

TAKING STOCK

An Update on Vietnam's Recent Economic Developments

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TABLE OF CONTENTS

	EXECUTIVE SUMMARY	2-3
I.	RECENT GLOBAL AND REGIONAL DEVELOPMENTS AND OUTLOOK	4-8
A.	Global Recovery: Steady but Uneven	
B.	Regional Context: Vietnam's Exceptions to the Regional Norm	
II.	RECENT ECONOMIC DEVELOPMENTS	8-22
A.	Cyclical Recovery amidst a Structural Slowdown	
B.	Booming International Trade	
C.	External Balance: Pessimism at Home but Optimism Abroad	
D.	Intolerable Inflation	
E.	A Digression: Measuring the Severity of Macroeconomic Instability	
F.	Fiscal and Debt Situation	
G.	Developments in the Banking Sector	
III.	RECENT POLICY DEVELOPMENTS	23-26
A.	Well Begun, But Only Half Done	
IV.	OUTLOOK FOR 2011 AND BEYOND	27-28
Annex		
	ESTIMATING VIETNAM INDEX OF MACROECONOMIC STABILITY (VIMS)	29-30

EXECUTIVE SUMMARY

- i. **In the last few years, Vietnam's macroeconomic situation has followed a predictable pattern.** When faced with external shocks the authorities have opted to protect the country's rapid growth rate, even if it meant tolerating higher levels of macroeconomic instability. This has meant modest growth slowdowns and frequent episodes of overheating. So when the economy started to overheat in late 2010 following the delayed withdrawal of the fiscal and monetary stimulus put in place in 2009, few expected a determined response from the government to stem the ensuing macroeconomic volatility.
- ii. **The current episode of macroeconomic instability has been as severe as the previous overheating episode of mid-2008.** We constructed a summary measure of macroeconomic instability – Vietnam Index of Macroeconomic Stability (VIMS) – based on the movement of four variables, namely nominal exchange rate, international reserves, inflation rate and nominal interest rate. Our measure shows that the degree of macroeconomic instability during the current episode did come quite close to mid-2008, but has not surpassed it yet. But unlike 2008, when the level of instability increased sharply and fell immediately, instability has persisted over a longer period of time during the current episode – from November 2010 to February 2011 – exposing Vietnam's economy to a prolonged period of nervousness and uncertainty.
- iii. **The government has succeeded in restoring significant level of macroeconomic stability in the past few months.** Following the successful completion of the XIth Party Congress in January and the celebration of the Lunar New Year in early-February, the authorities moved swiftly to address the macroeconomic problems facing the country. The dong was devalued by 9.3 percent against the US dollar on February 11, 2011, and Resolution 11 was approved on February 24, 2011. Resolution 11 contains a wide range of bold, mutually reinforcing and consistent monetary and fiscal policy targets and commits the government to undertake several structural measures including reform of the state-owned enterprises (SOEs), improving communication with the market and protecting the poor from future episodes of macroeconomic instability.
- iv. **Efforts to stabilize the economy, while well begun, are only half done.** Despite initial skepticism, the measures adopted under the Resolution 11 have started to show results towards regaining Vietnam's macroeconomic stability. The parallel market has disappeared and for the first time in three years, the dong is trading in interbank market below the official central rate. The State Bank of Vietnam (SBV) has started to purchase dollars in the inter-bank market, thereby building up much needed international reserves. Vietnam's sovereign bond spreads have steadily declined in the past few months. But there are plenty of macroeconomic risks in the system that can easily reverse the hard-earned gains of the past three months.
- v. **Therefore, initial success notwithstanding, the authorities need to remain vigilant against premature withdrawal of stabilization measures.** The implementation of Resolution 11

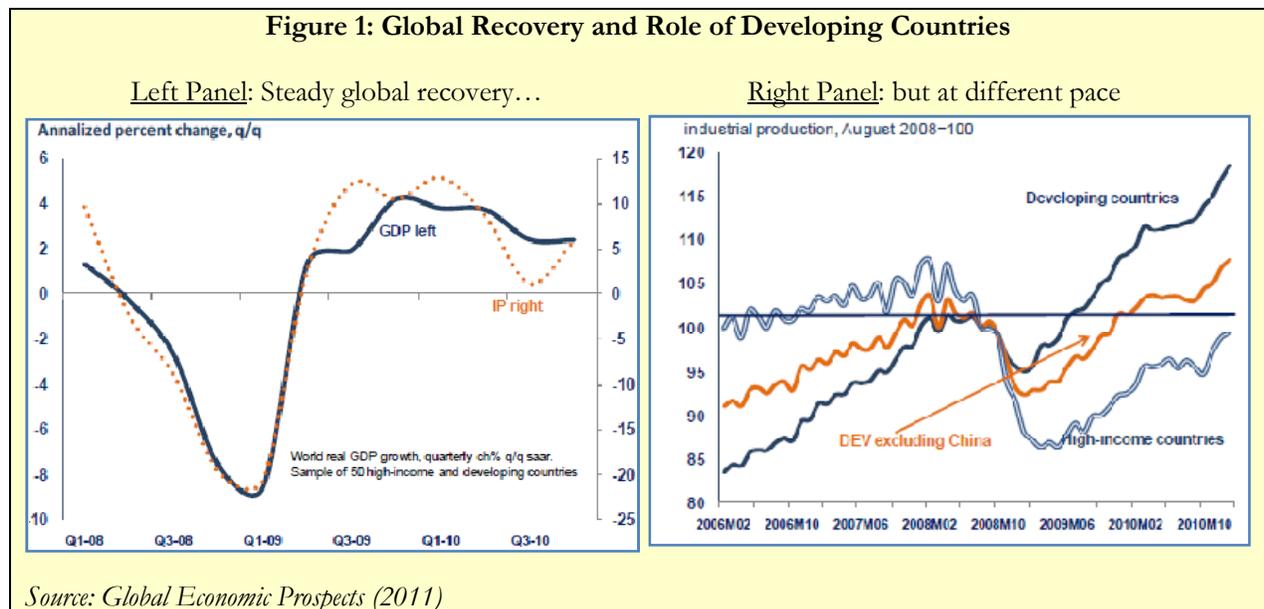
has not gone uniformly well: efforts to rein in investment budget have been less forthcoming, reforms of the state-owned enterprises have not been fully spelled out and measures aimed at better communication with the market have been slow and hesitant. With growth expected to slow down in the second and third quarters of 2011, there could be demands from various quarters to relax monetary and fiscal policies and to go slow on structural reforms. Capitulating to such demands could prove costly for the economy. Instead, the authorities have an opportunity to rebuild Vietnam's credibility by steadfastly and effectively implementing Resolution 11 until the following three milestones are achieved: (i) inflation is brought down to a stable, single-digit rate; (ii) foreign exchange premium is completely eliminated; and (iii) the level of international reserves is adequate to finance at least 2.5 months of prospective imports.

- vi. **We expect gradual improvement in Vietnam's economic situation during the second half of 2011.** The inflation rate is expected to peak in Q2 and then gradually fall to around 15 percent by the end of the year, as the full impact of policy tightening takes hold. The current account deficit is expected to be around 5 percent of GDP and the foreign exchange market should remain stable in the foreseeable future. With macroeconomic stability gradually returning, internal capital flight should subside in 2011, helping SBV to accumulate reserves faster. The output growth, after slowing down in Q1 and Q2, is likely to pick up strength by year end. We expect economic growth in 2011 to be slightly under 6 percent, with significant upside potential in 2012. However, our outlook is exposed to a number of downside risks. Those risks include premature withdrawal of stabilization measures, resurfacing of problems in the banking and state-owned enterprise sectors and continued increase in global commodity prices or a full blown sovereign debt crisis in Europe and its contagion effect on the rest of the world.

I. RECENT GLOBAL AND REGIONAL DEVELOPMENTS AND OUTLOOK

I.A Global Recovery: Steady but Uneven¹

1. The recovery of the global economy has gained firmer footing, despite growing tensions and potentially disruptive events in various parts of the world in recent months. Developing country GDP grew 7.0 percent in 2010 and global industrial production and trade are once again expanding rapidly (figure 1, left panel). Strong forces of recovery include vibrant domestic demand in developing countries, burgeoning south-south trade, continued expansionary fiscal and monetary policy stance in most advanced economies, and reduced drag on growth from a recovering financial sector. These factors have so far neutralized the influence of some of the negative shocks including rising global commodity prices, political turmoil in the Middle-East and North Africa, and the natural disaster and nuclear catastrophe in Japan.



2. While the economic crisis was global in nature, the recovery process seems to have a **distinct local flavor to it**. Recovery in industrial production has brought developing country output more than 19 percent above its pre-crisis August 2008 levels (figure 1, right panel), while production in high-income countries is nearly 8 percent below the peak of February 2008. Industrial output in China is more than 40 percent above its pre-crisis peak and 35 percent for the East Asia region as a whole, as well as for Vietnam. Within Europe, performance of the peripheries seems to have decoupled from the strong performance at the core, creating a two-speed Europe. Similarly, while the US economy has steadily recovered, the lack of political consensus to resolve its fiscal and debt problems is beginning to unnerve the markets. The recovery of the Japanese economy has been set back by the devastating earthquake and tsunami, which would also have some effect on Vietnam’s economy, albeit by to a modest magnitude degree (see Box 1).

¹ Draws on the “Draft Global Economic Prospects,” The World Bank (June, 2011).

Box 1 Economic Impact of Japan's Earthquake and Tsunami on Vietnam

Official estimates place the damage from the March 11 earthquake and tsunami between 3 and 5 percent of Japanese GDP, directly affecting a region that represents about 4 percent of Japanese GDP and 4.5 percent of its population. Some 450 thousand people have been left homeless, and more than 20,000 may have died. Although in some respects, the disaster is similar in scale to the Kobe earthquake of 1995, notable differences include the nuclear crisis, the additional loss of life and property damage attributable to the tsunami. In particular, the disaster has damaged an estimated 7.3 percent of Japan's power supply, about 3.8 percent due to disrupted thermal generation and 3.5 percent from nuclear generation.

Whereas the Kobe disaster had little impact on GDP growth, the current crisis is expected to cut into growth more sharply. Recovery from this year's disaster differs because of the electricity disruption and the pull-back in consumer spending that has been associated with the first weeks of the post-crisis period. Retail sales during March were down 8.5 percent from a year ago, machinery and business equipment sales were down 17 percent. For the car industry, disruptions are expected to last until the end of the second quarter, potentially reducing output by one-half. Although uncertainty is large, many are now expecting second-quarter GDP to decline by between 3 and 10 percent (annualized rates), before reconstruction efforts overcome the effects of economic disruption and cause growth to rebound.

There are strong economic ties between Japan and Vietnam. Japan is Vietnam's fourth largest trading partner. It is also Vietnam's largest contributor of Official Development Assistance (ODA) and one of Vietnam's top three foreign direct investors. In 2010, Vietnam earned significant amount of foreign exchange from Japan through exports, ODA, FDI, workers' remittances and tourism revenue from Japanese tourists.

Despite the strong economic linkages, the direct fall-out from the earthquake and tsunami is unlikely to exceed 0.2 percent of Vietnam's annual growth. However, while aggregate growth slowdown may be small, the impact for some of the sectors could be noticeable, including garments, fisheries and electrical wire and cables. The reasons for smaller aggregate impact are: (i) Japan's contribution to Vietnam's trade has been decreasing steadily as the latter has diversified its trade destinations, especially after its accession to WTO; (ii) with long-term growth of Japanese commercial interests in Vietnam preserved, we expect committed FDI from Japan to remain high, though it may dip slightly in the near-term; and (iii) finally, Japanese officials have maintained that ODA to Vietnam will not be affected by the recent events.

Source: Global Economic Prospects, The World Bank (June, 2011); ANZ Bank, The Impact of Japan's Crisis on Vietnam (April 6, 2011)

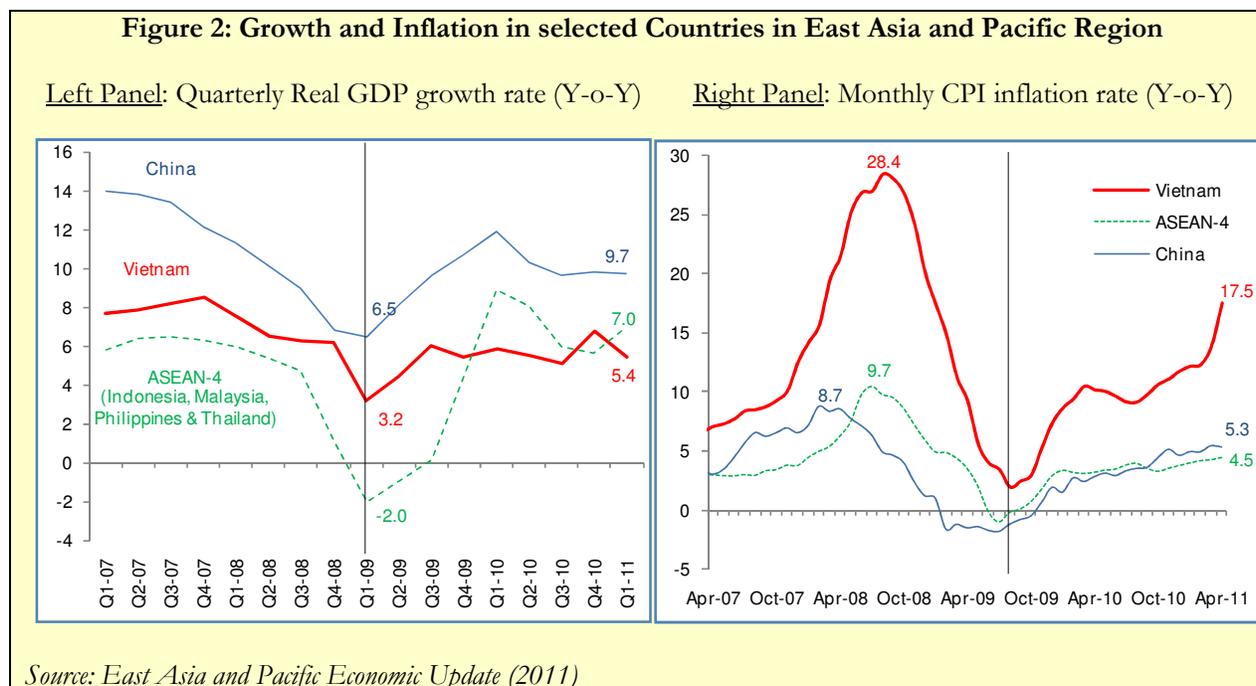
3. **The renewed pressure on global commodity prices poses considerable risk to global economic recovery.** High and rising demand from emerging markets, sharp decline in agricultural stocks to consumption, Middle-East tensions and agricultural supply shocks have pushed the global commodity prices higher. Prices of internationally traded food commodities have reached almost the levels observed during the 2008 food crisis. However, the price of grains – the most critical food component for the poor and one of Vietnam's key exports – has not increased as much as in 2008. Crude oil prices have been rising because of strong demand in Asia and disruption of oil deliveries due to political turmoil in the Middle East and North Africa.

4. **The recent disruptions notwithstanding, global growth is projected to remain strong from 2011 through 2013.** In high-income countries, the negative impact of banking-sector

restructuring and housing-sector declines will ease somewhat and many developing countries will regain activity levels consistent with underlying potential. According to the latest Global Economic Prospects (2011), a World Bank publication, global GDP – having expand by 3.8 percent in 2010 – is projected to slow to 3.2 percent in 2011 before firming to a 3.6 percent pace in both 2012 and 2013.

I.B Regional Context: Vietnam’s Exception to the Regional Norm²

5. **Output growth has been strong throughout developing East Asia in 2010.** This positive outcome reflected sustained monetary and fiscal stimulus measures and stronger growth in global demand. Real GDP growth in developing East Asia and Pacific (EAP) amounted to 9.6 percent for 2010 as a whole, significantly higher than Vietnam’s growth rate of 6.8 percent. Growth in 2010 has been uniformly high, with seven countries in developing East Asia growing by 7 percent or more. The growth numbers for 2010 were particularly high for countries that experienced negative growth in 2009 and hence saw a V-shaped recovery. However, countries such as China and Vietnam, which experienced only a modest growth slowdown in 2009, did not see any acceleration in their growth rates during 2010 (left panel, figure 2).

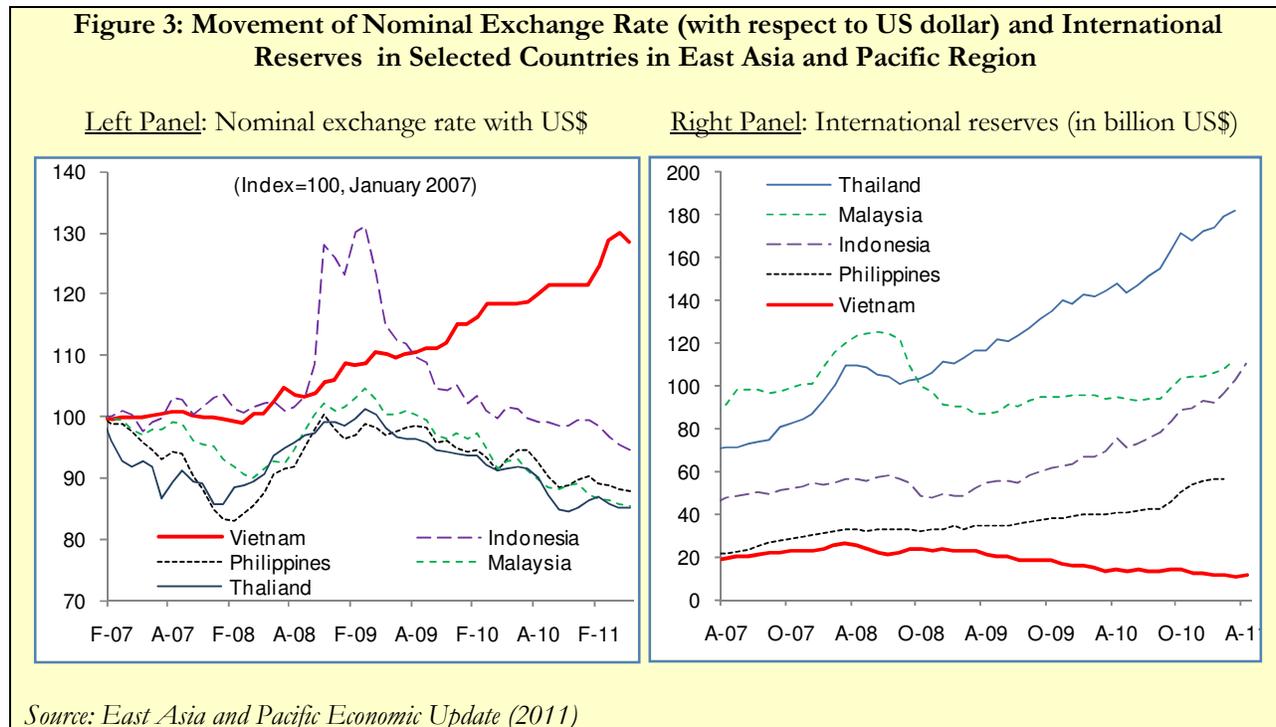


6. **Consumer price inflation rose faster than expected since late 2010 due to a surge in food and commodity prices, robust domestic demand, and limited monetary tightening.** Inflation is above targets or official projections in China, Indonesia, South Korea and Vietnam and is above the government’s comfort level in several other countries. The synchronous movement in

² This Section draws on the “East Asia and Pacific Economic Update,” The World Bank (March, 2011).

inflation rates across countries points to the increasing role of global factors in influencing domestic prices (right panel, figure 2). However, at the same time, high inflation rate has persisted in Vietnam, reflecting ‘pro-growth and pro-inflation bias’ in the country’s policy stance as well as its status as a surplus and large exporter of food products – the latter explaining the greater tolerance of Vietnam towards higher inflation, especially food price inflation. Moreover, the pass-through of high international prices of fuel and energy to the domestic consumers has been quite rapid in Vietnam, with the government choosing to raise the price of key utilities by a significant amount.

Figure 3: Movement of Nominal Exchange Rate (with respect to US dollar) and International Reserves in Selected Countries in East Asia and Pacific Region



7. **Most countries in the region have experienced nominal appreciation of their currencies as well as a build-up in reserves, while Vietnam continues to buck the regional trend.** Given the low interest rates in advanced economies and brighter growth prospects in emerging markets, there has been a surge of external capital into the latter, especially into developing Asia. Countries have used a combination of policy instruments to safeguard their economies from the vagaries of rapid fluctuations in external capital flows, including allowing their currencies to appreciate (left panel, figure 3), sterilizing inflows and building up reserves (right panel, figure 3) and, in some extreme cases, imposing capital controls. While Vietnam continues to receive robust capital inflows – mostly in the form of foreign direct investment and some portfolio flows – the authorities have faced a different sort of dilemma, namely to prevent the local currency from depreciating and finding ways to shore-up depleting stock of international reserves. This is largely a consequence of Vietnam’s massive internal capital flight, reflecting to a large extent foreign currency and gold hoarding by residents outside the financial system as a hedge against inflation and depreciation.

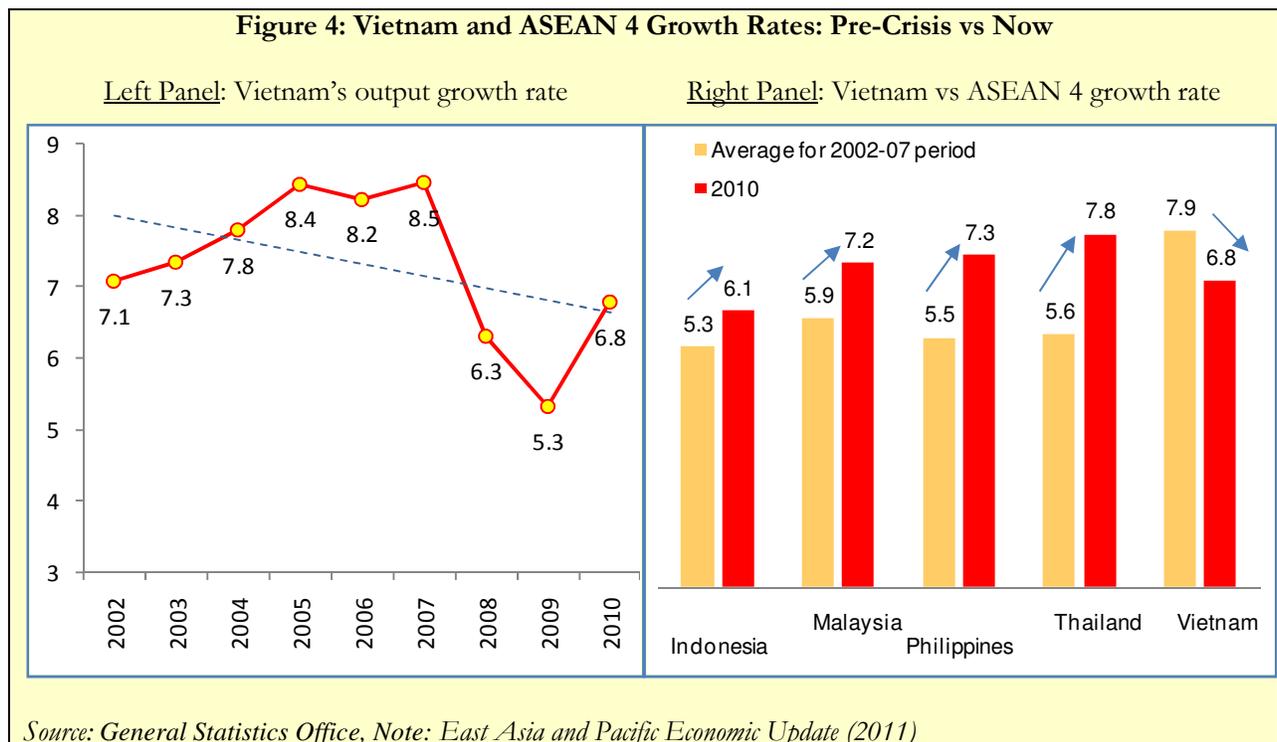
8. **Overall, the global and regional growth outlook remains favorable for Vietnam.** A steadily recovering global economy, relatively strong growth in East Asia despite some moderation

to combat inflation, and robust international capital flows bode well for Vietnam’s economy. As it attempts to cool down its overheated domestic economy by pursuing tight monetary and fiscal policies, the robust export demand from the rest of the world should give a much needed boost to its investment and growth prospects.

II. RECENT ECONOMIC DEVELOPMENTS

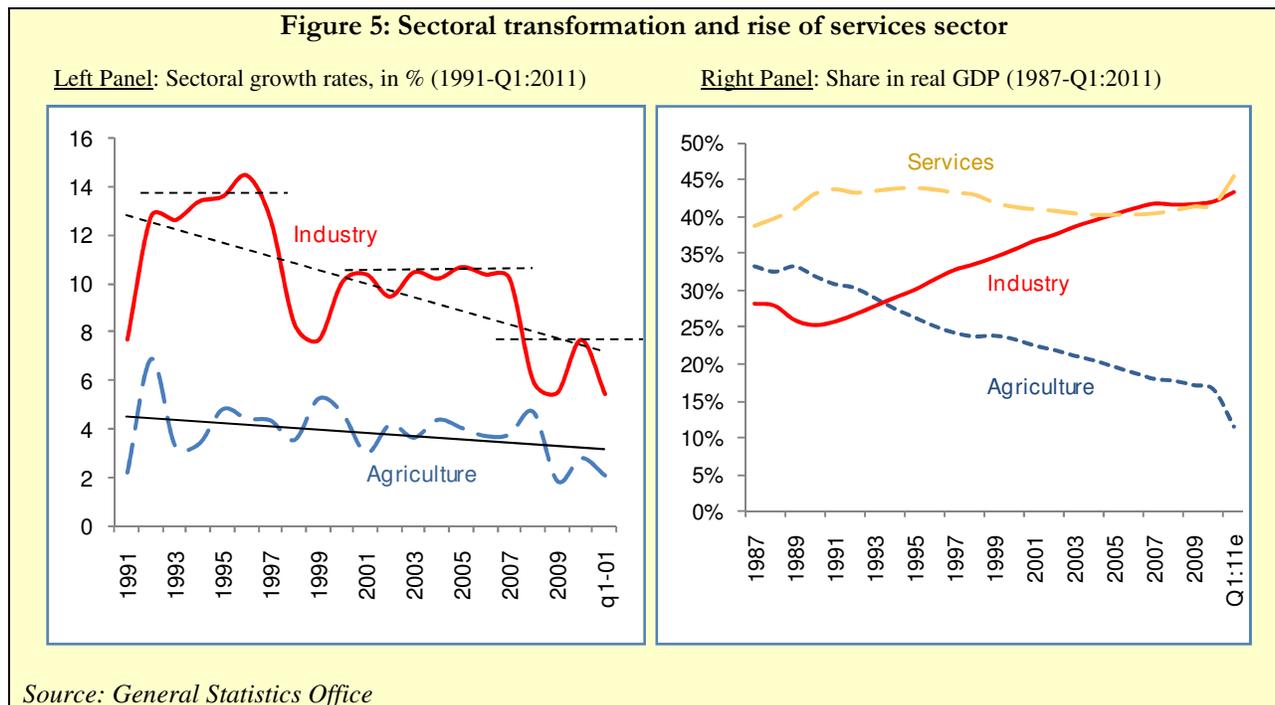
II.A Cyclical Recovery amidst a Structural Slowdown

9. **Vietnam’s economy continues to recover rapidly from the global economic crisis, aided by strong growth in public investment and rapid growth in domestic credit.** Real GDP grew at 6.8 percent in 2010 – the fastest pace in the last three years (left panel, figure 4). There was a steady recovery in output during 2010, with Q1, Q2 and Q3 growth rates reported at 5.8, 6.4 and 7.2 percent respectively. The uptrend was maintained through the last quarter, which saw a sharp increase in public investment and a rapid growth in domestic credit, with growth rate reaching to 7.3 percent in Q4 – the highest in the past 11 quarters. The expansionary policy however could not be sustained, as it triggered a new wave of inflation and forced a visible tightening of monetary policy in early 2011. The output growth in Q1 of 2011 fell to 5.4 percent, along the expected line. Initial reports indicate that first-half growth may be around 5.6 percent.



10. **While Vietnam has witnessed a healthy cyclical recovery, its structural growth rate seems to be significantly below its pre-crisis levels.** By 2010, most middle income countries in South East Asia had regained growth rates achieved in the pre-crisis period. But not Vietnam. As

shown in the right panel of figure 4, Indonesia, Malaysia, Philippines and Thailand reported growth rates in 2010 that were higher than their respective average growth rate during 2002-07 period. However, in case of Vietnam, the reverse is true – with the post-crisis peak growth rate being significantly below the pre-crisis average. There are several factors that point to a potential growth slowdown. The amount of committed (or registered) foreign direct investment has been steadily falling since 2008, with the first 5 months of 2011 registering a 48 percent decline. At the same time, acceleration in public investment of recent years, including those carried out by state-owned enterprises, is unlikely to be sustained into the future. It is therefore increasingly clear that without significant improvement in the quality and productivity of investment, Vietnam will not be able to return to the extraordinary growth rates of the early to mid-2000s.



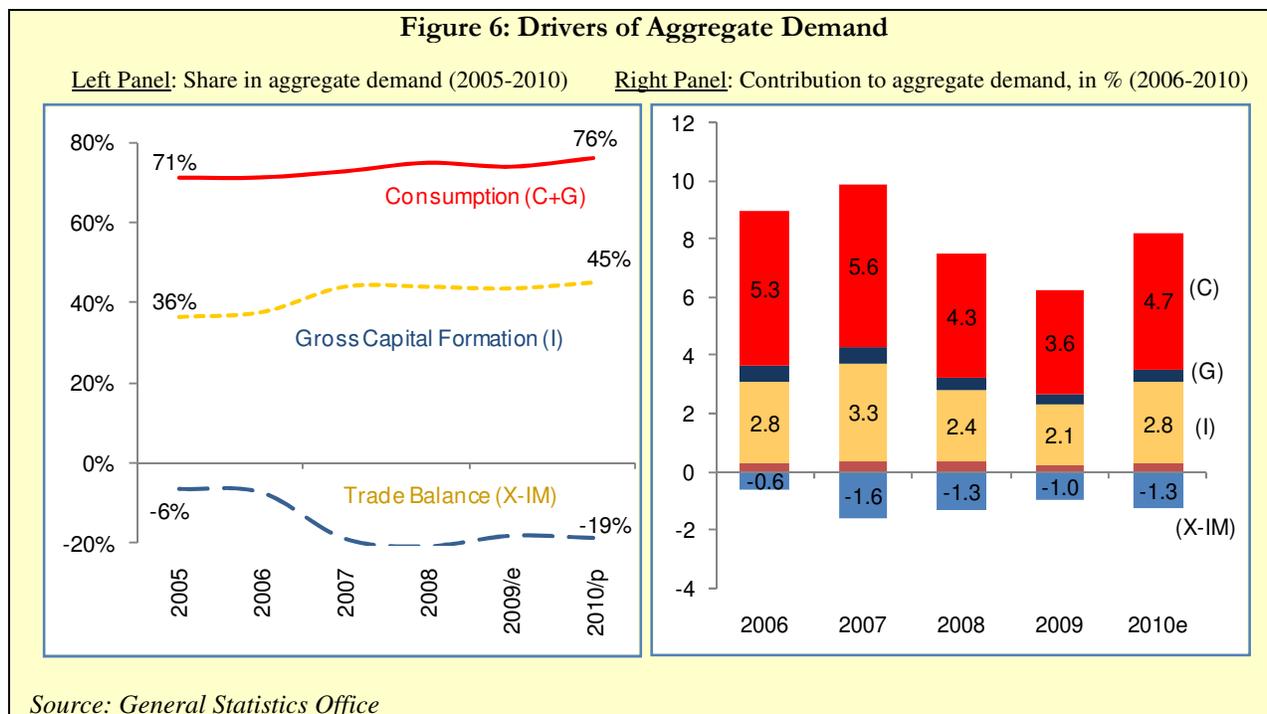
11. **A slow but steady sectoral transformation appears to be underway, with traditional tradable sectors – industry and agriculture – experiencing lower growth.** Until recently, Vietnam’s prized growth story has been about its ability to produce low skill, labor-intensive mass manufacturing products and generate massive amount of surplus food items and agricultural commodities for exports. This process has been facilitated by significant inflows of foreign direct investment and rapid integration of Vietnam’s economy with the rest of the world through a series of trade agreements. But surprisingly, these traditional tradable sectors have seen a steady decline in their growth rate over the last two decades (left panel, figure-5)³. The industrial sector has seen its growth rate fall after each major macroeconomic crisis: first during the East Asian crisis in the late 1990s and now with the recent global economic crisis. Are these changes part of a long-term

³ For a discussion on the long-term sustainability of commodity producing sectors in Vietnam, given their excessive reliance on natural resources and adverse consequences on the environment, see *Vietnam Development Report, 2011*.

sectoral transformation of the economy or temporary aberrations? It is difficult to predict, but the occurrence of sectoral transformation seems consistent with the structural growth slowdown discussed above.

12. **As a result of these changes, Vietnam's service sector has reemerged as the largest sector in the economy and the biggest contributor to the overall growth rate.** This trend is being facilitated by two factors: (i) slowdown in the growth of industrial and agriculture sectors; and (ii) increasing cross-border trade in services. Vietnam has seen a big boost in tourist intake in recent years. This has also led to significant foreign direct investment into real estate and hospitality sectors. Vietnam is also beginning to receive investment from information technology firms and its software industry is growing rapidly, albeit from a small base. Furthermore, Vietnam's ICT firms are starting to invest abroad. But lack of adequate manpower with tertiary education and appropriate skill set has already emerged as one of the main constraints to future growth, exposing the long-term limits of a service-led growth process in Vietnam. In 2011, we expect the service sector to contribute to around 42-43 percent of output, compared to 42 percent by industry and 15-16 percent by agriculture (right panel, figure 5).

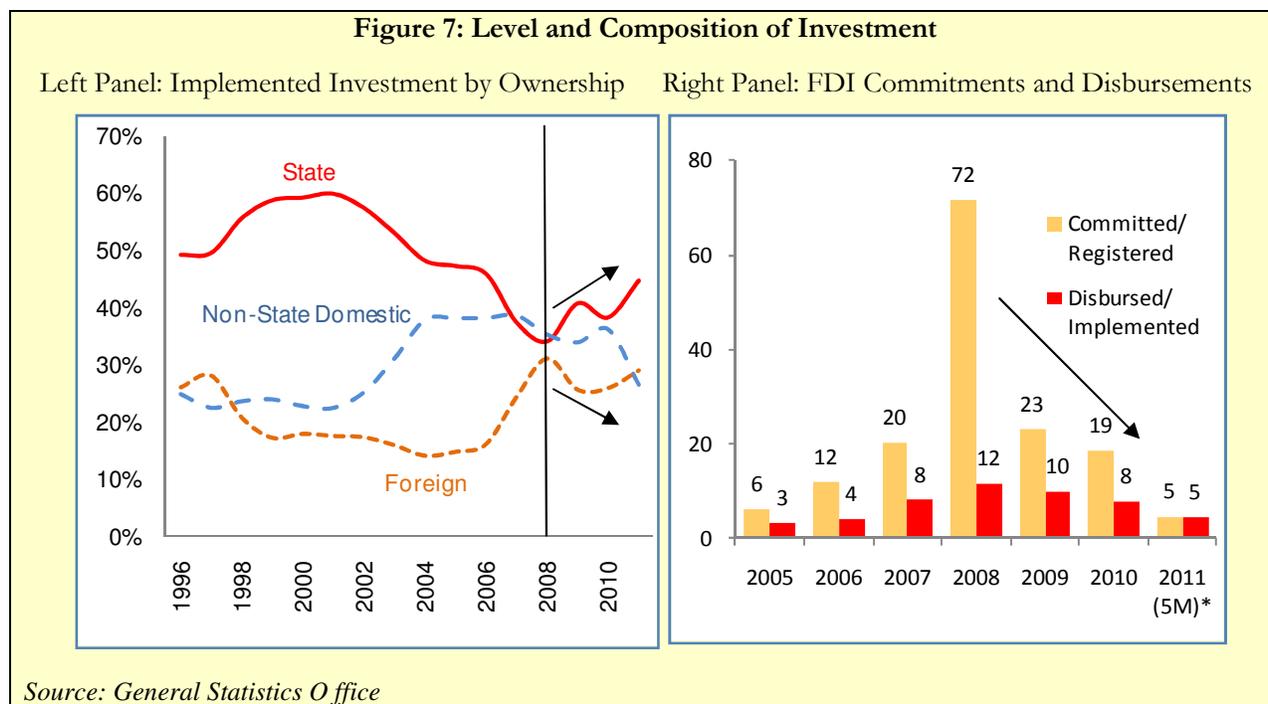
13. **Investment, especially public investment, and private consumption remain the major drivers of aggregate demand in the post-crisis period.** The composition of aggregate demand underwent a major shift around 2007, with a significant increase in gross capital formation, mostly fueled by rapid expansion of foreign direct investment and, more recently, due to increase in public investment (left panel, figure 6). This period also coincided with some increase in private consumption as a share of aggregate demand, albeit by a smaller magnitude than investment. The increased share of investment and private consumption was offset by an equally sharp decrease in the share of net exports, coinciding with a period of persistently large trade and current account deficits. The composition of aggregate demand has been more or less stable throughout the post-crisis period as seen in the right panel of figure 6. With imports growing slower than exports, the contribution of net exports to overall growth increased between 2007 and 2009, but then fell in 2010. The large stimulus package, some parts of which were retained through the middle of 2010, and rapid growth of domestic credit during the last quarter of 2009 provided the necessary buoyancy to investment and private consumption to continue to grow at a healthy pace throughout 2010.

Figure 6: Drivers of Aggregate Demand

14. **The recent decline in the share of private (non-state) domestic investment in total investment is a matter of concern.** Following the launch of a political and economic renewal campaign (Đổi Mới) in 1986, Vietnam has seen a slow but steady decline in the share of state investment in favor of foreign and non-state domestic investments. As shown in the left panel of figure 7, this trend accelerated between 2000 and 2008, but was reversed on the wake of the global economic crisis, as private investment pulled back and public investment stepped in to fill the gap. This was supposed to be a temporary response to a temporary shock. However, the government has been slow to withdraw its investment, with the state sector investment amounting to 45 percent of total investment in the first quarter of 2011, compared to 27 and 29 percent for non-state domestic and foreign investments respectively. This decline in private domestic investment does not bode well for Vietnam, which needs a thriving domestic private sector to support its middle income aspirations.

15. **The declining trend in committed foreign direct investment is also worrisome.** Foreign direct investment not only brings new technologies and management practices to Vietnam, it accounts for the bulk of manufacturing exports and is a major source of financing for the country's current account deficit. Given the unusually high level of FDI in the past, some slowdown is inevitable. But the recent decline has been higher than expected. In the first five months of 2011, US\$4.7 billion FDI was committed to Vietnam relative to US\$9 billion during the same period of 2010 – a whopping 48 percent fall. In addition, committed FDI in 2010 was lower than in 2009, which in turn was lower than the corresponding number in 2008 (right panel, figure 7). Fortunately, the disbursed (implemented) FDI has held up well so far, despite a rapidly shrinking pipeline of new commitments. Moreover, given the slow disbursement rate, decline in commitment will not have an

immediate impact on the economy. Nevertheless, this issue merits more research, especially understanding the role of the domestic factors such as macroeconomic instability, power shortage, growing scarcity of skilled professionals in explaining the current slowdown in FDI.



II.B Booming International Trade

16. **Vietnam's international trade has recovered rapidly to surpass its strong performance of the pre-crisis period.** Being a highly open and trade dependent country – with trade to GDP ratio exceeding 160 percent – there was a concern that Vietnam could be severely affected by the global economic crisis, with closure of firms and laying off of workers. Those fears did not materialize, partly due to the timely and large stimulus measures and partly due to the resilience of the export sector. In recent months, the country has also benefitted from higher global commodity prices and steady economic recovery in the advance economies. The trade deficit has narrowed by more than 7 percentage points in two years – from 14.2 percent of GDP in 2008 to 6.9 percent in 2010.

17. **The export sector has weathered the global and domestic shocks much better than anticipated.** After the worst year on record in 2009, Vietnam's export performance rebounded strongly in 2010, registering an overall growth rate of 26.4 percent (in value terms) and non-oil exports growth of 32 percent. Trade data for the first four months of 2011 have been equally impressive, with oil exports growing at 40 percent and non-oil exports by nearly 36.9 percent (table 1). In spite of retaining a larger amount of crude oil for domestic refinery, the value of oil exports has been strong, thanks to the higher export prices. Higher export prices of agricultural products

such as rice, coffee, cashew nut and rubber have also helped Vietnam to show a strong export performance.

Table 1: Vietnam's Export Performance

	Value in 2010 (in US\$ billions)	Growth in %		
		2009	2010	4M-11 compared to 4M-10
Total export earnings	72.2	-8.9	26.4	37.2
Crude oil	5.0	-40.2	-20.0	40.1
Non-oil	67.2	-2.7	32.0	36.9
Rice	3.2	-8.0	21.9	14.6
Other agricultural commodities	6.4	-13.1	35.1	89.9
Seafood	5.0	-5.7	18.0	28.3
Coal	1.6	-5.1	22.3	-8.1
Garment	11.2	-0.6	23.7	33.7
Footwear	5.1	-14.7	26.0	31.1
Electronics & computers	3.6	4.7	29.9	11.4
Handicraft (including gold)	3.3	133.1	5.3	15.6
Wood products	3.4	-8.2	32.3	14.6
Other	24.2	-6.3	49.0	42.9

Source: General Department of Customs

18. **Large foreign investments into the export sector and increasing market access through trade agreements seem to have also played a role in making the sector more resilient.** The labor-intensive manufacturing products such as garments, footwear, and electronics, many of which are produced either directly by foreign firms or through contract arrangement with local firms solely for the export market, have posted solid performance (table 1). Garment exports have remained strong in the first four months of 2011, growing by 33.7 percent year on year compared with 23.7 percent during 2010. Garment exports to the US have increased by 18.7 percent, accounting for 52.2 percent of Vietnam's total garment exports in the first four months of 2011. During the same period, footwear exports have risen 31 percent, with US absorbing one third of exports.

19. **The recent surge in investment and higher commodity prices have led to a rapid rise in the import bill.** The main import categories that have witnessed rapid increase include petroleum products, machinery and equipment, and other intermediate inputs for the export sector such as plastics, fabrics and chemical products (table 2). The sharp increase in import prices has also contributed to a surge in the import value for a wide range of products such as petroleum products, steel, fertilizer, plastic material, paper, yarn and cotton. Vietnam imported US\$2.2 billion more goods in the first four months of 2011 compared to the same period of last year. The direction of trade remains unchanged from last year, with China remaining its most important source of imports followed by ASEAN and other East Asian countries.

20. **To facilitate Vietnamese exports to move up the global supply chain has emerged as a key priority for policymakers and national scholars.** Despite the strong cyclical recovery of exports from the crisis, Vietnam has not made significant progress in diversifying its export basket to include higher value-added manufacturing and industrial products. In fact, Vietnam is still perceived as a large, low-cost commodity exporter with items such as rice, seafood and other agricultural commodities contributing to nearly 40 percent of its non-oil exports. The remaining exports are in low-cost, mass produced manufacturing products, most of whose intermediate products are imported. While there does seem to be a certain lack of dynamism in the exports, it is unclear what factors are contributing to it and what facilitating role, if any, the government can play in it.

Table 2: Vietnam's Import Performance

	Value in 2010 (in US\$ billions)	Growth in %		
		2009	2010	4M-11 compared to 4M-10
Total import value	84.8	-13.3	21.2	30.3
Petrol and gasoline	6.1	-43.0	-2.8	67.1
Machinery and equipments	13.7	-9.4	8.0	16.2
Garment and leather materials	2.6	-18.0	35.7	21.1
Computer and electronics	5.2	6.5	31.7	29.7
Steel	6.2	-20.2	14.8	17.6
Fertilizer	1.2	-3.9	-13.9	28.5
Plastics	3.8	-4.5	34.2	38.3
Fabrics	5.4	-5.2	26.9	43.7
Chemicals	2.1	-8.5	30.4	33.4
Chemical products	2.1	-1.5	30.0	26.0
Pharmacy	1.2	26.9	13.3	23.8
Fibers and weaving yarns	1.2	4.6	45.1	64.1
Pesticides	0.5	-34.3	12.4	11.9
Cotton	0.7	-16.0	71.9	111.3
Paper	0.9	2.3	20.1	33.6
Automobiles	2.9	3.8	-5.2	26.0
Other	29.0	-11.0	35.1	25.4

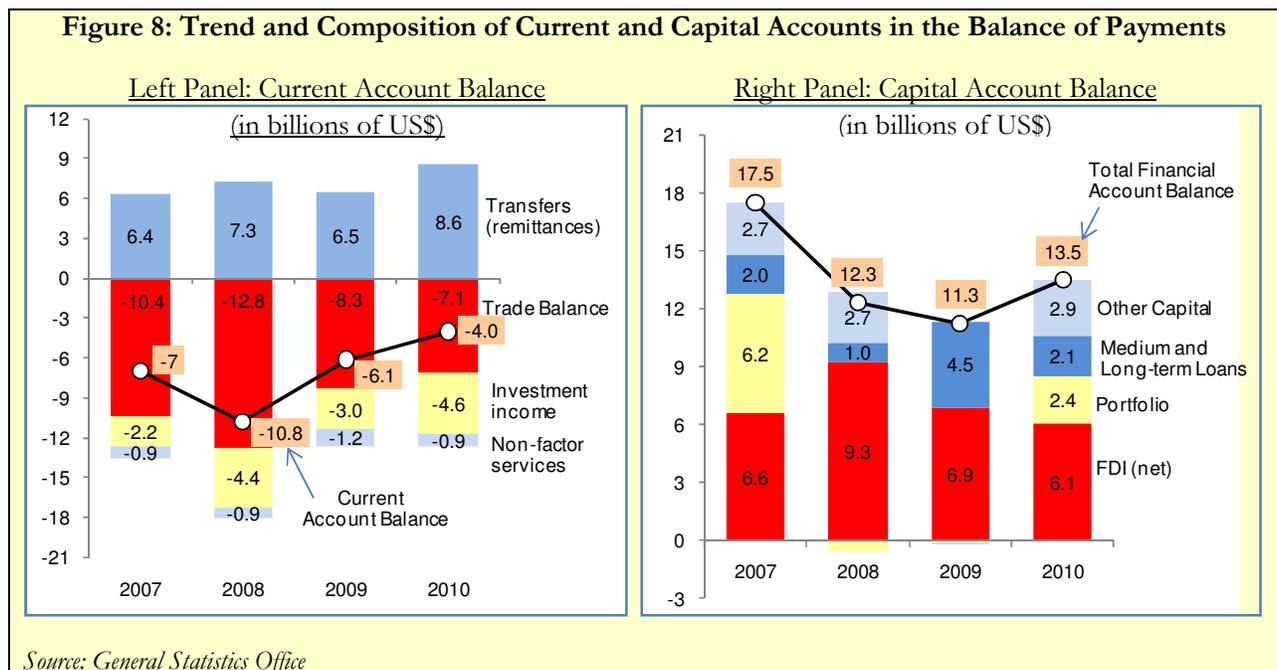
Source: General Department of Customs

II.C Balance of Payments: Pessimism at Home but (Some) Optimism Abroad

21. **Vietnam's balance of payments is a curious mix of a moderate level of current account deficit, large capital inflows and massive internal capital flight.** Periods of macroeconomic instability are often associated with a large and deteriorating current account deficit (CAD), which when exceeding the level of capital account surplus (CAS), leads to a depletion of international reserves. Vietnam has had its fair share of macroeconomic volatility in recent years and has also seen its reserves declining. But the latter has not been caused by a large and unsustainable

CAD or low and falling CAS. In fact the opposite has been the case. Vietnam’s CAD has narrowed from US\$ 10.8 billion in 2008 to US\$ 4.0 billion in 2010. During the same period, its CAS has hovered around US\$ 12.0 billion mark. So theoretically, Vietnam should have seen its international reserves increasing each year by an amount equal to the difference between CAS and CAD. Instead there has been a massive unrecorded outflow of capital each year – capital held by residents in foreign currency and gold outside the financial system as a hedge against inflation and depreciation – far exceeding the difference between CAS and CAD and resulting in reserve loss.

22. **Vietnam’s current account deficit has narrowed considerably in recent years, but has not led to a reduced pressure on the foreign exchange.** During 2008, when CAD reached US\$10.8 billion (or 11.9 percent of GDP), it was believed that such a high level of CAD is unsustainable and could be a major source of volatility in the foreign exchange market. But with stronger exports, increased receipts from tourism and a robust flow of remittances, CAD gradually fell – to US\$6.1 billion (or 6.6 percent of GDP) in 2009 and to US\$4.0 billion (or 3.9 percent of GDP) in 2010 (left panel, figure 8). Curiously, this decline in CAD did not lead to a reduced pressure on the dong as was widely anticipated. Thus the traditional explanation that balance of payments difficulties are often caused by large and unsustainable CAD does not seem to be the leading source of Vietnam’s current problems.



23. **Vietnam has managed to sustain a high level of external capital flows in spite of its ongoing macroeconomic instability.** The country remains an attractive destination for foreign investment, though the level of FDI has declined after hitting its peak in 2008. According to balance of payment statistics, net FDI is estimated to have fallen modestly to US\$ 6.1 billion in 2010 compared to US\$ 6.9 billion in 2009. At the same time, after a gap of two years, portfolio

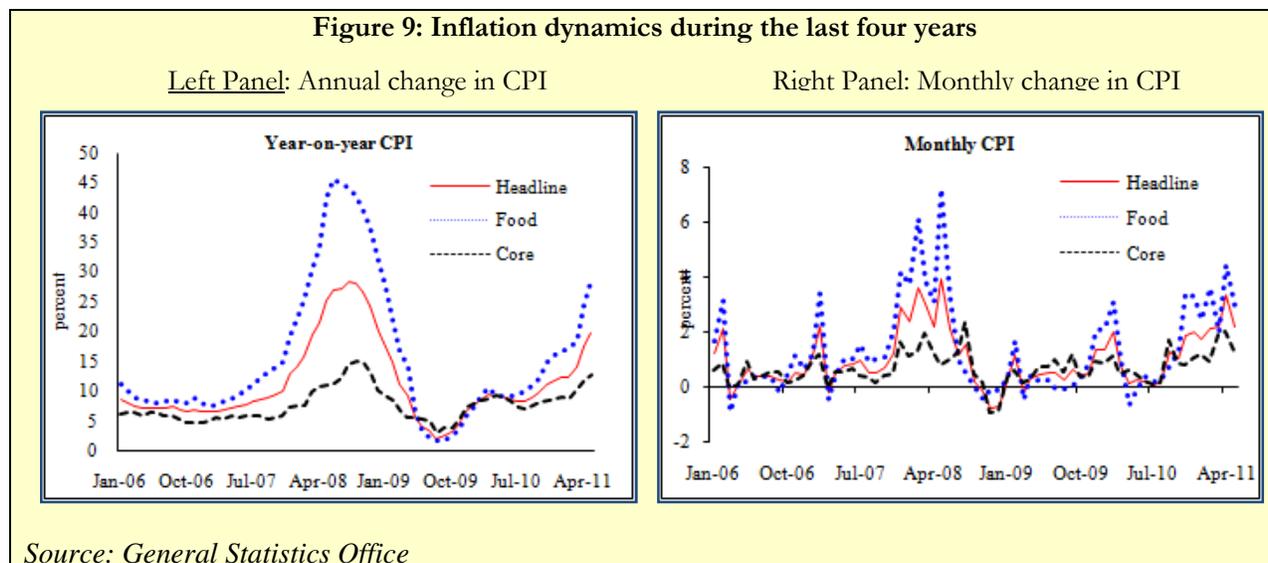
investment has returned to Vietnam, amounting to nearly US\$2.4 billion in 2010. The amount of medium and long-term loans, the bulk of which is from official sources, has regressed to its trend level of around US\$2 billion in 2010 after increasing sharply during 2009. Consequently, total CAS is expected to have increased to US\$ 13.5 billion in 2010 from US\$ 11.3 billion in 2009 (right panel, figure 8). Thus, the surplus in the capital account of balance of payments has far exceeded the deficit in the current account during the last three years and this trend is expected to continue into the future.

24. **Restoring macroeconomic stability and reducing internal capital flight (which will slow down the dollarization trend in the economy) should go hand in hand.** Vietnam's balance of payments problem is unusual as it is largely the product of 'domestic residents' looking for safe heavens in gold and US dollars to hedge their financial savings from future episodes of inflation and depreciation. Interestingly, at the same time foreign investors continue to send large sums of FDI and portfolio investment to the country. From the authorities' perspective, it is crucial that the confidence of the residents in the dong is restored before the macroeconomic situation starts to seriously affect the decisions of the foreign investors. And this can be done best by reducing inflation to a stable and single digit level. Use of administrative measures to force residents to give up their gold and US dollar holdings may work temporarily, but the long-term solution lies in curbing inflationary expectations and stabilizing the macroeconomic environment.

II.D Intolerable Inflation

25. **One of the salient features of Vietnam's economy in recent years has been the constant presence of high and volatile inflation.** During the last 40 months, the headline inflation rate in Vietnam has been below 5 percent (y-o-y) for 6 months and below 10 percent for only 19 months. The consumer prices have almost doubled since January 2008 with cumulative inflation amounting to a whopping 106 percent during this period. Why does Vietnam have such high inflation and how does it affect its low income households (for latter, see Box-2)?

26. **Vietnam's current bout of inflation is being caused by some of the same factors that led to the previous overheating episode of 2008.** The high and rapidly rising inflation in Vietnam has been a product of external factors – rising global food and fuel prices, adverse weather events – and a number of domestic factors – delayed withdrawal of stimulus package, rapid growth in liquidity and credit during the second half of 2010, simultaneous increase in fuel prices and power tariffs – combined with the lagged effect of dong devaluations. The hike in minimum wages, though routine and planned, is likely to have contributed to the inflationary expectations as well. Consequently, inflation in May 2011 was at 19.8 percent – the highest rate since December 2008. The fact that Vietnam now has one of the highest inflation rates in the world goes on to suggest that domestic factors have played a disproportionately larger role in the current inflationary episode.

Figure 9: Inflation dynamics during the last four years**Box-2 Social Impact of Rising Inflation on Low Income Households**

A new rapid impact assessment carried out by Oxfam/Hanoi in early May, 2011 in several low income neighborhoods in HCMC, Hanoi, and Haiphong highlights the high vulnerability of certain groups (viz. the elderly and persons living on fixed incomes, low-wage migrant workers, many self-employed workers, etc.) and also supports broad concerns voiced by public sector employees and persons in middle income brackets. Early findings of this assessment include:

Severity: No severe ‘crisis’ consequences were identified at the household level – children were not pulled out of school, there was no acute hunger. Families were managing by means of conventional informal measures, such as reduced consumption in foodstuffs (meat, fish, higher quality items), reducing electricity use, curtailing social expenditures, as well as reduced savings and remittances and temporary help from family and friends. Poor households living on fixed incomes were hardest hit; the measures they use are very much short run. The most serious implication is the rising tension (over mismatched salaries and price hikes) in industrial relations between employers and employees, especially in some labor-intensive industries.

Vulnerability: Those living on pensions, or whose primary source of income is low salaries, especially migrant factory workers, voiced the greatest concerns. Self-employed workers in the informal sector appear less vulnerable: they can exercise some flexibility by raising prices of their goods and services.

Policy Responses. Government recently put in place a number of somewhat ad hoc policy measures to help households cope with the immediate effects of rising prices, including a number of subsidies and one-time payments to eligible groups (e.g. low income public sector workers, pensioners, social beneficiaries and persons of merit) under Decision 641, also a monthly electricity subsidy of VND 30,000 for eligible poor households. The subsidy will reduce the cost of electricity consumption by up to two-thirds for many of the poorest households (those on the poverty list who consume less than 50 kWh/month). However most live in rural areas and electricity subsidies will do little to alleviate the impact of high prices on urban consumers. The minimum wage was raised by 13.7 percent, as were pensions and social insurance allowances for retired public sector and armed forces workers. Other measures are under consideration.

Source: Rapid Impact Assessment, Oxfam/Hanoi (May 2011)

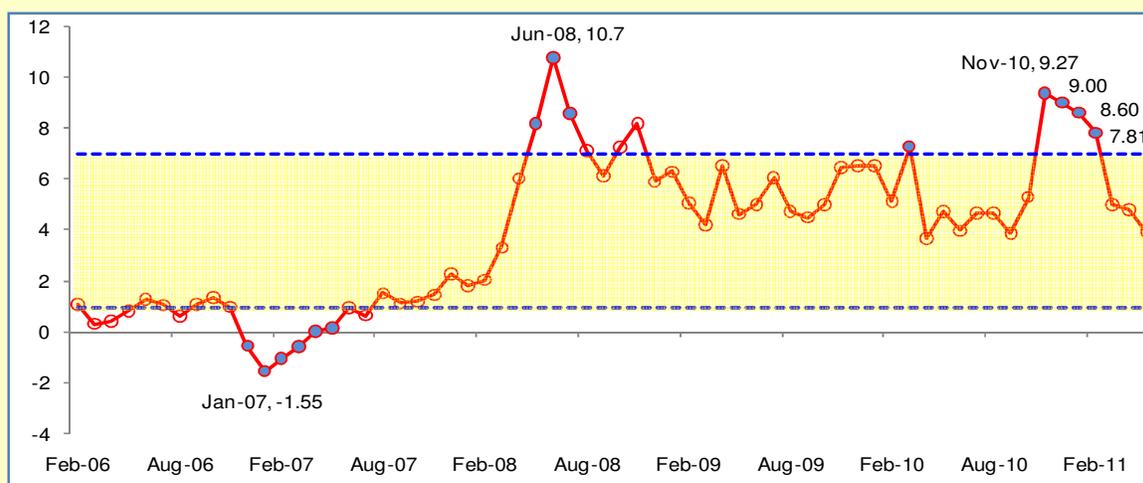
27. A vicious cycle of inflation-depreciation-inflation has been set in motion during the past 4 years that will be hard to break. The rapid inflation spurt in 2008 took many Vietnamese by surprise and forced them to look for ways to protect the value of their financial savings. This resulted in domestic capital flight and pressure on the local currency, as residents started piling up gold and US dollars. The dong, which had been relatively stable through the 2000s, experienced its first major devaluation in June 2008. This led to more imported inflation and a vicious cycle of inflation - depreciation – inflation took hold. It is from this perspective that “protecting growth at any cost” approach to monetary and fiscal policies has been counterproductive – as it has produced higher inflation and greater macroeconomic instability without much growth. Hence, maintaining a low and stable inflation rate for a sufficiently long period of time will convince the residents that the cycle has been broken and could lead to a virtuous cycle of low inflation and stable exchange rate – conditions that will facilitate a rapid growth rate in the future.

II.E A Digression: Measuring the Severity of Macroeconomic Instability

28. We have developed a simple measure that captures the severity of macroeconomic instability in Vietnam. Such a measure is important when a country is periodically subject to bouts of macroeconomic instability, and there are many factors that contribute to its making. A single summary measure can serve as a leading indicator of how the overall situation is shaping up and help the authorities to take preemptive actions. Since Vietnam’s macroeconomic conditions are rooted in foreign exchange instability, we have used a modified version of exchange market pressure (EMP) index that is widely used in study of currency crises. We have estimated Vietnam Index of Macroeconomic Stability (VIMS) incorporating the movement of four variables, viz. the exchange rate, international reserves, interest rates and inflation rate. The details of how VIMS is calculated are reported in the Annex-1.

29. Vietnam’s current episode of macroeconomic instability was as severe as the previous overheating episode of mid-2008, though stability seems to be gradually returning. Our measure of VIMS shows that the degree of macroeconomic instability during the current episode did come quite close to that of the mid-2008, but did not surpass it (figure 10). Nevertheless, the current episode stands out in terms of its durability and persistence. Unlike 2008, when the level of instability increased and fell quickly, macroeconomic instability has persisted over a longer period of time during the current episode – from November 2010 to February 2011 – thereby exposing Vietnam’s economy to a prolonged period of nervousness and uncertainty. However, given some of the limitations of measuring such an index (as discussed in Annex-1), it is important that the focus should not be on a specific value of VIMS but on its trend and the direction of change.

Figure 10: Vietnam Index of Macroeconomic Stability (VIMS) for Jan 2007-May 2011 period



Source: Estimates by World Bank staff

II.F Fiscal and Debt Situation

30. **While fiscal deficit is on a downward trend, the pace of fiscal consolidation is slower than required to achieve macroeconomic stability.** According to the latest IMF estimate, total budget revenue and grants increased from 26.7 percent of GDP in 2009 to 28.2 percent in 2010. Meanwhile, total budget expenditure (including off-budget expenditure) is estimated to have decreased by a mere 1 percentage points, from 35.7 percent of GDP in 2009 to 34.6 percent in 2010. The fiscal deficit is therefore estimated to have declined from 9.0 percent of GDP in 2009 to 6.4 percent in 2010 (table 3). This is considerably higher than the fiscal deficit level of 3 percent of GDP that is required to ensure long-term sustainability of public sector debt.

31. **Vietnam's public debt is likely to remain sustainable if the current economic recovery continues and the authorities carry out further fiscal tightening.** The results of the debt sustainability analysis conducted in 2011 indicate that the public sector debt was 52.8 percent of GDP at end-2010, two-thirds of which (42.3 percent of GDP) was owed to external creditors. Under the baseline scenario, this ratio was projected to increase to just above 50 percent of GDP during 2010-13, before starting to decline again. The large fiscal deficits in 2009 and 2010 do not affect the overall debt sustainability significantly, as long as the government reverts to the pre-crisis levels of deficit soon. The stress tests indicate that the two main risks to debt sustainability are: (i) a loss of access to non debt-creating capital inflows and (ii) a slowdown of exports.

32. **The largest source of uncertainty and hence, unquantifiable risk to debt sustainability, comes from implicit obligations which are not captured under public or publicly-guaranteed debt statistics.** Neither a clear definition nor a reliable estimate of such liabilities is available, which limits the government's ability to manage associated risks. Contingent

liabilities could arise from off-budget statutory funds such as health insurance fund, the banking sector, or large SOEs. The last one in particular is a serious concern after Vinashin's recent default. In the last four years, off-budget expenditure financed by Ministry of Planning and Investment (MPI) bonds has increased sharply from 1.5 percent of GDP in 2007 to 2.8 percent in 2010. However, it is scheduled to fall to 1.9 percent of GDP in 2011 and to 1.8 percent of GDP in 2012 (table 3).

Table 3: Selected Public Finance Indicators (as % of GDP)

(percent of GDP)	2008	2009/r	2010/e	2011/p
Total revenue and grants	29.0	26.7	28.1	28.5
Revenue (excluding grants)	28.4	26.3	27.9	28.3
Tax revenue	24.5	22.3	23.6	24.1
Oil revenues	6.1	3.6	3.5	3.4
Non-oil tax revenues	18.4	18.7	20.1	20.7
Non-tax and capital revenues	3.9	4.0	4.2	4.1
Grants	0.6	0.4	0.3	0.2
Official expenditures	27.7	31.8	30.0	29.5
Current	19.7	20.9	21.4	22.8
of which: interest	1.1	1.4	1.3	1.5
Capital	8.0	10.9	8.6	6.7
Official fiscal balance	1.2	-5.1	0.1	-1.0
Other expenditures	2.4	3.9	4.5	2.9
Financed by off-budget bonds	1.8	2.8	2.8	1.9
ODA on-lending	0.6	0.5	1.6	0.9
Interest rate subsidy cost	0.0	0.6	0.1	0.0
Total expenditure	30.2	35.7	34.6	32.4
Overall fiscal balance	-1.2	-9.0	-6.4	-3.9
Financing	2.6	8.8	6.2	3.9
Foreign (net)	1.7	3.6	3.2	2.0
Domestic (net)	0.9	5.2	3.0	1.9
Discrepancy (+ is over-financing)	1.4	-0.2	1.8	0.0

Source: Ministry of Finance, IMF and World Bank staff estimates;

II.G Developments in the Banking Sector

33. **Vietnam's banking sector has been adversely affected by the succession of asset price bubbles, monetary tightening and growth slowdown.** An unstable macroeconomic environment is inimical to sustained and stable growth of the financial sector. And Vietnam's macroeconomic conditions have been more unstable in the past four years than in the previous two decades. The banking sector has survived these big gyrations in economic conditions without a major meltdown is both laudable and encouraging. But the sector has encountered difficulty several

times during the last few years because of several factors ranging from the real estate bubbles to rapid disinflation in the economy.

34. **The banking sector landscape continues to change in favor of the commercial joint-stock banks (JSBs).** SOCBs play a dominant role in the banking sector, though they have been rapidly losing market share (in both credit and deposit markets) to the joint stock banks (JSBs) in recent years. At the end of 2007, SOCBs share in total outstanding credit was 59.3 percent and that for JSBs was 27.7 percent; by the end of 2010, these numbers were 51.4 percent and 34.8 percent respectively. Two SOCBs have started the equitization process and two other SOCBs plan to start it this year. The International Financial Corporation (IFC) has recently bought 10 percent stake in the third largest SOCB. In terms of credit growth, loan portfolio of the SOCBs has grown at a slower rate than the overall system in the past couple of years. For example, in 2010, SOCBs loan portfolio grew at 22 percent compared with the average of 40 percent growth in the JSBs. The share of SOCBs credit going to SOEs has also declined in recent years. Nevertheless, given the size of SOCBs and interconnectedness with SOEs, they are likely to remain a source of vulnerability for the sector.

35. **The banking sector continues to be impacted by the ongoing macroeconomic instability.** Depositors continue to shift their saving deposits to other alternatives (such as foreign currency, gold, etc.), contributing to higher dollarization of the economy and higher real estate prices. Individual savings in Vietnamese dong has shown an increasing trend in recent months (while corporate savings have diminished, causing a negative total growth in dong deposit), but this is primarily because the administrative measures have made alternative options less attractive. At the same time, depositors continue to switch banks without much consideration of the risks under the assumption that the SBV will not allow a bank to fail. The absence of an efficient rating system, coupled with fairly low level of transparency and disclosure, has contributed to this problem.

36. **Despite visible successes, the banking sector has faced with safety and soundness issues.** The country is an over-banked one with roughly 120 credit institutions operating (of which 5 are SOCBs or with majority state stake and 2 policy banks). Many of the credit institutions are small, urban-based and have seen rapid growth in their loan portfolios. Due to growth pressure, fairly under-developed risk management system and weak management skills, some of these banks have experienced liquidity problems in face of the high interest rate volatility of the recent years.

37. **The asset quality of bank portfolios remains an ongoing concern** given the unusually high credit growth of the past years, high lending rates, and relatively weak risk management capacity in the banking sector. According to the official data, the non-performing loan (NPL) ratio of the banking system was 1.9 percent and roughly 2 percent in end-2009 and end-2010. However, if the regulation were upgraded to international standards and enforced effectively, the NPL ratio of the banking sector is expected to be significantly higher. Currently, only 3 commercial banks are

accredited by the SBV to apply Article 7 of Decision 493 on loan classification which is closer to international method of calculating NPLs.

38. **SBV raised minimum capital requirements in response to the concerns about the health of the banking sector.** By the end of 2008, all commercial banks had met the new capital requirements. The process of increasing the minimum charter capital continues, in part as a gentle push towards consolidation of the smaller banks. However, the deadline to increase the minimum charter capital to 3 trillion dong (about \$150 million at today's exchange rate) by end 2010 was extended for one more year as 18 smaller banks were unable to meet this new requirement. The SBV opted for a more measured implementation of this policy, especially in the current fragile macroeconomic environment. An important step to increase the safety of the system was made when a new CAR requirement of 9 percent was introduced in October 2010.

39. **Policy reliant on administrative measures will need to be phased out in favor of more market based mechanisms.** The sector has been subject to several administrative measures in the past six months including caps on credit growth (20 percent for 2011), on deposit rates (VND deposit rate cap of 14 percent, USD deposit rate cap of 2 percent for individual savings and 0.5 percent on corporate accounts), as well as a cap on exposure to the non-manufacturing sectors, and ban on gold mobilization and lending. These administrative measures may have proven quite effective in the implementation of Resolution 11 in the short-run, however in the longer run, the overuse of these direct tools rather than market-based instruments, can be harmful to the soundness of the banking system as well as to the economic recovery process.

40. **Supervisory and regulatory framework and effective enforcement of the regulation will need to be further strengthened.** SBV has upgraded its supervision by establishing the Banking Supervision Agency and revising the two banking laws and regulation on prudential ratios. Capacity building for supervisors, for both on-site and off-site supervision, is ongoing, but demonstrated results are still lacking. The regulation enforcement appears to remain weak with a number of ad-hoc reporting requirements to the credit institutions in the past few years (although supervision has received abundant support from the authorities and donor community).

41. **SBV has been making efforts to improve transparency and disclosure, but continues to lag behind international and regional peers.** SBV has introduced more transparency in the system and to the public, as seen by the amount of data and information provided on its website and media coverage, but it still lags behind its peers in the region. With a revised Circular on information disclosure to be issued by mid-2011, there should be noticeable improvements, although current confidentiality regulations by the government do not give much room for comprehensive changes. In this respect, the establishment of a Statistics and Forecasting Department is helping to improve the SBV's capacity in meeting further disclosure requirements and monetary policy undertaking and forecasting.

III. RECENT POLICY DEVELOPMENTS

III.A Well Begun, But Only Half Done

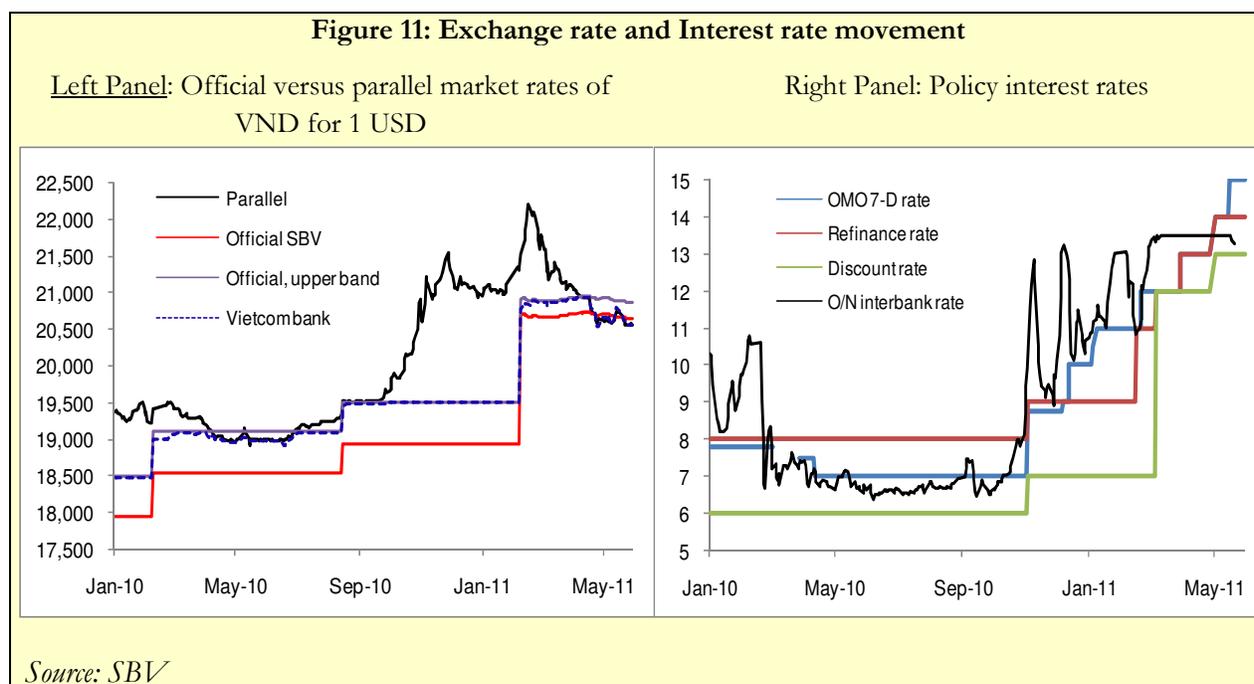
42. **Vietnam has seen a series of major policy announcement in recent months, which if implemented well could help the country to achieve lasting macroeconomic stability.** After the successful completion of the XIth Party Congress in January 2011, a consensus emerged within the government (including the provincial governments) to take strong measures to restore macroeconomic stability. The authorities recognized that their attention and focus should be on addressing instability even if this comes at the expense of slower growth in the short term. The government publicly indicated its intention to pursue “tight and prudent monetary and fiscal policy” and approved Resolution 11, which commits the government to a wide range of monetary, fiscal and structural policy reforms that are intended to cool an overheated economy. SBV has been most active in announcing follow-up measures as required by Resolution 11 and similar efforts are under preparation in all the relevant ministries. Here we provide a brief summary of the measures undertaken so far:

Exchange Rate Policy

- i) The dong was devalued by 9.3 percent against the US dollar and the trading band was narrowed from ± 3 percent to ± 1 percent. This is the single largest correction to the exchange rate following the onset of macroeconomic instability in 2007. The authorities have also indicated that the inter-bank average exchange rate will be managed more flexibly, consistent with the intention to gradually move to a more flexible exchange rate regime. In recent weeks, the foreign exchange premium in the parallel market has gradually reduced to zero. In May 2011, for the first time in 37 months, the dong is available in commercial banks below the official reference rate.
- ii) In an effort to reduce dollarization in the economy, a circular was issued in April, banning the commercial banks from accepting deposits or lending in gold.
- iii) On May 31, the State Bank of Vietnam issued Circular 13 that requires SOE to sell their deposits in US dollar to commercial banks.
- i) Given a large and rapidly growing quasi-illegal trade in gold, which led to a significant increase in errors and omissions in the balance of payments, Resolution 11 instructs SBV to prepare a Decree on Management of Gold Trading for issuance by the second quarter of 2011. The Decree will centralize gold exports, eliminate trading in gold bars, and prevent cross-border trafficking of gold. The Resolution instructs responsible authorities to ensure that foreign exchange and gold traders comply with the law.

Monetary Policy

- i) In the last four months, SBV has increased the base (refinancing) rate from 8 percent to 14 percent and revised the overnight market operation (repo) rate upward eight times— from 7 percent to 15 percent (right panel, figure 11).



- ii) According to Resolution 11, the target for credit growth in 2011 will be cut to 20 percent from 39 and 33 percent in 2009 and 2010 respectively. This will be the lowest target for credit growth in the last 10 years. Correspondingly, the target for broad money supply (M2) growth has been kept at 15-16 percent during 2011 — lowest growth target since the beginning of economic reforms two decades ago. Credit and liquidity growth during the first four months of 2011 were at 5 percent and 1 percent respectively, on track to achieve the respective annual targets.
- ii) SBV has increased the reserve requirement for foreign currency deposits to 6 percent for those with less than 12 months maturity, and to 4 percent over 12 months maturity (effective May 1, 2011); and put a cap on the dollar deposit rate at 1 percent for entities and 3 percent for individuals. On May 31, 2011 the deposit rates were further revised downward.

Banking Sector

- i) Resolution 11 limits banks' exposure to non-productive activities (which include real estate and security market) to 22 percent of total credit by June 30, 2011 and to 16 percent by December 31, 2011. Non-compliant banks will be asked to double their required reserves ratio and restrict their business activities. SBV will review compliance at the end of June 2011. The recent decline in the stock market indices is attributed to the enforcement of this regulation, which has

reduced the amount of banking sector credit being channeled into the equity market in search for higher returns.

- ii) The government is revising Decision 493 to upgrade loan classification and provisioning practice in the banking system to bring them closer to international norms. The revised Decision was supposed to be issued by May 2011, but has since been delayed.
- iii) The government has also confirmed its participation in the Financial Sector Assessment Program (FSAP), and has sought technical assistance from the World Bank and IMF.

Fiscal Policy

- i) The government has announced that it will cut non-salary recurrent expenditures by 10 percent, will not start any new construction projects in the public sector this year, including in SOEs, and thereby reduce fiscal deficit to below 5 percent of GDP in 2011 (as per GoV's definition) — a 1 percentage point reduction relative to 2010 and 0.3 percentage point reduction relative to 2011 budget estimates.
- ii) Efforts to reduce investment spending by stopping wasteful projects have however not made satisfactory progress. No official announcement has yet been made about the exact reduction in the investment (capital) budget for 2011, though media reports indicate that the cutback proposed by the MPI is likely to be sizeable.

State-Owned Enterprises

- i) The government has asked key Economic Groups to carry out independent audits using international norms and make the results available by end 2011. MPI has been asked to review planned loans and investment projects of SOEs to identify those that can be dropped or scaled down. The report from MPI was due to the National Assembly by the end of March 2011. Resolution 11 also indicates that the government will accelerate the equitization process and strengthen the governance of SOEs, though exact measures have yet to be spelled out.

Other Structural Measures

- i) The government is preparing a Circular to increase disclosure of information and policies affecting monetary management and banking, including submitting key statistics to the IMF's International Financial Statistics on schedule. Finally, the government is moving from an administrative mechanism for setting the prices of key commodities such as electricity, gas and fuel, to a more market-based mechanism. It announced an increase in electricity tariffs by 15.3 percent, and two rounds of price increase for gasoline, diesel, and kerosene amounting to more than 30 percent. In addition, Resolution 11 instructs MOIT to prepare a regulation for establishing a market mechanism for pricing electricity.

43. **The above policy measures, in our view, constitute a credible first step for Vietnam to regain macroeconomic stability.** The measures have been widely discussed and debated within

the government, with representatives of large SOEs as well as with national scholars. It has the broad support of line ministries as well as key finance and budget committees in the National Assembly. The international financial markets have reacted favorably to the recent announcement, with Vietnam's sovereign and credit default swaps (CDS) spreads steadily declining over the past few months. This augurs well for successful implementation of Resolution 11.

44. **Initial success notwithstanding, the authorities need to guard against 'premature declaration of victory' against the war on macroeconomic instability.** Unfortunately, the implementation of Resolution 11 has not been uniformly well. The efforts to rein in the investment budget have been stalled, with no consensus yet to reduce the fiscal deficit in the medium-term to a more sustainable level of 3 percent of GDP. Similarly, the nature of reforms of the SOEs has not been fully spelled out yet, including improving their corporate governance, strengthening the audit reports and acting on the audit objections and accelerating the equitization process. There are some measures being aimed at improving the communication with the market, though more meaningful reforms in this area will be difficult in face of current laws governing state secrets. Similarly, there needs to be continued updating and strengthening of regulatory systems to forestall problems in the banking sector. With growth expected to slow down in 2011, there will be demands from various quarters to relax monetary and fiscal policies and to go slow on structural reforms. Capitulating to such demands could prove costly for the economy.

45. **Instead of thinking of an exit timetable for withdrawal of stabilization measures, the authorities may consider defining a set of indicators to measure the implementation progress.** The current situation presents the authorities with an opportunity to rebuild Vietnam's eroding credibility by steadfastly and effectively implementing Resolution 11. And to assess implementation success the authorities may like to define a set of indicators with clearly specified targets. As and when those targets are met, Resolution 11 could be considered to have achieved its objective. Based on the above discussion on Vietnam Index of Macroeconomic Instability (VIMS), we suggest the following three indicators: (i) inflation rate is reduced to a stable, single-digit rate; (ii) foreign exchange premium is completely eliminated; and (iii) the level of international reserves is adequate to finance at least 2.5 months of prospective imports.

IV. OUTLOOK FOR 2011 AND BEYOND

46. **With considerable uncertainty in the global outlook and the domestic policy situation in a constant churn, our outlook for Vietnam's economy is underpinned by some strong assumptions.** We use the World Bank's latest forecast for global growth rate and developing East Asia growth rate, which are projected to be 3.2 percent and 8.2 percent respectively. We assume that there will be no new global food and fuel price shocks and the prices prevailing during March-May 2011 period reflect the peak price levels for 2011. We also assume that there will be no new significant and unpredictable increase in domestic fuel and energy prices during the remainder of 2011. And most importantly, we assume full and effective implementation of Resolution 11,

including the crucial assumption that the liquidity and credit targets for 2011 will be met. Given the optimism underpinning our assumptions, our outlook is likely to be biased upward.

47. **We expect gradual improvement in the situation during the second-half of 2011.** Improvement should include slow but steadily declining inflation rate, modest pickup in the growth rate by end of the year and no significant deterioration on the external front. 2012 is poised to see further improvements, though without some bold and decisive actions on structural fronts, we don't see Vietnam returning to its pre-crisis heydays of growth in the near to medium-term.

48. **Despite domestic slowdown and global economic uncertainties, external sector will perform as good as last year.** Export demands for Vietnam's labor-intensive manufacturing goods and agricultural products are likely to hold up through 2011. Stronger exports growth however will keep the import bill high given the large import content of Vietnam's exports. Therefore, we expect the trade deficit in 2011 to be marginally higher than 2010 in both absolute terms as well as a share of GDP. Increase in trade deficit and slowdown in growth of remittances are likely to cause the current account deficit to increase by about one percentage point – from 4 percent of GDP to 5 percent. An increase in CAD may coincide with reduced capital inflows, given the slowdown in FDI and possibility of lower portfolio investments in the midst of continuing macroeconomic volatility. However, we expect the internal capital flight to decline during 2011, helping SBV to gradually built-up its stock of international reserves.

49. **Strict enforcement of Resolution 11 should help to decelerate inflation during the second-half of 2011.** Vietnam headline inflation accelerated to 19.8% (year-on-year) in May 2011, the highest in the past 26 months. This reflects rising international food and commodity prices, the impact of large adjustment of domestic prices of key utilities and a rapid pass-through of import products into domestic prices through a weakening dong. We expect the year-on-year inflation rate could reach its peak by the end of second quarter and start to steadily decelerate thereafter to reach around 15 percent by December 2011. The inflation forecast for 2011 depends critically on whether the government's policy package (Resolution 11) will succeed in restoring policy credibility as well as the confidence of domestic and foreign investors. Decisive and sustained implementation is therefore critical to rein in inflation, build confidence, and to strengthen the external position.

50. **Vietnam's near-term growth outlook remains highly challenging.** The economy started to slowdown in the first quarter of 2011, when the full impact of high inflation and stabilization measures had not yet been felt. The second and third quarters of 2011 are likely to be tougher than the first quarter, though recent forecast from MPI shows that the economy is likely to grow at 5.6 percent during the first-half of 2011. Tightening monetary and fiscal policies is expected to weaken investment growth further, while sharp rise in interest rates and increasing inflationary pressure would adversely impact private consumption. Higher production costs will also narrow the growth potential for the corporate sector. Contraction in production sector in turn, will likely to impede services activities this year. However, assuming that the government's policy measure will

restore confidence and rebuilt the momentum for growth, we expect the economy to achieve a growth rate of slightly below 6 percent.

51. **Given the optimism underpinning some of our assumptions, our economic outlook is exposed to a number of downside risks.** Major risks include, premature withdrawal of stabilization measures, resurfacing of problems in the banking and state-owned enterprise sectors and continued increase in global commodity prices or a full blown sovereign debt crisis in Europe and its contagion effect on the rest of the world.

ANNEX: 1

ESTIMATING VIETNAM INDEX OF MACROECONOMIC STABILITY (VIMS)

A1. **When a country is periodically subject to bouts of macroeconomic instability, it is not uncommon to compare the severity of one episode with another.** Vietnam has been subjected to at least two episodes of overheating in the last three years, the first one took place in mid-2008 and the second one started in end-2010 and is ongoing. It has also experienced at least one episode of rapid slowdown of economic activities and disinflation – coinciding with global economic crisis in 2009 – which can also be considered an episode of macroeconomic instability. In the current context of high inflation and volatile foreign exchange situation, one is often asked, is 2010-11 macroeconomic instability more severe the one in 2008?

A2. **There is no standard technique to measure the severity of macroeconomic instability.** In fact the problem is much deeper than finding the right technique. It starts with the concept of ‘macroeconomic instability,’ which is widely used in the policy-oriented literature, but is almost never really defined. A paper by Elbadawi and Schmidt-Hebbel (1998) tries to measure macroeconomic instability as a combination of macro-financial policy indicators – public sector deficit to GDP ratio, adjusted base-money growth, real-exchange rate misalignment, and the current account deficit to GDP ratio – and macro-financial crises indicators, understood as severe macroeconomic and financial disequilibria in the areas of fiscal, monetary, and real exchange rate policies. But their version of macroeconomic instability is less relevant in the Vietnam’s context for two reasons. First, their definition is too broad to distinguish the instability caused by cyclical factors from those rooted in structural problems. Second, the index can be produced at an annual or quarterly frequency, which is of little use if the idea is to estimate a high frequency index that policymakers can use to monitor macroeconomic conditions and do mid-course policy corrections.

A3. **Since Vietnam’s macroeconomic conditions are rooted in foreign exchange instability, a more appealing measure can be the exchange market pressure (EMP) index, used widely in study of currency crises.** The most common definition of EMP index is a composite variable that incorporates the following three variables, viz. the exchange rate, international reserves and interest rates (see Eichengreen, Rose and Wyplosz (1994) and Kaminsky, and Reinhart (1999)). Given that relatively large volatility of one component might dominate the movement of the EMP index, it is a common practice to use the inverse of the variance or standard deviation of each series as its respective weight.

A4. **For Vietnam we propose to estimate Vietnam Index of Macroeconomic Stability (VIMS), which is a modified EMP index.** EPM indices have been developed almost exclusively to measure instability in the foreign exchange market, which is an important source of macroeconomic instability in Vietnam. The other source of instability has been the inflation rate. We therefore propose VIMS that incorporates the following four variables, viz. the exchange rate, international reserves, interest rates and inflation rate in a manner shown in the below equation. We

also use the inverse of standard deviation of the series as our weights, instead of variance as used in the EMP index.

$$VIMS_t = \frac{1}{\sigma_e} [E_t^p - E_t^o] - \frac{1}{\sigma_R} \left[\frac{R_t - R_{t-1}}{R_{t-1}} \right] + \frac{1}{\sigma_i} [i_t^{VN} - i_t^{US}] + \frac{1}{\sigma_\pi} [\pi_t^{VN} - \pi_t^{US}]$$

where,

$VIMS_t$: Vietnam Index of Macroeconomic Stability for month t.

E_t^p : Nominal exchange rate between VND and USD in the parallel market for month t

E_t^o : Nominal exchange rate between VND and USD in the official market for month t

σ_e : Standard deviation of the series $[E_t^p - E_t^o]$

R_t : Level of international reserves for month t

σ_R : Standard deviation of the series $\left[\frac{R_t - R_{t-1}}{R_{t-1}} \right]$

i_t^{VN} : Nominal interest rate in Vietnam for month t

i_t^{US} : Nominal interest rate in US for month t

σ_i : Standard deviation of the series $[i_t^{VN} - i_t^{US}]$

π_t^{VN} : Inflation rate in Vietnam for month t

π_t^{US} : Inflation rate in US for month t

σ_π : Standard deviation of the series $[i_t^{VN} - i_t^{US}]$

A5. While using VIMS for making policy decisions it is important to know its limitations.

VIMS is a composite index and its value can fluctuate depending on the time period used, choice of reference country (here we use US), weighting scheme (see Li, Rajan and Willett (2006) for a critique) and specific variables used in the estimation (e.g., for interest rates, one could use overnight repo rate or six month inter-bank rate or something else). While such variations could result in a different number for the VIMS, the qualitative characteristics of the series will be invariant to such changes. Therefore, rather than being too focused on a specific value of VIMS, the emphasis should be on its trend and the direction of change.

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