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TAKING STOCK

An Update on Vietnam's Recent Economic Developments

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ACRONYMS AND ABBREVIATIONS

ASEAN	Association of Southeast Asian Nations
FDI	Foreign Direct Investment
GDC	General Department of Customs
GDP	Gross Domestic Product
GSO	General Statistics Office
IMF	International Monetary Fund
MOF	Ministry of Finance
MPI	Ministry of Planning and Investment
MUV	Manufacturing Unit Value
NPL	Non-Performing Loan
SBV	State Bank of Vietnam
OECD	Organization for Economic Co-operation and Development
ODA	Official Development Assistance
SOCB	State-Owned Commercial Bank

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INTRODUCTION

Over most of the last decade a steady expansion of international trade, growing capital flows to developing countries and moderate world inflation had made macroeconomic management relatively easy for the government of Vietnam. The domestic policy debate was mostly focused on microeconomic issues: how to complete the transition from plan to market, how to reform the state sector, how to lay down the institutional foundations to become an industrial country in one generation…

The end of the year 2007 marked an end to that tranquil setting. Since then, the Vietnamese economy has faced a global rollercoaster, including massive capital inflows in late 2007 and a collapse in the demand for exports in late 2008.

These past two years have tested the macroeconomic management capacity of the government. In early 2008, only half a year after the first signs of overheating were visible, the government shifted its priorities decisively, from growth to stabilization, effectively ending the real estate bubble and bringing the inflation rate down in a matter of months. In late 2009, when some analysts still claimed that inflation could be running out of control, the government swiftly shifted its priorities once again, from stabilizing the economy to sustaining growth. The stimulus measures adopted in the following months were effective at reversing the decline in economic activity and preventing any major-scale social impact. By late 2009 the Vietnamese economy is among the fastest growing in the world.

However, due to their sheer magnitude the stimulus policies also put pressure on the balance of payments and especially on the markets for foreign exchange and gold. In late 2009, while going through the second anniversary of macroeconomic turbulence in Vietnam, it is reassuring to see that the government is rebalancing its objectives once again, giving more priority to stability. The decisions made between late October and early December amount to an appropriate macroeconomic framework being put in place.

While effective, the policy response has also been characterized by rough stop-and-go adjustments. The response relied heavily on standard policy instruments, including monetary and fiscal policy. But the government was also prepared to adopt heterodox policies to achieve its goals. Over these two years, there has been a gradual widening of the foreign exchange rate band, but not a decisive move away from a managed peg. The stabilization package of early 2008 relied on a large compulsory bond issue, to mop up liquidity. The stimulus policies of early 2009 included an interest rate subsidy scheme for working capital, to encourage the refinancing of onerous corporate debt. Administrative measures and moral suasion (especially on state-owned enterprises and banks) have consistently complemented more conventional monetary and fiscal measures. No bank or financial institution fell during these two turbulent years, but

rudimentary on-site supervision more than sophisticated risk management systems are to be credited for this outcome.

In spite of its relatively heterodox and at times rudimentary nature, Vietnam's macroeconomic management has so far been effective. But it was not always well received by the markets. Insufficient information on budget outturns, the secrecy on the level of international reserves, and a still insufficiently developed statistical system meant that the assessments of outside observers varied considerably. Over just a few months, some believed Vietnam to be "the other East Asian miracle" while others considered it "the next Thailand 1997"… At present the pendulum may be swinging back again. These changes in market sentiment have an impact on short-term capital inflows and portfolio decisions by residents. In doing so, they add to the already sizeable global instability, making good communication with the public critically important.

Looking forward, macroeconomic turbulence may not be over. While some analysts worry about the possibility of a "double dip" crisis in industrial countries, the prospect of renewed capital inflows and localized price bubbles is also a matter for concern. The appropriate policy response will be different in each case. Rapid developments, in one direction or the other, may test once more the government's capacity to steer the economy through difficult times.

Meanwhile, it will be necessary to continue pushing through the policy and institutional reforms that will eventually make the Vietnamese economy less vulnerable to global turbulence.

A central bank empowered to steer monetary policy, a strengthened capacity to supervise the financial system, more timely data on budget execution, disclosure on the level of international reserves and other key financial indicators, deeper capital markets supporting open market operations, accounting standards revealing exposure to exchange rate risk by enterprises and financial institutions, are some of the key areas to focus on. Others are more structural in nature. In late 2007, large Economic Groups and state-owned General Corporations fueled the asset price bubble by diversifying into real estate and finance. In late 2009 they contributed to tensions in the foreign exchange market through their hoarding of foreign currency. Entities which are large enough to be a source of systemic risk for the economy need to be subject to an arms-length relationship with regulators, to strong corporate governance rules and to stringent transparency requirements, regardless of whether they are state owned or not.

THE GLOBAL AND REGIONAL CONTEXT

The global economy is expanding again, pulled up by the strong performance of Asian countries and stabilization or modest recovery elsewhere. The threat of a deep and prolonged global recession appears to be receding thanks to unprecedented policy actions by both large developed and developing countries, as well as stepped-up support from the international financial institutions.

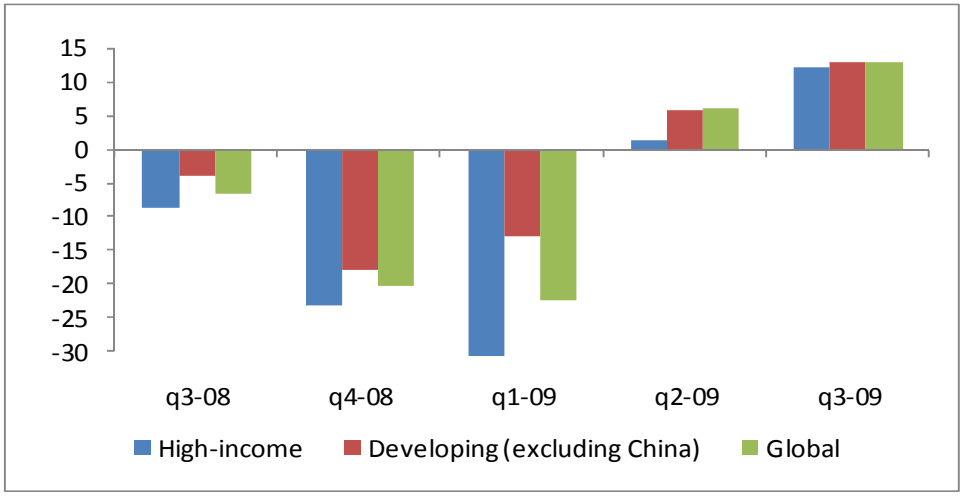
Global production and Gross Domestic Product (GDP) are increasing at a stronger pace, led at first by developing countries, especially in East Asia, then by major OECD countries (Table 1). Industrial production at the global level went from an annualized growth of 6 percent in the second quarter to 12 percent during the third, with inventories now being replenished and export orders firming (Figure 1). Commodity prices increased as well, with oil prices breaking out of their trading range of the last months and approaching US$80/bbl due to some improvement in the fundamentals, including declining crude oil stocks and robust demand in China. Continued depreciation of the dollar has also led to higher dollar-denominated import prices.

Table 1: Global Indicators

	2007	2008	2009F	2010F
GDP				
World	3.7	1.7	-2.9	2.0
High-income countries	2.6	0.4	-4.2	1.3
Developing countries	8.1	5.9	1.2	4.4
Export volume				
World	7.6	3.4	-2.1	6.0
High-income countries	6.4	2.9	-3.7	5.1
Developing countries	10.9	7.2	2.1	8.1
Trade price				
Manufacturing unit value (MUV)	5.5	6.0	-4.9	1.5
Oil (US$/bbl, average)	71.1	97.0	61.1	73.3
Non-oil commodities	17.1	21.0	-24.9	-2.8
Nominal interest rates				
US Dollar LIBOR (6M, percent)	5.2	3.2	1.5	2.0

Source: World Bank

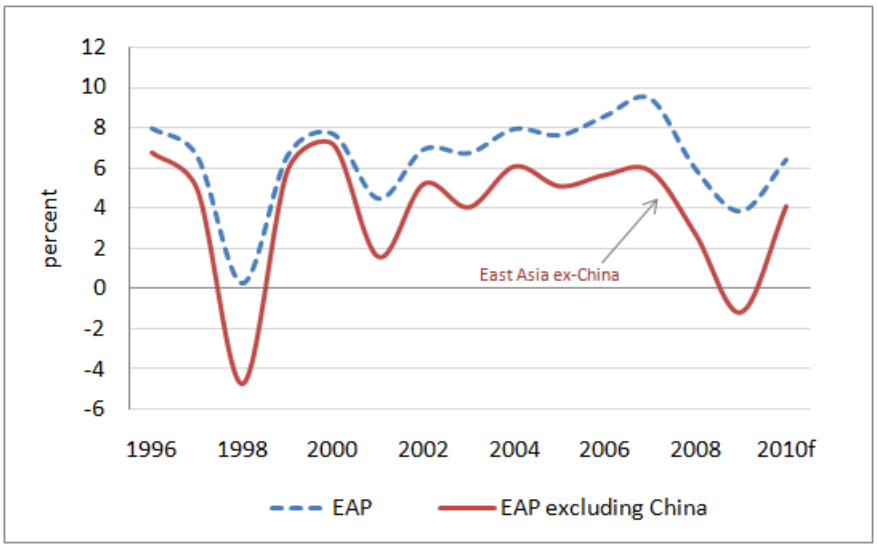
Figure 1: Global Industrial Production



Source: World Bank. Figures are growth rates, in percent.

Following the sharp impact from the financial crisis and global recession that began in late 2008, a robust rebound is under way in East Asia since the second quarter of 2009. The rebound is due to a combination of timely and large fiscal and monetary stimulus in most countries in East Asia, notably in China. These developments are set against a backgound of solid macroeconomic fundamentals, including generally high foreign exchange reserves, large private and corporate savings, and low corporate and government debt. Real GDP growth in East Asia slowed by less than during the 1997-98 crisis (Figure 2).

Figure 2: Real GDP Growth in East Asia

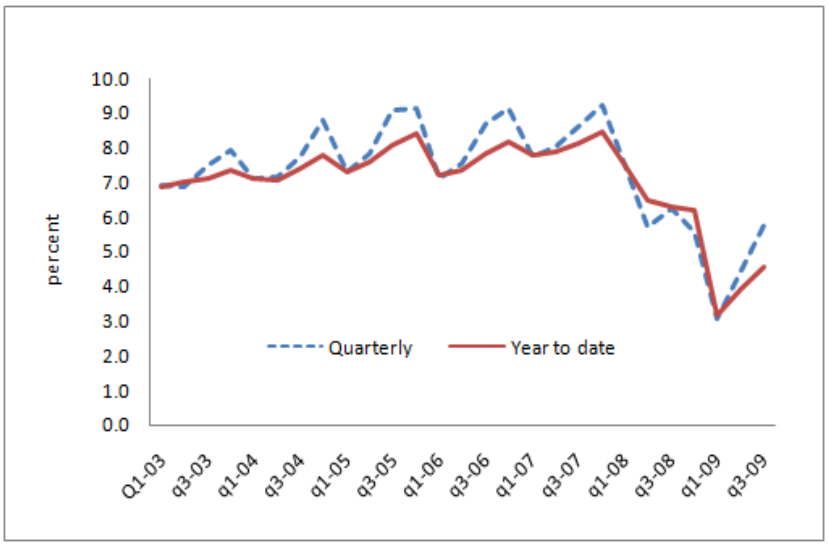


Source: World Bank

RECENT GROWTH PERFORMANCE

The global financial crisis led to a sharp slowdown of economic growth in Vietnam. The impact was severe in the first quarter of 2009, when GDP increased by 3.1 percent compared to the same period in 2008 (Figure 3). However, unambiguous signs of recovery emerged since the second quarter, partly reflecting the government's efforts to support economic activity. A sizeable stimulus package adopted in early 2009 included various measures, from an interest rate subsidy scheme to tax breaks to additional capital spending. As a result, GDP grew by 4.5 percent in the second quarter and 5.8 percent in the third, raising real GDP growth to 4.6 percent year-on-year for the period January-September.

Figure 3: Vietnam GDP growth



Source: GSO

While the manufacturing sector is still facing challenges, construction is leading the recovery, with value-added in the sector projected to reach a double-digit growth rate for the whole year (Table 2). Domestic consumption is also playing an important role, with retail sales increasing 10.1 percent in real terms during January-October from a year earlier. Both construction and retail sales are driven by domestic demand, which is an indication that the stimulus policies of the government contributed indeed to offset the downturn from a declining foreign demand. Even if the growth rate for the whole year may not exceed 5.3 percent for 2009, it is clear that so far Vietnam's economic activity has held relatively well compared to other countries in the region

Table 2: Quarterly GDP change

	2008				2009		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Total GDP	7.5	5.7	6.0	5.8	3.1	4.5	5.8
Agriculture, forestry & fishery	3.0	3.7	5.9	4.7	1.3	1.4	2.0
Industry & construction	8.0	5.3	5.5	4.8	1.7	5.0	6.2
Industry	8.8	6.8	7.8	6.7	0.9	3.8	4.9
o/w: Manufacturing	12.0	11.0	9.9	10.4	-0.8	2.8	3.5
Construction	3.3	-0.5	-1.9	-0.2	6.9	9.8	11.0
Services	8.3	7.3	6.5	7.4	5.1	5.7	6.8
Trade	7.6	7.1	5.3	6.1	6.5	6.5	7.2

Source: GSO

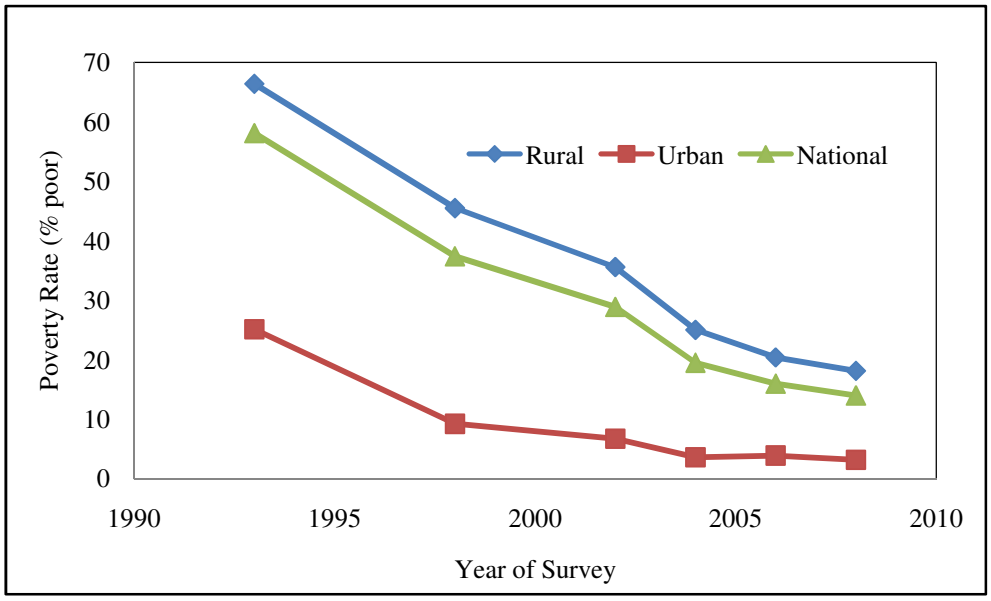
A COUNTINUED REDUCTION IN POVERTY

The economic difficulties faced by Vietnam's economy in 2008 and the early half of 2009 raise concerns about increasing vulnerability among workers and households. Inflation rates were high in 2008, with the price of rice reaching a peak in May-June, before stabilization measures started having an effect. The construction sector, a major source of employment for unskilled workers from poorer households, was hit hard by the credit squeeze in the middle of the year and came to a halt through the remainder of 2008. Agriculture suffered a series of shocks and output volumes were depressed in several regions.

In spite of these difficulties, preliminary findings from the 2008 Vietnam Household Living Standards Survey (VHLSS) show continued progress at reducing poverty in both urban and rural areas, albeit at a somewhat slower rate than previous periods. According to the 2008 VHLSS, the national poverty rate (the percentage of the population with expenditures below the World Bank/GSO poverty line) was 14 percent in 2008 (Figure 4). As usual, the poverty rate was much higher in rural areas (18.1 percent) than in urban settings (3.1 percent).

The poverty headcount fell by around 1 percentage point each year between 2006 and 2008, as compared to 2-3 percentage points per year in earlier periods. A gradual slowdown in poverty reduction is to be expected over time. Urban areas illustrate the point: as the poverty rate approaches zero, it becomes very difficult to achieve any significant gain. However, some part of the slowdown is likely due to the economic difficulties of 2008. If anything, the slowdown in poverty reduction might have been sharper in early 2009, when GDP growth rates fell substantially.

Figure 4: **Poverty Trends**

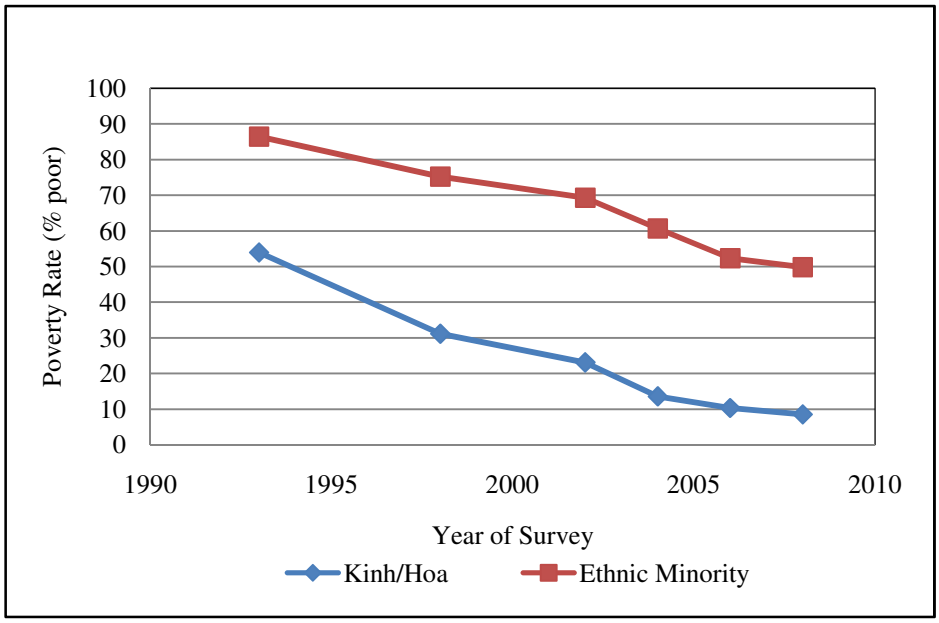


Source: World Bank estimate based on GSO data.

Unfortunately, there is no up-to-date statistically representative information either on poverty or employment available for 2009. But there is abundant evidence of increased hardship during the first half of 2009, especially in industrial parks and in handicraft villages. Small sample surveys, special studies and ongoing rapid assessments suggest that underemployment has been more common than open unemployment, and many export sector workers were absorbed into the urban informal sector. Semi-skilled and skilled workers fared better. There is also a clear heterogeneity of impacts across enterprises. A survey of the industrial parks that serve as the platform for a large share of manufacturing exports reveals that a significant minority of enterprises was adversely hit. However, rapid impact assessments relying on structured focus group discussions with workers suggest that major adverse effects, such as falling into poverty, facing acute food shortages, pulling children out of school, selling land, or becoming homeless, were relatively uncommon.

This relatively upbeat assessment should not mask the important challenges remaining in relation to poverty reduction. The 2008 VHLSS shows modest progress in reducing poverty levels among ethnic minority populations. Among this admittedly heterogeneous group the poverty rate only fell from 52.3 percent in 2006 to 49.8 percent in 2008 (Figure 5). In relative terms, this is much less than the reduction observed in the poverty rate for Kinh and Hoa populations (from 10.3 to 8.5 percent). Average welfare levels did increase among minority populations between 2006 and 2008, and there were reductions in both the depth and the severity of poverty. But growth was not sufficient to bring about substantial reductions in the poverty rate.

Figure 5: **Poverty Trends by Ethnicity**



Source: World Bank estimate based on GSO data.

Careful analysis is needed to understand the reasons for the slowdown in progress among minority households. High inflation and sharp reductions in jobs in the construction sector tell some of the story. The share of ethnic minority workers earning a wage or a salary fell by several percentage points in 2008, whereas the share of those self-employed or in agriculture rose to 85 percent.

LESS BUOYANT FOREIGN TRADE

The global economic recession has had a significant impact on Vietnam's external sector. The main channel of transmission was exports, whose total value (not to be confused with value added) is equivalent to 70 percent of GDP. Over the first ten months of 2009, Vietnamese exports declined by 13.8 percent compared to 2008 (Table 3). This is less than in most other developing countries, but will make 2009 the first year with negative export growth since the beginning of Vietnam's economic reforms. And the decline would be larger if the sizeable gold exports of early 2009 were not included in the figures.

An even more dramatic decline in imports, by 21.7 percent in the first ten months of 2009, succeeded in reducing the trade deficit. The decline reflected the downturn of economic activity. Lower demand for capital investment and intermediate goods as well as weaker private consumption and falling import prices of petroleum products and materials have caused the import values fall in all items (Table 4). However, imports are rebounding rapidly at present as a result of the recovery of economic activity and in response to growing private consumption.

Table 3: Export Values

	Value (US$ million, 2008)	Growth (in percent)		
		2008	10M-08	10M-09
Total export earnings	**62,685**	**29.1**	**36.7**	**-13.8**
Crude oil	10,357	22.0	43.2	-43.0
Non-oil	52,328	30.6	35.4	-7.6
Rice	2,894	94.3	83.4	-7.8
Other agricultural commodities	5,505	17.2	20.0	-19.9
Seafood	4,510	19.8	23.7	-8.7
Coal	1,388	38.8	57.4	-19.4
Garment	9,120	17.7	20.3	-1.5
Footwear	4,768	19.4	16.9	-16.1
Electronics & computers	2,638	22.5	27.3	0.1
Handicraft (including gold)	1,363	65.1	95.7	154.3
Wood products	2,829	17.7	18.6	-14.0
Other	17,312	44.3	52.9	-16.5

Source: GSO. Growth computed over the same period in the previous year.

Table 4: Import Values

	Value (US$ million, 2008)	Growth (in percent)		
		2008	10M-08	10M-09
Total import value	**80,714**	**28.8**	**42.6**	**-21.7**
Petroleum products	10,966	42.2	71.1	-47.9
Machinery and equipments	13,994	25.8	33.0	-13.0
Computer and electronics	2,355	9.4	28.3	-0.3
Pharmaceuticals	3,714	25.5	19.5	26.8
Garment and footwear accessories	6,721	31.5	11.8	-23.2
Iron and steel	1,473	47.3	57.2	-30.7
Fertilizer of all kinds	2,945	17.5	41.1	-18.1
Plastics	4,458	12.7	29.9	-10.9
Fabrics	1,776	21.1	13.3	-8.6
Chemicals	1,604	24.8	35.7	-15.2
Chemical products	864	22.9	32.5	-9.5
Automobiles (COMP/CKD/IKD)	775	4.6	106.6	-12.0
Yarns and fibers	744	94.3	11.5	-4.2
Pesticides	467	74.7	41.1	-11.6
Cotton	753	25.5	67.0	-15.2
Paper of all kinds	2,958	57.2	31.9	-3.9
Other	24,147	28.2	45.7	-23.3

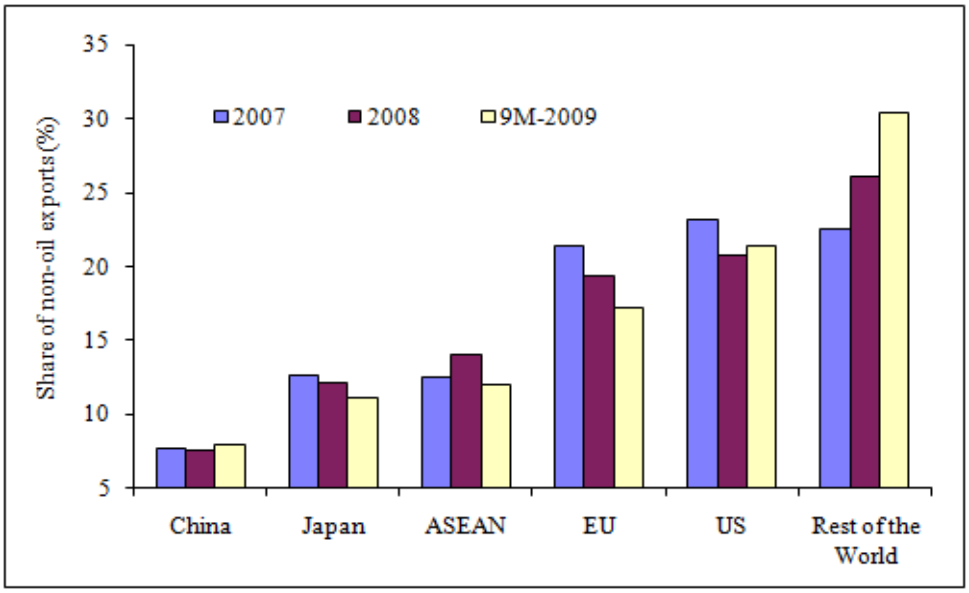
Source: GSO

THE EXPORT SUPPLY RESPONSE

While the impact of the global crisis on the demand for Vietnamese exports was severe, the domestic supply response was swift, partially mitigating the impact on economic activity.

Part of the response involved a market re-orientation, towards regions less adversely hit by the global crisis. As in previous years, in 2009 the United States remains the biggest importer, absorbing about a fifth of Vietnam's exports, and nearly 22 percent of non-oil merchandise exports. It is followed by the European Union, Japan and ASEAN countries. However, a distinctive feature of Vietnam's export pattern in recent years has been the sustained growth in the share of exports to other countries, including Latin America, Africa and the Middle East (Figure 6). Among industrial countries, the United States held better than others, reflecting an earlier and stronger recovery compared to the European Union and Japan. On the other hand, China's share remained fairly stable, in contrast with what has been observed elsewhere in the region.

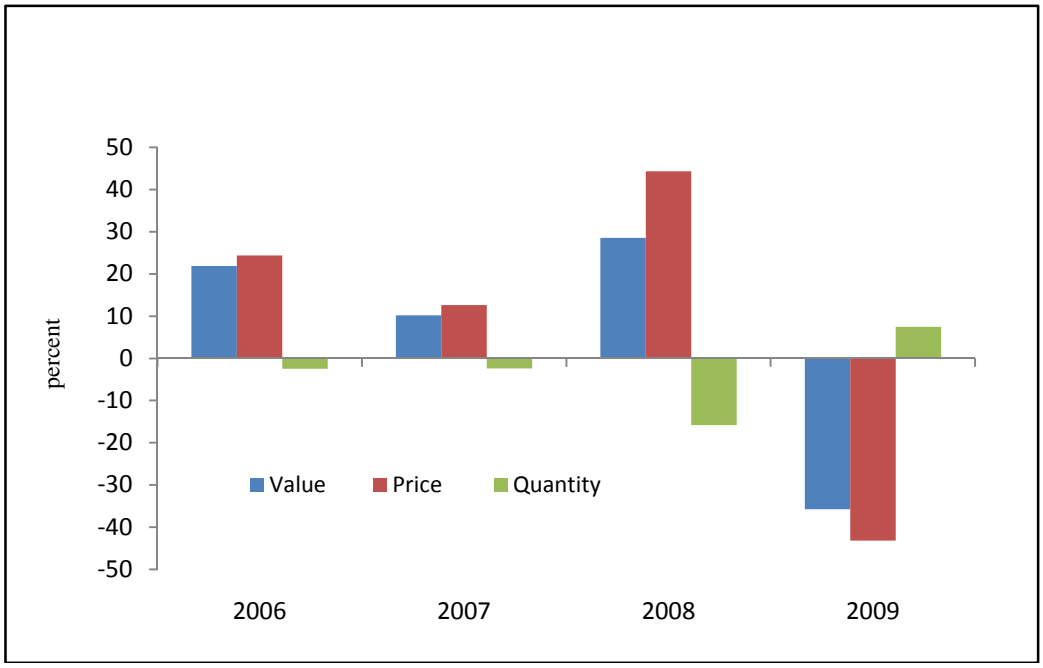
Figure 6: A Reorientation of Export Markets



Source: GSO

The decline in export prices was also mitigated by a substantial increase in the export volumes of key commodities (Figure 7). This is after three years of continued decline. With international commodity prices projected to increase in 2010, these higher volumes should boost Vietnam's export earnings.

Figure 7: Exports of Key Commodities

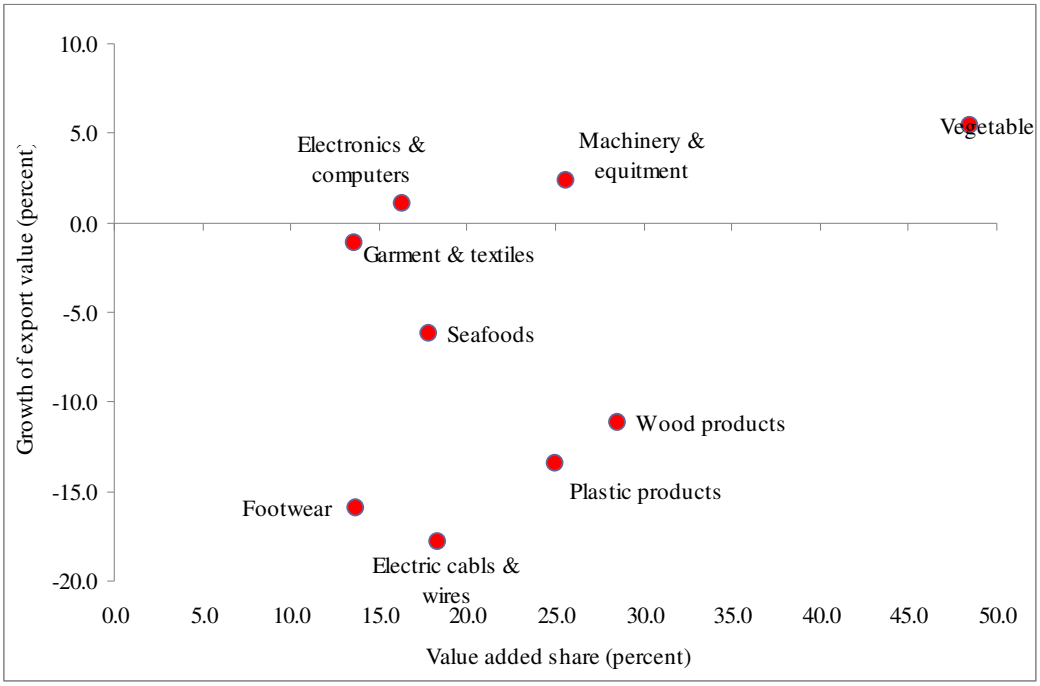


Source: World Bank estimate based on GSO data. Key commodities include crude oil, coal, rice, coffee and rubber. Figures are weighted averages for changes in export values, prices and volumes.

The value added component of Vietnam's exports varies considerably across sectors. Exports of natural resources and raw materials (crude oil, coal, metallic ore….) and agriculture products (rubber, coffee, tea…) are characterized by high value added per unit of final output. On the other hand, manufactured exports like garments, footwear, wood products and seafood have low value added, because imported inputs account for a large share of their total export value.

However, even key setting commodities aside, differences in value added shares are considerable. In 2009, Vietnamese exports of processed products have held better, on average, in sectors with relatively higher value added shares (Figure 8). This differentiated response, in turn, mitigated the impact of the global crisis on domestic economic activity.

Figure 8: Change in the Value of Exports across Sectors



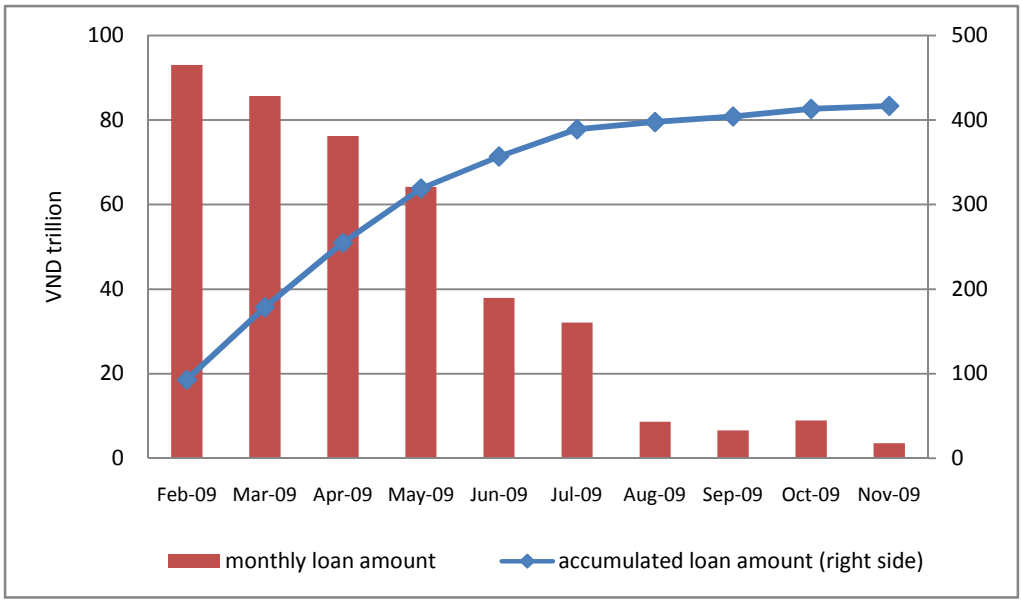
Source: World Bank based on GSO data.

THE STIMULUS POLICIES OF 2009

In addition to the export supply response by the business sector, a determined policy reaction contributed much to sustaining economic activity. In November 2008, "five groups of measures" aimed at supporting economic activity were announced. This time the package included cuts and delays in tax payments, especially for Corporate Income Tax and Value Added Tax, and for small and medium enterprises. It also included cash transfers to poor households on the occasion of the Lunar New Year, when migrant workers typically return to their hometowns. Other measures followed in February 2009, including a short-term interest rate subsidy scheme that was used to re-finance enterprise debts contracted in very onerous terms during the stabilization period.

This scheme helped in keeping credit flowing to the economy, and contained distress in the corporate sector. Its continuation beyond the disinflation phase and its extension to capital investments lacks a sound economic justification. However, eligibility rules to borrow under the investment window of the interest rate scheme were stringent enough for lending under these two schemes to lose steam after a few months (Figure 9).

Figure 9: Credit under the Interest Rate Subsidy Scheme



Source: World Bank estimates based on SBV data.

The succession of policy announcements on stimulus measures raised concerns in the market about the overall implications for the budget and the balance of payments. Concerns were amplified by shortcomings in communication. Some gaps with international practice remain in the presentation of budget data, and there are also important gaps between budget plans and budget execution. The evolving nature of some of the stimulus measures, some of which were led by ministries and agencies with relatively little coordination with the Ministry of Finance (MOF), also added uncertainty regarding the actual cost of the measures, and who would bear it in the short term. The cost of some of the measures was over-estimated, as was the share of the cost that would fall on the budget. Together with some double counting this resulted in some implausibly large figures quoted for the overall size of Vietnam's stimulus package (Table 5).

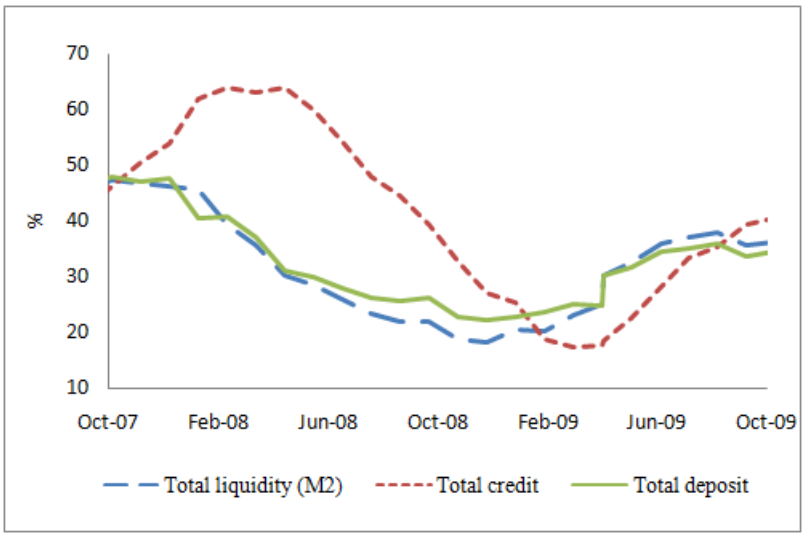
The stimulus package of 2009 came on top of an already expansionary budget plan, resulting in an overall budget deficit substantially above those of previous years. In addition to the explicit measures adopted to stimulate economic activity, the fall in oil prices and the slowdown in economic activity resulted in a large decline in government revenue. This decline was partially offset in the second half of the year, as both international commodity prices and domestic economic activity became more buoyant. There is also a systematic bias towards underestimating government revenue. However, in spite of these caveats, an overall budget deficit of 9.7 percent of GDP could be expected for the year as a whole.

Table 5: The Size of the Fiscal Stimulus

VND trillion unless otherwise noted	Proposed stimulus package	Estimated fiscal cost
Revenue foregone	25.4	20.0
Corporate Income Tax (CIT)	10.4	9.9
Personal Income Tax (PIT)	6.5	4.5
Value Added Tax (VAT)	7.4	4.5
Licenses and fees	1.1	1.1
Additional expenditures	117.6	45.0
Interest rate subsidy	17.0	
Budget advanced from 2010	37.2	26.0
Government bond carried over from 2008	7.7	5.0
Investments funded by additional bond issuance	20.0	14.0
Expenditures carried over from 2008	22.5	
Deferral of repayment of budget allowance for 2009	3.4	
Social spending	9.8	
Additional VDB lending (compared to 2008)		7.1
Overall fiscal stimulus	**143.0**	**72.1**
In percent of GDP	*8.5*	*4.3*

Source: World Bank estimates based on MOF, MPI and IMF data. Expenditures are based on expected implementation

Figure 10: Monetary Aggregates



Source: SBV and IMF. Figures are year-on-year changes, in percent.

An expansionary monetary stance was also part of the government's effort to support economic activity. The growth of liquidity and credit was relatively subdued during the first part of 2009. This was in spite of the interest rate scheme, whose impact

on total credit was attenuated by the fact that many of the loans for working capital allowed enterprises to repay loans contracted in very onerous terms during the stabilization phase of 2008. But once the determination of the government to boost growth rates became clear, and economic activity started recovering, bank lending picked up again, supported by a very low level of policy rates (Figure 10).

BANKING SECTOR VULNERABILITY

The succession of asset price bubbles, monetary tightening and growth slowdown had an adverse impact on the banking sector. The real estate bubble of end-2007, and its subsequent bursting in early 2008, combined with the slowdown of the economy put pressure on corporate performance and their repayment ability, thus adversely impacting portfolio quality of commercial banks. The rapid deceleration of inflation in late 2008, at a time when interest rates were still very high, put additional burden on the ability of enterprises to service their debt obligations. More recently, the loosening of monetary policy as part of the stimulus program, combined with the weak orders faced by many enterprises, might also have contributed to further pressure on the quality of bank loans.

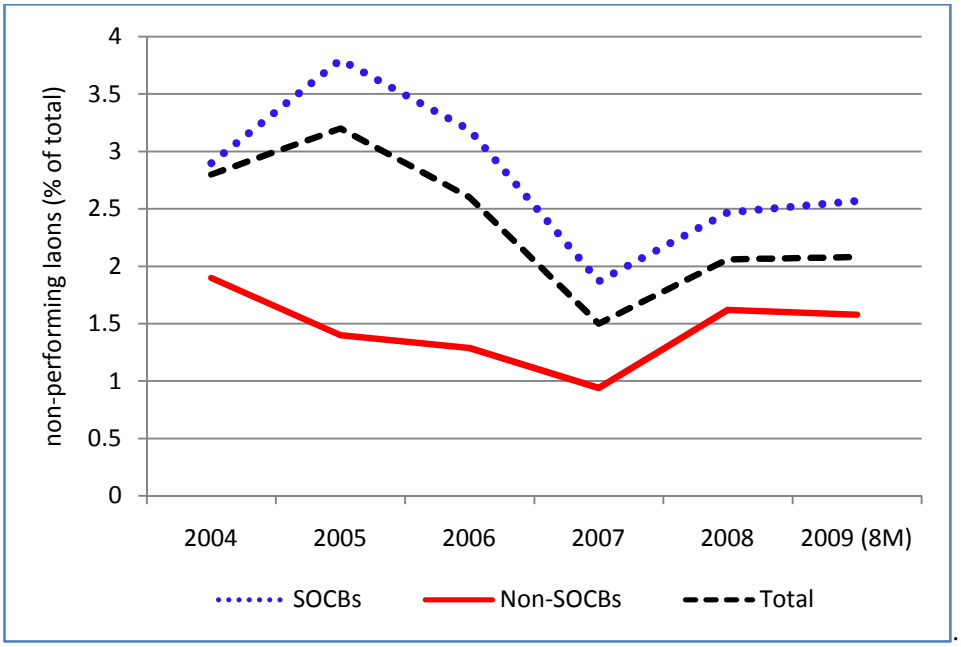
Assessing the share of non-performing loans (NPLs) in total lending is not straightforward. Quantitative NPL indicators, based on the number of days a loan is in arrears, suggest that the share increased substantially between 2007 and 2008, and remained at that higher level in 2009 (Figure 11). Qualitative indicators, such as management practices, quality of regulation and supervision, suggest a higher share of NPLs, but these indicators are difficult to quantify and highly sensitive to assumptions. The increase in the share of NPLs comes after several years during which the efforts by SOCBs to clean up their portfolios in preparation for equitization had resulted in an overall improvement in the quality of lending.

Despite its increased vulnerability, the banking sector of Vietnam remains in reasonable health. In 2008 the profitability of banks was generally good reflecting a strong growth in the volume of lending and diversification of some banks into fee based services. The profitability of the banks also benefited from sizeable capital gains on high yielding government bonds, which many banks purchased when foreign investors fled Vietnam in the first half of 2008, at a time when interest rates were still high. These capital gains partially offset the low net interest rate margins, resulting from the current cap on lending rates, at 150 percent of the base rate. Profit figures reported by listed banks up until the third quarter 2009 remain satisfactory.

The relatively good health of the banking system is partly the result of an active stance by the authorities. The SBV has continued to upgrade its regulatory framework and supervision efforts over the past years. In parallel, it has raised minimum capital requirements. By the end of 2008 all commercial banks, including the nine small joint stock banks that seemed most vulnerable had met the new requirements. This process continues, with the minimum charter capital set at 3 trillion dong by end 2010. Banks

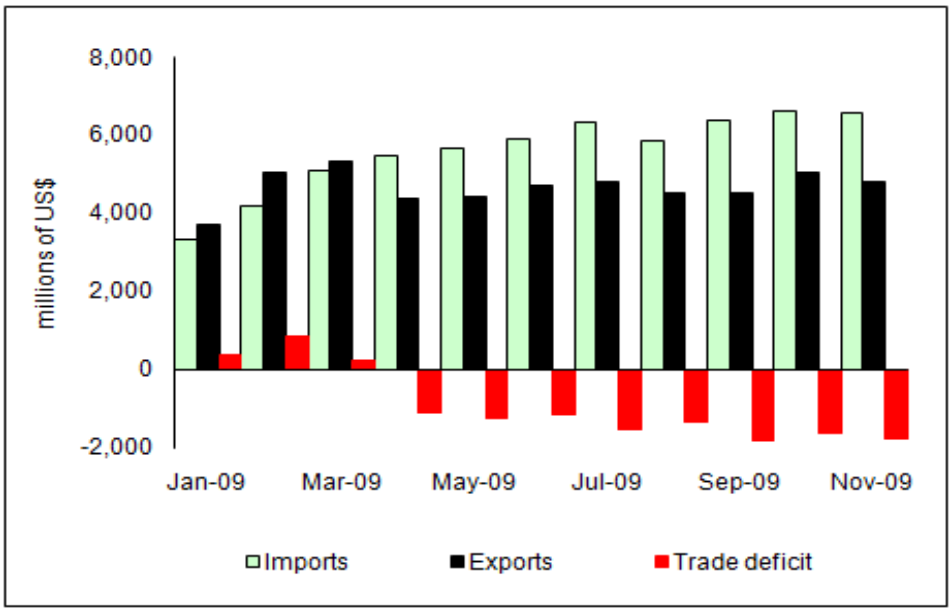
which fail to meet this requirement will be forced to merge with other larger banks, or will have their business licenses revoked.

Figure 11: The Share of NPLs in Total Lending



Source: SBV

Figure 12: A Widening Trade Deficit



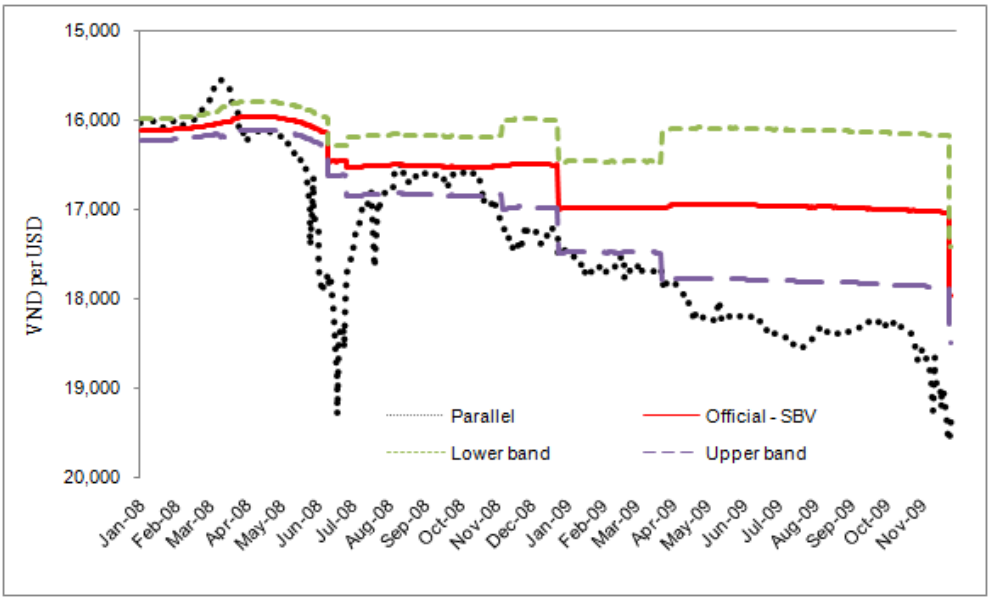
Source: GSO

EMERGING MACROECONOMIC IMBALANCES

The stimulus program, while effective at boosting economic activity, contributed to increased external vulnerability. Rapid credit growth together with an expansionary fiscal policy, have led to a sustained increase in inputs and a widening trade deficit (Figure 12).

A larger demand of foreign exchange by importers, combined with market expectations that the dong would be devalued, led to a shortage of foreign exchange which was particularly severe in May-July, and again in November, imposing significant costs on enterprises. Uncertainty regarding the level of international reserves also encouraged a precautionary demand for gold and dollars. These developments resulted in significant depreciation pressures on the exchange rate, with the dong trading at the weaker end of the band for an extended period and the spread between interbank and parallel exchange rates widening to 3 to 6 percent depending on the period (Figure 13).

Figure 13: A Weakening Dong



Source: SBV and World Bank.

As a result of the growing trade deficit and the decline in remittances, the current account deficit is projected to be about US$ 7.4 billion in 2009, or 7.9 percent of GDP (Table 6). This is clearly below the 11.9 percent deficit of 2008. Admittedly, the global crisis has led to a decrease in the volume of FDI inflows whereas portfolio investment flows by foreigners have been volatile over the last two years. However, the capital account surplus is projected to reach US$ 10.2 billion in 2009, which should be enough to finance the current account deficit.

Table 6: The Balance of Payments

USD billion	2006	2007	2008 e/	2009 p/
Current account balance	-0.2	-7.0	-10.7	-7.4
Trade balance	-2.8	-10.4	-12.8	-8.1
Non-factor services	0.0	-0.9	-0.8	-1.3
Investment income	-1.4	-2.2	-4.4	-4.2
Transfers	4.1	6.4	7.3	6.1
Financial account balance	3.1	16.8	12.1	10.2
FDI investment (net)	2.3	6.6	9.1	7.9
Medium and long-term loans	1.0	2.0	1.0	2.6
Other capital (net)	-1.6	2.0	2.7	-0.3
Portfolio Investments	1.3	6.2	-0.6	0.0
Error and omissions	1.4	0.3	-0.9	-9.4
Overall balance	4.3	10.2	0.5	-6.6

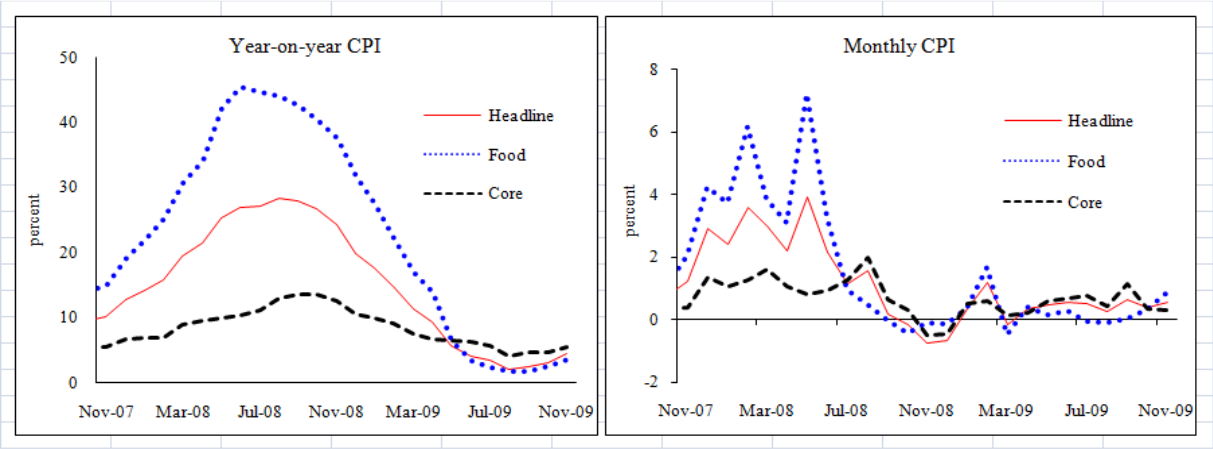
Source: SBV, IMF and World Bank.

Portfolio decisions by residents also have an impact on the balance of payments due to the dollarization of the economy and the large stock of foreign currency circulating outside the banking sector. In the first half of 2009, these portfolio decisions have been affected by the devaluation expectations of the market. A reallocation of the portfolio of domestic enterprises and investors towards assets denominated in foreign currency is at the roots of the large "errors and omissions" in the balance of payments during the first three quarters of 2009. For the year as a whole, errors and omissions could reach US$ 9.4 billion (negative).

Put differently, there is sufficient abundance of dollars in the Vietnamese economy to finance the current account deficit of 2009. But for this to happen, residents need to be encouraged in one way or another to sell some of their foreign currency holdings. And until late October, there were no clear incentives for them to do so.

So far, the expansionary fiscal stance and loosening monetary policy are not resulting in an acceleration of inflation (Figure 14). If anything, the stabilization program of early 2008 and the collapse of commodity prices later in the year have brought all standard inflation indicators down. In November, the consumer price index rose by 0.55 percent, or 5.07 percent compared to the previous year. Single-digit figures for annual inflation are at hand for 2009.

Figure 14: Inflation Down to Single Digits



Source: GSO

However, price stability should not be taken for granted. Internationally traded goods, and especially food and foodstuff, carry a heavy weight in the consumer price index of Vietnam. The domestic prices of those goods are sensitive to changes in the corresponding world prices, which are mediated by the exchange rate. The global recovery is already leading to an increase in the prices of key commodities, which could even accelerate in 2010. The recent devaluation of the dong implies that the same international price, measured in dollar terms, translates into a higher domestic price. A weakening of the dollar could further accelerate this trend. Therefore, even with a tighter monetary stance some acceleration of inflation can be expected going into 2010. To determine whether such acceleration should be a matter of concern for policy makers, it will be important to monitor the "core" inflation, which is the part of the consumer price index more sensitive to domestic demand pressures, as opposed to international price hikes.

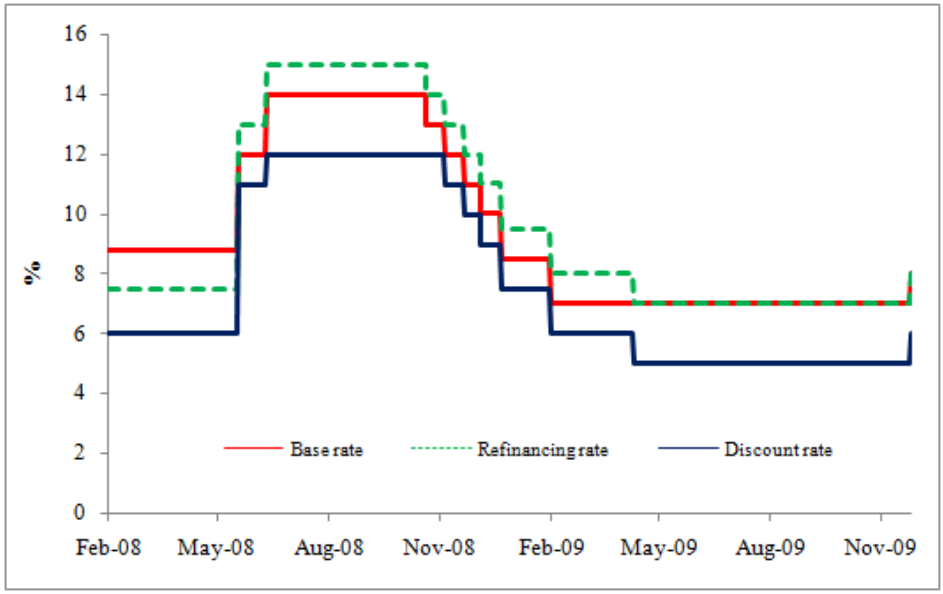
A REBALANCING OF POLICY ORIENTATIONS

Emerging macroeconomic imbalances called for an adjustment to the overall policy framework, giving more priority to the stabilization objective, which the government effectively did between late October and late November (Box 1). By then, the "growth gap" in the global economy had narrowed, and demand for exports had started recovering. Therefore, the need to boost domestic demand had receded. Moreover, financing the large budget deficit of 2009 had been possible thanks to a large mobilization of ODA resources (by the Asian Development Bank, Japan and the World Bank) and the drawdown of government deposits in the banking sector. These two sources of financed cannot be tapped to the same extent in 2010. In fact, due to the absence of centralized cash management, the government may need to rebuild some of its deposits in the banking system. Finally, Vietnam cannot rely on large international reserves to support its expansionary stance, unlike China. Faced with both a diminished

need for stimulus policies and constraints to finance them, a policy rebalancing was warranted.

In relation to monetary policy, the new monetary stance was endorsed by the government's monthly meeting held at the end of October 2009, reflected in the monetary plan of early November and supplemented by additional measures at the cabinet meeting of late November 2009 (Box 1). SBV prepared a monetary plan in line with these decisions, and consistent with the decision by the National Assembly that the inflation rate should not exceed 7 percent in 2010. The plan foresees very modest credit growth for the remaining of 2009, and one of the lowest credit growth targets in a decade for 2010. Subsequently, the base rate was raised by one percentage point, effectively raising lending rates by 1.5 points (Figure 15).

Figure 15: Key Policy Rates



Source: SBV

The budget plan for 2010 involves a substantial contraction compared to 2009, but still a relatively expansionary stance compared to previous years. The National Assembly authorized a budget deficit not exceeding 6.2 percent of GDP, compared to the 6.5 percent proposed by the executive. The calculation of the official budget deficit in Vietnam deviates from standard international practice in three ways. First, debt amortization is counted as expenditure, rather than as a financing item. Second, so called "off budget" expenditures managed by MOF need to be added up. These expenditures are "off budget" only by name, as they are also approved by the National Assembly and subject to the same financial management rules as "on budget expenditures". Finally, for their estimate of Vietnam's budget deficit, the international financial institutions also include as part of government expenditures on-lending of ODA resources and lending by the Vietnam Development Bank.

Box 1. A Tighter Fiscal and Monetary Stance

October 24-26. The SBV convened meetings of all commercial banks to inform them about the forthcoming monetary tightening, including a ban on extending loans from funds borrowed in the interbank market.

November 6. The National Assembly passed the Resolution of Socio-Economic Development Plan for 2010, setting a growth target of 6.5 percent for GDP (below the actual growth of GDP expected for the fourth quarter of 2009) and an inflation target of no more than 7 percent.

November 6. SBV set the target for the growth rate of total credit in 2009 at about 35 to 36 percent. It also set the target for both the growth rate of total liquidity and the growth rate of total credit in 2010 at 25 percent.

November 9. An administrative request is sent by SBV to selected Economic Groups to report all their revenues and expenditures denominated in foreign currency. The information is due to SBV in late November, 2009.

November 11. The National Assembly passed the Resolution on State Budget Bill for 2010, setting the limit for the official budget deficit in 2010 at 6.2 percent of GDP, compared to 6.5 percent proposed by the government.

November 11. The resolution of the Government's monthly meeting of late October, 2009, ended most of the tax breaks and deferrals approved as part of the 2009 stimulus package, except for Corporate Income Tax for small and medium enterprises in the first quarter of 2010.

November 12. The SBV convened a high-level meeting with the directors of the five SOCBs to discuss credit growth targets, management of liquidity, and foreign exchange matters, consistent with the new monetary stance.

November 13. The SBV issued a decision stating that credit institutions are not allowed to provide loans with negotiable rates to invest in real estate, financial assets (gold, foreign currencies, securities and others) and operations related to production and business.

November 16. The official meeting of the National Assembly discussed the draft laws on the State Bank of Vietnam and on Credit Institutions, which both contain articles aimed at effectively removing the cap on lending rates.

November 25. The SBV raised the benchmark base rate to 8.0 percent from 7.0 percent effective December 1, 2009. The refinancing rate was also increased by 1 percentage point, to 8 percent.

November 25. The central exchange rate for the dong was increased by 5.4 percent, and the floatation band narrowed from ±5 percent to ±3 percent. Given that the dong was trading at the upper end of the band, this amounted to an 3.4 percent devaluation.

November 27. The SBV requested all local credit institutions providing foreign exchange services to report on the deposit balance and outstanding loans in foreign currency of state-owned groups and corporations.

December 1. OOG announces that the interest rate subsidy scheme for working capital will be terminated at the end of 2009, as originally scheduled, and the subsidy element of the scheme for medium- and long-term investments will be cut from 4 to 2 percentage points.

Translating the authorized official budget deficit into a forecast of the overall budget deficit involves makings assumptions on each of the three deviations mentioned above. There are also systematic differences between plans and realizations, which need to be taken into account. As a result of these assumptions, different analysts may quote different figures for the overall budget deficit. Beyond the specifics, it seems clear that the fiscal stance in 2010 will be tighter than in 2009 (Table 7)

Table 7: The State Budget

VND trillion unless otherwise noted	2007	2008 e/	2009 p/	2010 f/
Total revenues and grants	326.3	416.8	394.9	462.6
Revenues	320.3	409.5	388.9	456.6
Tax revenues	267.0	359.1	348.6	403.5
Oil revenues	77.0	88.8	58.8	66.3
Non-oil revenues	190	270.3	289.8	337.2
Non-tax and capital revenues	53.3	50.4	40.3	53.1
Grants	6.0	7.3	6.0	6.0
Budget expenditure	336.1	434.2	454.7	497.5
Current expenditure	231.8	298.3	339.5	390.8
Expenditure on investment development	104.3	135.9	115.2	106.7
"Off-budget" expenditure and net lending	25.7	49.8	104.5	87.3
Net lending	7.0	22.8	34.3	48.1
ODA financed	-3.0	9.0	13.4	11.9
VDB net lending	10.0	13.8	20.9	36.2
“Off-budget” investment expenditure	18.7	27.0	70.2	39.2
Plan	18.7	27	25.2	39.2
Stimulus			45.0	
Overall fiscal balance	-35.5	-67.2	-164.3	-122.2
In percent of GDP	*-3.1*	*-4.5*	*-9.7*	*-6.2*

Source: MOF, IMF and World Bank staff estimates.