provided to exporters of certain goods and services has been objected to by Vietnam’s trading partners, as it constitutes an export subsidy. In response, the government is planning to reduce such credit extension in a phased manner over 2006-10. The affected items are likely to include agricultural products, processed foods, textiles, garments, footwear, bicycles and bicycle parts, handicrafts, electronics, computers, electric wires and cables, and sea-going ships.

Box 2: Permanent Normal Trade Relations with the US

Under US trade law Vietnam currently has conditional normal trade relations (NTR) status. It is conditional in that it must be renewed annually. The underlying key condition for renewal is Vietnam’s continued compliance with the freedom-of-emigration requirement of the Jackson-Vanik amendment, a provision of Title IV of the Trade Act of 1974 affecting a listed group of twenty plus non-market economies including Vietnam. While listed as a Jackson-Vanik country under this amendment, the Secretary of State under Presidential delegation of authority can, in effect, grant one-year extensions of NTR based on freedom of emigration criteria. The extension remains in force unless both Houses of Congress pass a joint resolution of disapproval by August 31 and the President signs it. Vietnam’s present NTR status also is based on a reciprocal NTR provision of the comprehensive U.S.-Vietnam bilateral trade agreement (BTA), which entered into force on 10 December 2001, subject to either party’s statutory authority to maintain it in force. As a result of such criteria, Vietnam does not have permanent normal trade relations (PNTR) status or in WTO language unconditional most-favored nation (MFN) status.

While prior granting of PNTR status by the US is not necessary for Vietnam’s accession, nor does Vietnam’s accession automatically obligate the U.S. to grant PNTR to Vietnam, Members of the WTO are generally obligated to grant on a reciprocal basis immediate and unconditional most-favored nation treatment to the products of all other WTO Members. Therefore, at Vietnam’s accession to the WTO, the U.S. must either grant Vietnam unconditional NTR or PNTR status or else choose before the accession to invoking the “non-application” provision of Article XIII of the WTO Agreement. If the non-application clause is invoked, however, Vietnam will have the right to withhold from the U.S. the benefits of its WTO accession commitments that have been granted to other WTO members (i.e., those commitments that go beyond the BTA). Thus far, six Jackson-Vanik countries have become full members of the WTO prior to their receiving PNTR from the U.S.


Reforming state-owned enterprises

As a result of ongoing transformations, the number of SOEs had been reduced to below 3,200 at the end of September 2005 compared with more than 5,600 that existed in
2001. The numbers of transformations continued to increase through 2004, but appears to have slowed somewhat in 2005 (Table 6). However, if as in 2004, there is a pick-up towards the end of the year the number of transformations in 2005 may well be greater than in the previous year. The numbers reported in Table 6 are lower than officially released transformations. This is because the official data cover transformations under implementation, while only completed transformations are reported here.

Table 6: Number of SOE Transformations

<table>
<thead>
<tr>
<th></th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005 (10m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equitizations</td>
<td>199</td>
<td>214</td>
<td>353</td>
<td>626</td>
<td>470</td>
</tr>
<tr>
<td>PPCs</td>
<td>158</td>
<td>148</td>
<td>235</td>
<td>371</td>
<td>--</td>
</tr>
<tr>
<td>Ministries</td>
<td>27</td>
<td>46</td>
<td>101</td>
<td>195</td>
<td>--</td>
</tr>
<tr>
<td>GC91s</td>
<td>14</td>
<td>20</td>
<td>17</td>
<td>60</td>
<td>--</td>
</tr>
<tr>
<td>Sales/Assignments</td>
<td>59</td>
<td>38</td>
<td>48</td>
<td>41</td>
<td>6</td>
</tr>
<tr>
<td>Liquidation/Bankruptcy</td>
<td>21</td>
<td>24</td>
<td>30</td>
<td>39</td>
<td>16</td>
</tr>
<tr>
<td>Single Member LLCs</td>
<td>2</td>
<td>8</td>
<td>32</td>
<td>20</td>
<td></td>
</tr>
<tr>
<td>Sub-total</td>
<td>279</td>
<td>278</td>
<td>439</td>
<td>738</td>
<td>512</td>
</tr>
<tr>
<td>Mergers</td>
<td>2</td>
<td>58</td>
<td>113</td>
<td>34</td>
<td>5</td>
</tr>
<tr>
<td>Total</td>
<td>281</td>
<td>336</td>
<td>552</td>
<td>776</td>
<td>517</td>
</tr>
</tbody>
</table>

Source: Project on Monitoring of SOE New Establishments and Transformations, NSCERD.

The average size of SOEs undergoing transformation though small has been increasing over time. In 2005, the average equitized SOE had a state capital of 14.5 billion dong, bank debt of 18 billion dong, and 300 employees, all of which are higher than in 2004 (Table 7). SOE transformation also seems to be associated with more substantive restructuring at present, as reflected in the operation the social safety net for redundant workers. While only 1,147 SOE workers were laid-off and assisted by the safety net in 2002, the figure increased to 43,659 in 2004 and 46,815 in the first nine months of 2005. The average payout amounted to 30 million dong.

Equitizations are often “closed” transactions with outsiders having no involvement, but the incidence of this is reducing. The percentage of SOEs that did not sell any shares to outsiders has come down from 52 percent in 2003 to 29 percent in 2005. In 2004, the proportion of equity sold to outsiders amounted to no more than 9 percent of the total equity in these enterprises, but rose to 14 percent in 2005. This ratio is expected to rise as the larger SOEs are equitized. In the past, given the small size of many equitizing SOEs, once the employees had exercised their option to buy, there was little left for other potential investors.
An area of SOE reform that is receiving more attention relates to the conversion of General Corporations (GCs) and selected independent SOEs into “mother-child” holding companies. These corporations include industrial clusters in sectors such as coal (Vinacoal), cement (Vinacement), garments and textiles (Vinatex), telecommunications (VNPT), and electricity (EVN). The regulations for such transformation are provided by Decree 153 of August, 2004. A number of major steps are involved in the transformation and their sequential application is leading to prolonged time scales. One is the approval of the conversion proposal at more than one level including the GC itself and the relevant Line Ministry. A second step is the approval of the charter of the parent company, and finally, the approval of the financial regulations of the company by the MOF. In addition, there is a requirement for all the SOEs within a GC cluster to be transformed, usually by equitization or the formation of a single member limited liability company. This means that the transformation of the most difficult SOE in the cluster will delay the whole process. It also means that for the largest entities where the potential benefits of the corporatization process are the greatest, the difficulties involved are also the greatest. Indeed no large GC has, as yet, completed the process even though some started it 2 years ago. Of the 124 GCs/SOEs that have announced the intention to be converted into mother-child companies 52 have had their proposals approved, but only 8 have reached the third stage whereby they can operate under the new model.

A survey of 550 equitized SOEs was conducted in 2005. Almost 90 percent of those sampled said that their financial performance had improved. The pick-up in performance began promptly on equitization. Although tax incentives available to equitized SOEs tend to inflate post-tax profits, there is sufficient evidence that pre-tax profit rates have improved as well. Turnovers increased by 13 percent on average, and pre-tax profits by 9 percent. These improvements are higher than those observed in the population of unequitized SOEs. Investments and salaries also showed increases. Most equitized SOEs continue to be managed by the same individuals that managed the SOEs under 100 percent state ownership. The main explanation for the improvement in performance seems to be the better motivation of managers and workers. Further work is needed to improve

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**Table 7: Selected Features of SOE Transformation**

<table>
<thead>
<tr>
<th></th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005 (10m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average Charter capital (VND billion)</td>
<td>7.0</td>
<td>6.6</td>
<td>10.3</td>
<td>12.6</td>
<td>14.5</td>
</tr>
<tr>
<td>Share of transformed SOEs with charter capital greater than VND 10 billion (percent)</td>
<td>17</td>
<td>29</td>
<td>27</td>
<td>29</td>
<td>38</td>
</tr>
<tr>
<td>Average bank debt (VND billion)</td>
<td>5</td>
<td>6</td>
<td>8</td>
<td>9</td>
<td>19</td>
</tr>
<tr>
<td>Average number of employees</td>
<td>247</td>
<td>218</td>
<td>184</td>
<td>237</td>
<td>304</td>
</tr>
<tr>
<td>Share of transformed SOEs with State holding remaining above 35 (percent)</td>
<td>27</td>
<td>29</td>
<td>43</td>
<td>56</td>
<td>53</td>
</tr>
<tr>
<td>Share of transformed SOEs with no shares sold to outsiders</td>
<td>50</td>
<td>50</td>
<td>52</td>
<td>46</td>
<td>29</td>
</tr>
</tbody>
</table>

*Source: Project on Monitoring of SOE New Establishments and Transformations, NSCERD.*

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corporate governance. A little over one-third of shareholders have an adequate understanding of their rights and obligations, and only about a quarter of equitized SOEs conduct audits unless required to so. Although this figure is low, it is higher than in other Vietnamese business sectors.

The survey presented some evidence that the rates of improvement may be linked to the extent to which state shares in SOEs were reduced. Upon equitization, there seems to be a more rapid improvement in performance where the state dominance as a shareholder is removed, although thereafter, growth rates are greater in entities where the state retains a dominant shareholding. Part of the explanation appears to lie in company size as the state has tended to relinquish most of its shareholding in the smallest ones.

**Banking reform**

Vietnam’s banking reform roadmap, prepared by SBV, was recently endorsed by the Politburo. SBV will now issue a decision to put the strategy into effect. The reform of the banking system entails fundamentally re-writing the law on credit institutions and the law on the SBV. These new laws which were initially planned for 2010 have been brought forward to 2007, and will be effective from 2008. The new laws will be designed to transform the SBV into a modern and independent central bank charged with executing monetary policy and supervising the banking system. The supervision functions of SBV will be separated from its management functions in relation to SOCBs, and the operation of SOCBs on a commercial basis will be ensured. The laws will also be shaped by the international commitments that Vietnam takes on as part of WTO accession. A Banking Reform Committee with dedicated experts, and chaired at a very high level, has been proposed to oversee the strategic changes.

The planned restructuring of the SBV will also see a reduction in the number of its branches. The provincial branches will likely be consolidated into regional offices, thereby potentially removing the interference of provincial governments in the operations of the SBV at the branch level. Such interference has prevented the SBV from making decisions on a centralized basis and has limited the effectiveness of banking supervision. The reform program will also include a transformation of central bank governance to clarify and enhance management and accountability structures.

The strengthening of banking system supervision is expected to happen in two phases. In the first step the banking supervision department of SBV will be strengthened and upgraded. The focus will mainly be on banks as they are likely to be the dominant part of the financial sector in the medium term. In the second and longer term phase, an independent financial supervision board will be established. The SBV has already undertaken measures to begin upgrading its supervision functions. In October 2005, it initiated an assessment of its supervision practices against international standards, the Basel Core Principles. The assessment is scheduled for completion in the first half of 2006 with the production of a comprehensive supervision development plan.

At present, the SBV is responsible for exercising the ownership (or shareholding) rights of the state in the SOCBs, a function which conflicts with its role as supervisor of the
same banks. Under the proposed changes to the legal framework, the ownership role will be transferred to the MOF or to a dedicated agency and the SBV’s role in selecting management positions and remuneration in SOCBs will be removed.

It has been stressed that the pace of reform will be tailored to the human resource capacities within the SBV and the SOCBs. As the envisaged changes are fundamental in nature, they will need to be accompanied by an equally major development of human resources and a realignment of the incentives structure to the objectives of the institutions.

The organizational and financial restructuring of SOCBs to support their commercial orientation is expected to happen alongside their equitization. The equitizations are to be completed before 2010, except for VBARD. The equitization process of VBARD is, however, expected be well on track by then. Important decisions with regard to the equitization of banks are the much awaited approvals of plans for Vietcombank and MHB. At the end of 2004 Vietcombank’s assets were valued at about 121 trillion dong and its capital at 8 trillion dong, under Vietnamese standards. In the case of MHB assets stood at 7 trillion dong and capital at 820 billion dong. Share sales are to take place through auction at the securities exchange and will begin in 2006. Vietcombank will initially sell convertible bonds worth 1.2 trillion dong to boost its capital before equitization. These bonds can only be bought by Vietnamese individuals or institutional investors. The state’s shareholding in banks is to be gradually reduced: To no less than 70 percent by end-2006 and eventually to 51 percent by 2010. Total foreign holding of shares will be limited to 30 percent with a single institutional investor allowed to hold a maximum of 10 percent. The valuation of both the banks will be conducted through reputed external advisors. In the case of MHB, the external advisors will also help in selecting strategic investors. At this stage, however, it is not clear as to what limits will be placed on the stake that will be offered to strategic investors, especially if they are foreign institutions.

In recent months, the government has taken a series of new actions related to the banking sector. In August, the issuance of Decree 109 on deposit insurance increased the coverage of deposits from 30 million dong (1,900 dollars) to 50 million dong (3,200 dollars). It also disallowed protection to depositors who are shareholders with more than a 10 percent stake in the bank. In October, the SBV issued a Decision 888 in an attempt to limit a rapid expansion of the branch network by banks that may not have adequate capital and capacity to manage such expansion safely. The Decision requires a bank to invest at least 20 billion dong (1.27 million dollars) in each new branch and requires that a bank with chartered capital of 270 billion dong (17 million dollars) may only have a maximum of 10 branches. Although intended to safeguard the financial system, this decision may need some flexibility to allow the formal banking system to expand outreach in underserved areas as many banks may not be able to meet the new requirements.

The government has also taken steps aimed at improving access to finance. Decision 270/2005/QD-TTg of October 31 expands the range of basic financial services offered by the Vietnam Postal Savings Company (VPSC) through the extensive postal network of about 8,000 outlets. These new services will be provided under the regulatory framework for banks and will include saving certificates, remittance processing, payment services including checks, ATM cards, and agency services. In addition to the VPSC, a
new association of People’s Credit Funds (PCFs) was also established in October to coordinate and standardize the operational policies of the PCFs, including on credit risk management and accounting.

A number of actions were taken to improve payment related matters. A new Law on Negotiable Instruments passed in November, will regulate the issuance, guarantee, transfer, and mortgaging of tools such as checks. The Decree on Foreign Exchange passed in October eases restrictions on Vietnamese citizens to exchange currency and transfer it overseas. Finally, the SBV issued a regulation in October to allow banks to provide a fuller range of transactions at one point of service. The new regulation will permit banks to provide a host of banking transactions through one bank officer, not multiple officers as was required in the past.

On a different front, the government has recently announced that it will convert the Development Assistance Fund (DAF) into a development bank. One of the functions of this bank will be to serve as an “export-import” bank providing financial services to exporters and importers. This could perhaps be a way of providing government supported trade finance in a manner that is consistent with WTO principles. Under the current proposal the bank will provide loans to both domestic exporters and foreign importers who buy products made in Vietnam.

**Securities market development**

A draft stock exchange strategy for 2006-2010 calls for efforts to increase the total value of listed securities to 10 per cent of GDP by 2010. At present 30 stocks are listed on the Ho Chi Minh City exchange with a total market capitalization of around 300 million dollars or less than 0.6 percent of GDP. Six stocks are also traded on the official over-the-counter (OTC) market at the Hanoi securities trading center which began operating earlier this year.

Two main policy decisions have been taken this year to help expand the stock market towards the government’s goal. The first, Decision 528 of June 2005, directed 178 joint stock companies with dominant stake held by the state to list on the stock market, and 75 SOEs to auction their shares on the securities trading centers. The selected joint stock companies have a total registered capital of 4,828 billion dong (nearly 306 million US dollars) with 76 percent contributed by the state. Among them, the largest is Vinamilk with a capital of 1,500 billion dong. The 75 SOEs, include many well-performing ones in the fields of telecommunications, petroleum, electricity and cement.

The second policy development, Decision 238 of the Prime Minister issued in September 2005, increased the cap on the total foreign shareholdings in listed companies from 30 percent to 49 percent. Foreign investors had already hit the older ceiling of 30 percent in five companies, and were close to it in another five. Earlier decisions had allowed some foreign invested companies to convert to joint stock companies and list on the stock market.
Progress on Decision 528 has been poor and hardly any of the transactions have occurred. One reason could be that the timetable set out by the decision does not match the enterprises’ business plans and their assessment of the right time for listing, even though they may have met the listing requirements. But more generally, while over 2000 SOEs have been equitized thus far, hardly any have listed on the market. Unofficially the shares of some of these companies do, however, trade, and it is estimated that the volumes traded in this gray market are about 5 times the official one. One oft cited reason for the joint stock companies choosing not to list is the perception that disclosure requirements are too onerous. But according to some, the disclosure requirements are actually not high by international standards. From this perspective, disclosure requirements for companies in Vietnam are generally weak and even modest securities’ market requirements are seen to be exacting. Thus it is claimed that increasing disclosure requirements of unlisted joint stock companies would have an additional effect of decreasing the reluctance to list. Another point of view sees the non-listing problem as stemming from a limited awareness of the benefits of listing on formal markets.

B. Social Inclusion and Environmental Sustainability

*Enhancing education quality*

Vietnam continues to make impressive improvement in access at education of all levels. Net enrolment rates reached 94 percent for primary, 80 percent for lower secondary and 45 percent for upper secondary in the school year 2003-04. More importantly, the gap between the rich and the poor continues to narrow. The net enrollment rate for the poorest income quintile improved from 70.5 percent to 90.7 percent, and for ethnic minority children from 61.8 percent to 87.7 percent between school the years 1992-93 and 2003-04.

The Fundamental School Quality Level (FSQL) has been accepted as a key tool for sector performance monitoring and linking resources to needs. For primary education, the FSQL input index has improved nationwide. Improvement is particularly apparent in the areas of school infrastructure (access to clean water, sanitation and classroom equipment), teacher qualifications (percentage of teachers meeting national standards), and school organization (schools having development plans and the frequency of principals’ visits to satellite sites). Importantly, schools in disadvantaged districts recorded a higher speed of improvement with respect to these indicators. Areas where significant improvements are not visible yet are regular training, and support to school managers and teachers.

A larger, increasingly diversified and decentralized education system, has made sector governance, planning and budgeting more complex. The on-going work on the education sector MTEF and provincial planning is aimed at rationalizing the planning and budgeting processes. These tools buttress the roles of different stakeholders in sector governance: MPI for the provision of a clear economic framework for planning; MOF for integrating planning and deployment of resources, and balancing sectoral spending; MOET for a sector stewardship role in setting and guaranteeing service quality and facilitating provinces to achieve national objectives; the provinces for integrating investment and
recurrent funding for school system operations, and being accountable for sector output and outcomes.

Quality of education has become a major focus of government policy and is viewed as a key driver for sustainable growth. The introduction of new curricula for all sub-sectors aims at enhancing the capacity of students to master basic literacy and numeracy as well as nurturing creativity and problem solving skills. At the primary level, professional standards have been developed to guide teacher training needs, teacher appraisal and deployment. Similar tools are being developed for the secondary level. At the tertiary stage, the government has just approved the “Higher Education Reform Agenda 2020” which sets out strategic measures to improve quality and participation, including: increasing autonomy and enhancing governance; improving curriculum and teaching methods; increasing private sector participation in higher education; enhancing staff and research capacity of universities; rationalizing sector financing policy; and preparing for the sector’s greater international integration.

**Better Health**

Vietnam has made considerable gains towards achieving the MDGs on health, especially those related to infant and child mortality. Gains have also occurred on the communicable disease front, including progress with regard to malaria, and successes in diagnosing and curing a high proportion of new TB cases. However, despite this strong performance, the MDG-related agenda remains unfinished and other health-related objectives need to be urgently addressed. Non-communicable diseases, injuries, and accidents now account for almost 75 percent of reported deaths. In addition, population aging, changing socioeconomic conditions, emerging diseases (e.g. avian flu, HIV/AIDS, SARS) and behavioral risks such as smoking lie behind a trend that is also affecting health service needs, and in particular, enhancing demand for inpatient care in hospitals, leading to higher treatment costs and greater financing needs.

Politburo Resolution 46 of February 2005 recognizes Vietnam’s achievements in health, but also identifies systemic weaknesses, e.g. a failure to adapt to changing disease patterns and to the market economy; poor quality of services; and problems in meeting the needs of the poor and those living in remote, mountainous and ethnic minority areas. These problems are attributed to a disconnect between demand and supply side elements. Demand is propelled by an expanding and aging population that is registering income gains but facing a changing mix of diseases. With demand increasing and becoming more diverse, the supply of services in this “new context” is portrayed as weakly responsive, unable to engender adequate levels of investment and to adapt to the market economy.

The Resolution exhorts government to finance curative care for the poor, under-6 children and other social policy beneficiaries, in order to create a “springboard” for upgrading health care and advancing to universal health insurance by 2010. These aspects of the Resolution are operationalized via Decree 63 on health insurance, in effect from July 1, 2005. Decree 63 mandates compulsory health insurance (CHI) for several groups, such as, workers in fixed term contracts of 3-months and above, pensioners, war veterans, children under-6, and beneficiaries under the Health Care Funds for the Poor (HCFP).
Health services can be received from public or private providers as long as they are contracted by Vietnam Social Security (VSS). CHI holders will be entitled to both in-patient and out-patient services. Transportation costs will be covered in case of referral for the poor and those in remote areas. Voluntary health insurance is available to all, including those under CHI who wish to obtain a higher coverage. VSS is the agency in-charge of the implementation of the health insurance policy. MOH will issue technical standards against which VSS will assess and contract providers. MOH and MOF will provide guidance on the management of insurance funds. MOH will deal with complaints relating to health care, while MOF will deal with complaints on fund management.

Various challenges need to be addressed in order for the proposed expansion of health insurance to work smoothly. First, the capacity of VSS to take on the additional responsibilities will need to be considerably strengthened. An important aspect here would be to upgrade the ability of VSS to negotiate health packages with providers on a wholesale basis. Moreover, successful implementation will be contingent on a high level of cooperation between MOH, MOF, and VSS, and the modalities of such beneficial interaction need to be established. Last but not least, the financial viability of greater insurance coverage needs to be thoroughly evaluated. Various elements are involved here. As an example, on the supply side this would include an assessment of costs of delivering services, as well as the extent to which they may be reduced through efficiency improvements, say at the hospital level. On the demand side an assessment of the impact of the higher poverty line on the number of beneficiaries under the HCFPs will be required.

Environmental Sustainability

Vietnam continues to make progress on the legal framework for sustainable development. The Amendment to the Law on Environmental Protection, recently passed by the National Assembly, provides for improvements in a number of areas such as environmental liabilities, compensation for environmental damages, and strategic environmental assessments (SEAs), such as for sectoral and land use plans. The Ministry of Environment and Natural Resources is collaborating with other ministries to pilot several SEAs and prepare guidelines for scaling up this approach to mainstreaming environment into plans and strategies, with assistance from international donors. Vietnam is also improving the implementation arrangements for the Kyoto Protocol on climate change, through Decision 35 of the Prime Minister approved in October, 2005. This decision assigns responsibilities among the ministries for expanding Vietnam’s participation in the Clean Development Mechanism (CDM) and mainstreaming CDM activities into provincial and sectoral development plans.
C. Building Modern Governance

Improved Planning

The framework for strategic planning in Vietnam requires that every ministry, province and city prepares a medium term plan every five years that describes how they will implement the vision set out in the ten year Socio-economic Development Strategy of the Communist Party of Vietnam. The Ministry of Planning and Investment (MPI) is responsible for producing a five year Socio-economic Development Plan (SEDP) for the country as a whole. This document is not designed to reproduce the detail of the individual ministry and province plans. Instead it provides the overarching framework to ensure that these more detailed strategies can, together, effectively deliver the growth, poverty and social outcomes that have been identified through an open process.

The past year has seen the preparation of draft plans by ministries and provinces and the drafting of the SEDP 2006-2010 at the central level. The planning activities that have taken place have been shaped by the introduction of Prime Minister’s Directive 33 and subsequent guidelines on the planning process issued by the MPI. These guidelines encourage a more open and strategic approach to planning at the national and subnational levels, compared with the “command-and-control” approach of the past.

Both at the national and subnational levels, participatory consultations on the draft SEDP have drawn in stakeholders from inside and outside the government. These include workshops with officials from local governments, the domestic private sector, local associations, international NGOs and development partners, and researchers. There have been particular efforts to solicit the views of women. And there has been intensive research at the community level, where teams of researchers have gathered feedback from communities and grassroots’ officials.

The document that has resulted from this process is now being discussed by the National Assembly. Once delegates have provided their feedback, MPI will revise the document in readiness for discussion at the Party Congress in early 2006. The National Assembly will adopt the SEDP 2006-2010 after this discussion. The document represents considerable progress in developing an outcome-focused, medium-term plan, which combines the twin objectives of growth and social inclusion, and describes the reforms that will provide for a robust economy. Importantly, the document explicitly recognizes the institutional and regulatory challenges associated with completing the transition to a market economy. It describes a large number of planned legal actions which, together with the reform agenda implied in the accession to WTO, will strongly support this transition. Initial measures have been undertaken to establish an effective Monitoring and Evaluation system for the implementation of SEDP.

Following consultations, the drafting team is considering how to strengthen a number of elements of the current draft. These include improving the macroeconomic framework, in terms of coherence between sources and uses of funds; mainstreaming
poverty considerations, going beyond targeted programs for poverty reduction; more systematically acknowledging the role of the private sector in attaining the objectives of the plan; establishing a stronger connection between SEDP objectives and the allocation of budget resources; better reporting on recent policy decisions (especially on banking, legal and judicial reform); revising the policy matrix so that it better captures cross-sectoral actions and objectives; and strengthening the link between the plan's objectives and monitorable indicators and programs.

Managing public resources better

In April 2005, the Prime Minister instructed the MOF and MPI to coordinate their efforts in implementing the recommendations of the Public Expenditure Review-Integrated Fiduciary Assessment prepared jointly by the government and donors. In this respect the government’s program on public financial management has initiated studies on: An evaluation of fiscal risks as well as measures to mitigate them; a revision of norms for budget allocation to provinces taking into account poverty rates; the implications of moving from project-based support to targeted budget support; and aligning government financial statistics closer to international practice.

Financing of municipal infrastructure has also been on the reform agenda. The demand for municipal infrastructure is increasing rapidly in Vietnam as it copes with urbanization and decentralization. The government’s response to this rising demand has been to encourage the provinces to take greater responsibility for financing municipal infrastructure. To address these needs, thirteen provinces have already established Local Development Investment Funds (LDIFs) in charge of raising resources and channeling them towards selected projects. The four most active funds are those in Ho Chi Minh City, Dong Nai, Binh Duong, and Hanoi. These funds offer the prospect to support private participation in the provision of infrastructure services. They could also provide an opportunity to bilateral and multilateral donors to move from project by project or “retail” funding of local infrastructure to “wholesale” funding whereby their funds are channeled through the LDIF. However, the existing funds still have serious shortcomings in terms of transparency and rules of operation. Before contingent liabilities start building up, a sounder regulatory framework is needed. The MOF is currently drafting a decree on the organization and operations of investment funds, including LDIFs. This decree and any other regulations aimed at ensuring that LDIFs become efficient financial intermediaries would need to: Define investment eligibility criteria; provide consistent accounting and financial management standards; ensure LDIFs’ independence from the operations of the provincial government; make borrowing more transparent and increase the tenor of borrowing; and develop a consistent and transparent framework for partnering with the private sector.

With regard to state asset management, Decree 101 issued in August 2005 represents an important step. It allows for the establishment of independent price evaluation or asset appraisal companies. In the past, asset appraisal has been conducted by price evaluation centers under the MOF or provincial governments. These centers will be transformed into companies, and asset valuation will be conducted on a market price basis. New price evaluation firms can take the form of joint stock companies, partnerships,
limited liability companies, and foreign-invested enterprises. The government’s role will change to that of a regulator. The decree will form an important part of the ongoing efforts towards strengthening the management of state assets. For instance, the independent valuation of SOEs and their property is expected to speed up the process of equitization as well as improve its transparency. Independent appraisal will also be conducted for asset purchases through the state budget, as well as for valuing land for conversion from one use to another.

The circular guiding the preparation of the 2006 budget took an important step towards preparing the government budget within a medium term framework. While the submission and approval of the budget by the National Assembly will continue to be done on an annual basis, line ministries and provincial governments were asked to prepare a budget framework for the period 2006-2010, based on the SEDP. The reference to a five-year period should be conducive to a better integration between capital and recurrent budgets. It should also help ministries and provinces to prepare more realistic plans, to better prioritize their spending, and to improve the overall efficiency of public expenditures.

**Fighting corruption**

A law on corruption prevention and control was considered for promulgation by the National Assembly in November 2005. The Government Inspectorate (GI) took the lead in drafting this new law which will replace the ordinance on corruption. The law focuses on corruption in public sector institutions. It includes chapters on corruption prevention and detection, handling of corruption, organizations and mechanisms for investigation, prosecution and judicial agencies in anti-corruption, role of society and media in anti-corruption, international cooperation in anti-corruption, and implementation provisions. The law is thus more comprehensive than a typical anti-corruption legislation, which also translates into implementation challenges. This aspect is recognized by the GI’s programmatic framework on “Strengthening Comprehensive Capacity of the Inspectorate System up to 2010,” by devoting special attention to the preparation of implementation guidelines for the law. The drafting of implementing decrees could also benefit greatly from the results of the recently concluded diagnostic study of corruption.

The main initiatives for fighting and controlling corruption include increased public disclosure and transparency in areas such: as public procurement; construction activity; management and equitization of SOEs; auditing of the state budget; management and use of land; and personnel management. The law specifies the contents and modalities of such disclosure. It also provides individuals with the right to request for information from specified bodies, such as Peoples Committees. A key provision of the law relates to the compulsory declaration of assets and income of state employees, including spouses and children in the same household. The law strengthens the accountability of heads of organizations and agencies by specifying that they shall be responsible for corruption occurring inside the entities under their management and authority. Public administration reforms aimed at simplified and more transparent administrative procedures, is another mode for preventing corruption. The government will also specify and regulate
transactions that must be settled through the banking system. The law encourages "whistle-blowing" by the public and other agencies, and rewarding such actions.

A high level national level steering committee is to be created to perform an oversight function. The issue of whether such a committee should fall under the Communist Party, the National Assembly or the Prime Minister has generated considerable debate. As of now, it appears that it will fall under the purview of the Prime Minister.

Asset declaration is one of the most important provisions of the law. In particular, the broader definition of the “declarer” to also include “spouses and children in the same residential certificate” is commendable. Some deputies of the National Assembly have, however, been skeptical about the enforcement of this article. To address this concern, a phased approach could be employed in enforcing the provision. This is an area where the recently conducted diagnostic assessment could inform policies. For instance, asset declaration could be piloted in the most corruption-prone agencies identified by the diagnostic study. It could also initially be piloted for high-ranking public officials only. A widespread application of asset declaration in the initial period could risk overwhelming the capacity of the inspectors, thereby diluting its efficacy. Another area of the law that requires special care relates to ensuring witness protection and privacy in whistle blowing and denunciation.

As part of the efforts aimed at strengthening public procurement, the standard bidding documents for procurement of goods, were issued by MPI in September 2005. The paper version of a Public Procurement Bulletin has been in official use since April 2005 for publication of bidding opportunities and information on award of large contracts. The development of the e-procurement bulletin is at an advanced stage. The draft law on Procurement prepared by MPI is being reviewed by the National Assembly’s current session. Once passed, the law will help consolidate the fragmented legal framework for procurement in Vietnam.

**Legal development**

The Legal System Development Strategy (LSDS) was approved by the Politburo on 24 May 2005. The document has now been made public and shared widely. This is a broad-ranging document which seeks to build legal institutions and systems that will ensure the rule of law. An action plan is now being drafted to operationalize the objectives of the strategy and a facility has been established by the Prime Minister to allow donors to support this process.

On the 2 June, the Politburo issued a Resolution adopting the Judicial Reform Strategy (JRS) to 2020. This has also been made publicly available and is regarded as an important complement to the LSDS. The JRS seeks to improve criminal and civil policy and legislation in line with the transition to a socialist-oriented market economy, ensuring that judicial procedures are consistent, democratic, and transparent and protective of human rights. It aims to ensure that institutions supporting the judiciary are well-structured, placing the courts at the heart of the judicial system and emphasizing the role of adjudication. The courts will not be under the management and supervision of prosecutors
and prisons will be transferred to the Ministry of Justice. The JRS highlights the need to build the capacity of judicial and support staff, as well as enhancing their legal responsibility and authority. It proposes to introduce higher specialized standards for each category of staff, including the adoption of an examination process for recruiting and appointing officials for some judicial posts. The JRS also aims to strengthen the oversight role of elected bodies and the public.