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TAKING STOCK

AN UPDATE ON VIETNAM'S RECENT ECONOMIC DEVELOPMENT

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THE WORLD BANK

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ACRONYMS AND ABBREVIATIONS

BOP	Balance of Payments
BTA	Bilateral Trade Agreement
CDS	Credit Default Swap
EAP	East Asia and Pacific
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GFS	Government Finance Statistics
GSO	General Statistics Office
IMF	International Monetary Fund
MOF	Ministry of Finance
MOLISA	Ministry of Labor, Invalids and Social Affairs
MPI	Ministry of Planning and Investment
NSCERD	National Steering Committee for Enterprise Restructuring and Development
ODA	Official Development Assistance
PMI	Purchasing Manager Indices
PPP	Purchasing Power Parity
SBV	State Bank of Vietnam
SOEs	State-owned Enterprises
TPP	Trans-Pacific Partnership
VAT	Value Added Tax
VHLSS	Vietnam Household Living Standards Survey
WB	World Bank
WTO	World Trade Organization

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EXECUTIVE SUMMARY

i. **The authorities' determined implementation of stabilization measures over the past year has helped to avert a macroeconomic crisis.** Vietnam entered 2011 in a phase of heightened macroeconomic vulnerabilities. This was characterized by high and rising inflation rate, extreme volatility in the foreign exchange market, rapidly dwindling international reserves, a sharp rise in country risk following default by one of its biggest state-owned enterprises, high levels of fiscal and trade deficits, and weaknesses in the banking and corporate sectors. In the past twelve months many of these negative trends have been reversed, helping Vietnam to gradually enter a more stable macroeconomic environment. Though the country remains susceptible to future bouts of macroeconomic instability, there is little doubt that Resolution 11 — containing measures to stabilize the economy and ensure social stability — has helped to stem the tide of instability and to rebuild the Government's economic management credentials.

ii. **If the deterioration of the macroeconomic environment in 2010-11 was rapid, the improvement in the situation in the past twelve months has been equally swift.** Inflation (y/y) has fallen for the ninth consecutive month — from a peak of 23 percent in August 2011 to 8.3 percent in May 2012. The current account deficit is estimated to have declined to 0.5 percent of GDP in 2011, from 4.1 percent in 2010, and a peak of 11.9 percent of GDP in 2008. The unofficial exchange rate has traded within the ±1 percent band around the official exchange rate for most of the past year. The increased supply of US dollars in the market has enabled the State Bank of Vietnam (SBV) to replenish foreign exchange reserves in the first months of 2012, which are reportedly close to 9 weeks of imports. There has been a sharp decline in credit growth, from 32.4 percent at end-2010 to 14.3 percent at end-2011. Fiscal deficit (by GFS definition) is estimated to have declined to 2.7 percent of GDP in 2011 from a peak of 7.2 percent of GDP in 2009.

iii. **Regaining macroeconomic stability has been costly, but not stabilizing the economy would have led to even bigger losses.** Real GDP growth has decelerated from 6.8 percent in 2010 to 5.9 percent in 2011, and further to 4 percent in the first quarter of 2012 — as higher prices has lowered domestic demand, affecting sectors such as construction, manufacturing and utilities. Industrial production has slowed, inventory for key industrial products has accumulated, and a number of small and medium enterprises have either closed, been liquidated or temporarily suspended their operations. While the stabilization efforts may have contributed to a cyclical slowdown, Vietnam's trend growth rate has been on a downward path for the last 5-6 years, largely on account of the slow pace of structural reforms. Inefficiencies in state-owned enterprises, banks and public investments have been a drag on the country's long-term growth potential.

iv. With gains from macroeconomic stabilization still recent and fragile, especially in an external environment that is fraught with uncertainty, the government needs to be careful not to shift to an expansionary stance prematurely. In a move to shore up domestic demand, SBV has reduced policy rates by 300 basis points in a period of eight weeks. With rapid disinflation and negative credit growth during the first four months of the year, such a decline in interest rates was perhaps justified. Similarly, Government's Resolution 13 tries to support affected enterprises by deferring tax payments and lowering land lease fees, whose fiscal impact will be limited to less than 0.5 percent of GDP. But given Vietnam's history of premature loosening of policy, there are reasons to exercise caution. First, there is a 3-4 months lag between policy change and outcome, which means the effect of recent expansionary policy will be felt by the end of the third quarter of 2011 not only through higher growth, but also higher inflation. Second, with public debt at a more elevated level, there is less room for fiscal stimulus in 2012 than was the case in 2009. Finally, with lingering inefficiencies in state-owned enterprises and weaknesses in the banking system, stimulus measures will contribute to preserving an inefficient growth model, going against the Government's own desire to move towards a more productive and competitive economy.

v. Implementing a credible restructuring program—involving deep and sustained structural reforms—therefore can provide the best stimulus the economy needs. In October 2011, the Government announced its intention to restructure state-owned enterprises, the public investment regime and the financial sector. Blueprint for reform in each of these areas already exist or are being developed. For example, MPI is working to develop a restructuring plan for public investment including the formulation of a Decree on medium-term investment planning, a new law on public investment, and a law on spatial planning. A report by National Steering Committee for Enterprise Restructuring and Development (NSCERD) was published in December 2011 with ambitious targets on SOE equitization. It was followed by a draft restructuring plan for SOEs for 2011-15 by MOF's Steering Committee which includes measures on management and supervision of state capital and performance monitoring of SOEs. Decision 254 on "Restructuring credit institution system in the 2011-2015 period" provides a framework to deal with weak banks and sets out a number of restructuring options. But what is perhaps missing is a 'restructuring roadmap' with a clear timetable and an effective oversight mechanism for implementing it. Without these reforms, especially in a context of continued global economic uncertainty, the economy is unlikely to shift to a higher growth path and at the same time avoid recurring macroeconomic imbalances such as those seen in the past four to five years.

PART I

GLOBAL AND REGIONAL ECONOMIC OUTLOOK

A. Global Context[1]

1. **After positive economic news in the first four months of 2012, market confidence has been rattled by recent political developments in the Euro Area**—underscoring the uncertainty surrounding the future course of economic policy to support global recovery. With some of the crisis-ridden European countries adopting much needed structural and fiscal policy reforms, the conditions in global financial markets began to ease in the first quarter of 2012. That, along with a more accommodative monetary policy stance in several large middle-income countries, triggered a recovery of financial conditions around the world. But that optimism appears short-lived, as pro-austerity political parties have lost ground in elections in several European countries, forcing a reassessment of the future course of economic policies.

2. **Until recently, there was considerable optimism about the strength of the global economic recovery.** Market concerns about fiscal sustainability in Europe declined markedly in the first quarter of 2012, in the wake of major policy initiatives in high-income Europe, including: cross-party agreement to fiscal consolidation plans; the adoption of far-reaching structural policy reforms; the successful restructuring of Greek debt; agreement of pan-European fiscal rules and firewalls; and a significant easing of borrowing conditions by the European Central Bank in the context of its Long-Term Refinancing Operations. As a result, the CDS rates throughout the Euro Area as well as in most non-European high-income and developing economies eased considerably. Equities in both developing and high-income countries recovered much of the value lost during the second half of 2011.

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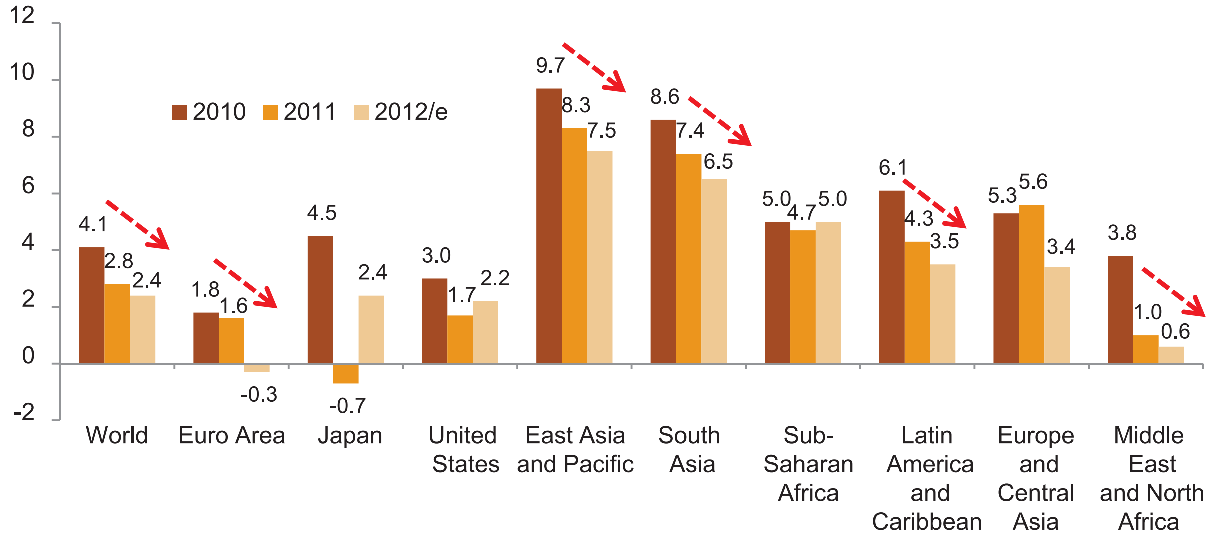
[1] Based on *Global Economic Prospects: Back from the Brink?* Volume 5, June 2012; and *Weekly Global Economic Brief* (several issues), The World Bank (wwwr.worldbank.org/prospects).

3. Improved conditions in financial markets reflect the turnaround of the real economy. Global industrial production, which had been very weak through much of the second half of 2011 (partly due to supply disruptions from the earthquake and tsunami in Japan and from extensive flooding in Thailand), started expanding once again in the first quarter of 2012—growing at a 10.1 percent annualized pace during the three months ending February 2012. The resurgence of industrial activity has been strongest among developing countries. The upturn was partly prompted by a loosening of monetary policy in developing countries in the second half of 2011 in the face of slower growth and falling inflation.

4. Inflation has fallen world-wide, though domestic food prices remain high in several countries. Overall, inflation in developing countries has eased substantially since 2011, mainly reflecting a deceleration of domestic food prices in developing countries to below 5.5 percent in the fourth quarter of 2011 (3m/3m saar). Food price inflation is now 1 percentage point below headline inflation. Despite the welcome stabilization of domestic food price inflation, domestic food prices in developing countries remain 25 percent higher than non-food consumer prices compared to the beginning of 2005 — representing a very large hit to real incomes, especially among poor urban families where food often represents more-than one-half of total household expenditures.

5. The global growth will remain relatively weak, held back by significant headwinds. Overall, global GDP is projected to increase 2.4 percent in 2012. In high-income countries, GDP is expected to expand only 1.6 percent this year weighed down by higher oil prices, banking-sector deleveraging and ongoing fiscal consolidation in advanced economies. Most developing countries will also experience slower growth in 2012 relative to 2011 and 2010 (figure 1). Some of the key risks to the global growth outlook arise from policy uncertainty in Europe, capacity constraints in several large middle-income countries, weak capital flows and high crude oil prices on account of geo-political developments in the Middle East and Persian Gulf.

Figure 1: Real GDP Growth Rate in Selected Countries/Regions of the World, in %



Source: Global Economic Prospects, World Bank, June 2012

6. While crisis management will remain the preoccupation of governments in the developed world, developing countries need to turn their attention to growth enhancing structural reforms. Most developing economies have fully recovered from the crisis. Their focus needs to turn to managing overheating pressures, reducing vulnerabilities to external shocks and investing in growth enhancing structural reforms — tasks complicated by the liquid and volatile financial conditions created by loose monetary policies in high-income countries.

B. Regional Context [2]

7. **Growth in the East Asia and Pacific (EAP) region continued to moderate in 2011.** The developing East Asia region grew by 8.3 percent in 2011, which is a sharp decline from the nearly 10 percent growth rate recorded in 2010 (table 1). This slowdown was largely due to lower than expected growth in manufacturing exports as well as severe flooding in Thailand. Net exports dragged down regional growth, with electronics trade, which constitutes about 40 percent of regional exports, experiencing no growth and net capital inflows falling by around a third. Though commodity exporters continue to see strong growth as a result of elevated commodity prices. Domestic demand and investment were also strong, though policy tightening in China dampened credit-dependent private investment while public investment slowed as infrastructure-targeted stimulus support was withdrawn.

Table 1: Growth in East Asia Pacific

	2009	2010	2011	2012/f	2013/f
East Asia and Pacific	7.5	9.7	8.3	7.5	8.1
China	9.2	10.4	9.2	8.1	8.6
Indonesia	4.6	6.2	6.5	6.0	6.5
Malaysia	-1.6	7.2	5.1	4.4	5.2
Philippines	1.1	7.6	3.7	4.0	5.0
Thailand	-2.3	7.8	0.1	4.3	5.2
Vietnam	5.3	6.8	5.9	5.7	6.3
EAP excluding China	1.5	7.0	4.5	5.1	5.8

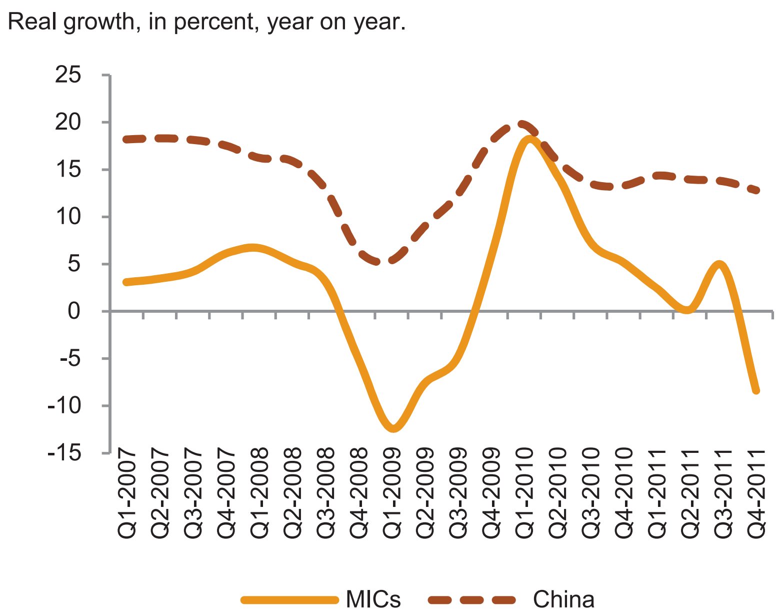
Source: East Asia & Pacific (EAP) Economic Update, May 2012

8. **Growth in the manufacturing sector appears to be on a downward trend since the post-crisis peak in early 2010.** Real growth in Thailand and the Philippines has been held back by declining net exports caused by slowing world demand and supply chain disruptions (e.g., two large typhoons in Philippines, the Japan tsunami in Q1 and the Thai flooding in Q4). The electronics sectors, especially the manufacture and export of computer hard-drives, were particularly hard hit (figure 2). On the upside, industrial production growth, which had slumped in the first half of 2011, began to improve in Q3 in Indonesia and Malaysia. Growth continued to slow in China as the authorities took various policy measures including tighter monetary policy, stronger prudential controls, and stricter qualification requirements for mortgages to cool an overheated property market. The Purchasing Manager Indices (PMI) in the newly industrialized countries—on a downward trend since 2010—showed modest improvement in Q1-2012, with indices above 50 percent in March for each country except China (figure 3).

9. **The distribution of growth throughout the region shifted in favor of commodity exporters.** Mongolia and Timor-Leste were clear examples with real GDP growth rates of 17.3 and 10.6 percent respectively. Indonesia and Malaysia, which retain substantial commodity export shares, also benefitted. For example, in Malaysia, manufacturing output was outperformed by growth in agriculture. Mining output in PNG and Malaysia would have been a major contributor to growth in 2011 as well but for continued operational problems in oil production.

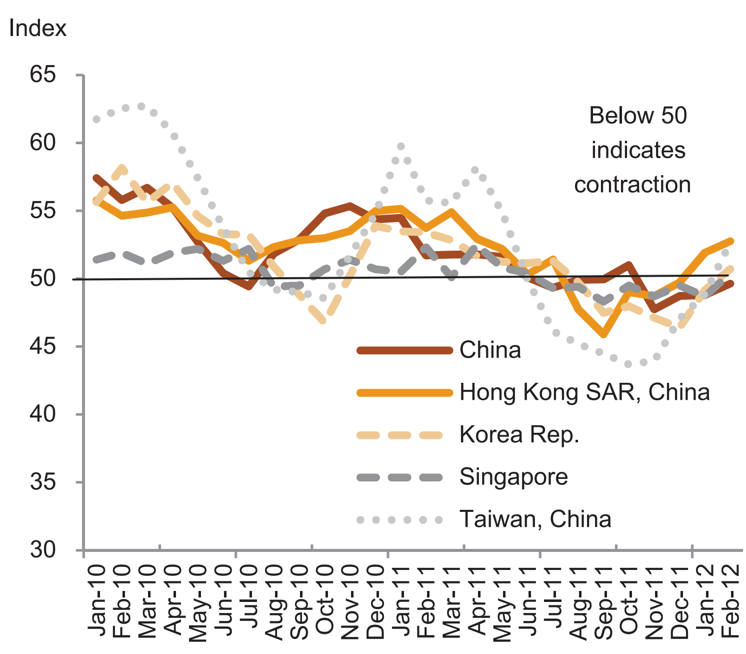
[2] Based on *East Asia and Pacific Economic Update -- Capturing New Sources of Growth, May 2012,* The World Bank (wwwr.worldbank.org/eapupdate).

Figure 2. Growth in manufacturing was modest and fell in Thailand and the Philippines in late 2011



Source: Haver Analytics
Note: Real growth in manufacturing output for China. Weighted values for Indonesia, Malaysia, Philippines, and Thailand (called the MICs).

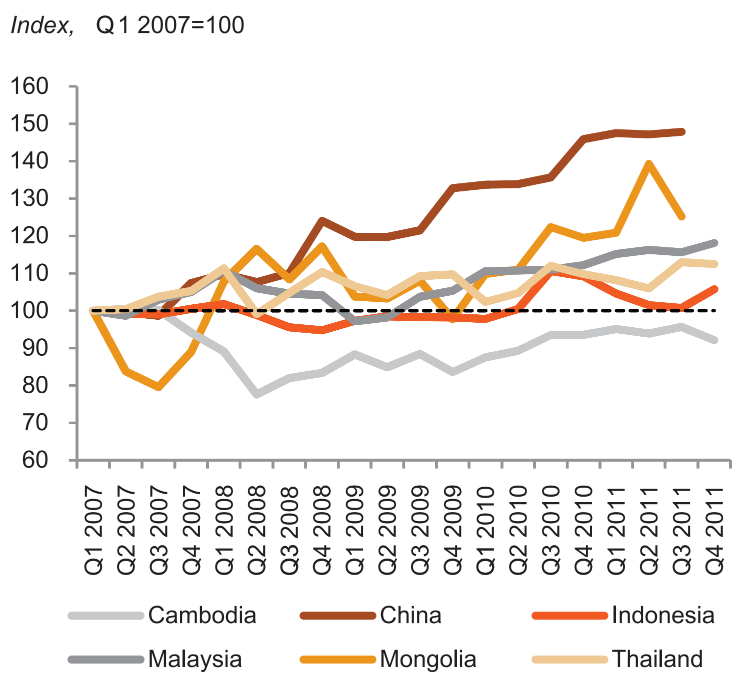
Figure 3. The Purchasing Managers Index improved in early-2012



Source: Markit/Haver Analytics

10. Job creation and wage growth were relatively flat in 2011. In line with the relatively slow growth in GDP, employment growth was fairly benign across most of the EAP region in 2011. Growth in manufacturing employment slowed in line with the general slowing in global manufacturing trade. However, the bright spot has been employment in services, which has expanded in the aftermath of the financial crisis, both in absolute terms and as a share of total employment. Similarly, wage growth in 2011 remained subdued after experiencing some growth in 2010. Most notably, wages in Cambodia have not yet returned to their pre-crisis levels (Figure 4). In Thailand, wages were mostly unchanged in 2011 from 2010 levels as the return of some post-flood productive capacity in Q4 2011 produced a sharp spike that largely offset the declines earlier in the year. Wage growth in China and Mongolia slowed, and fell sharply during Q4 in the latter, breaking a period of strong growth.

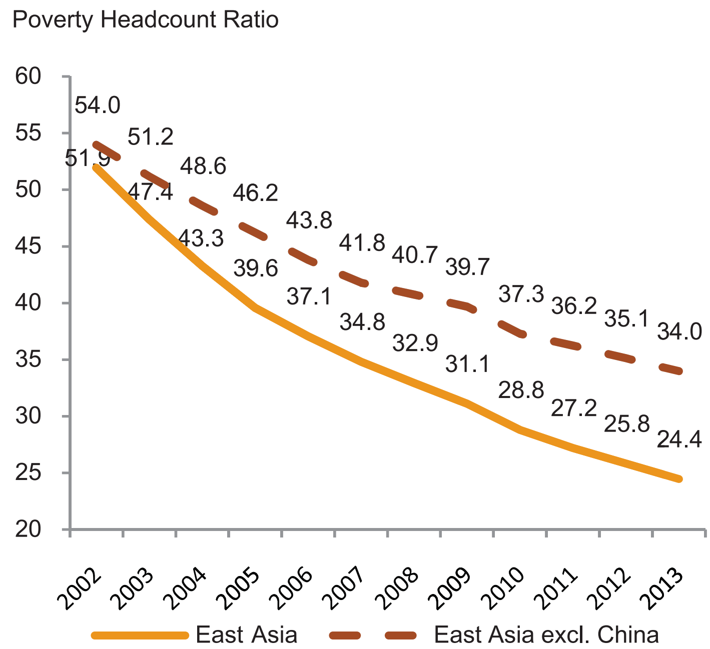
Figure 4. Real wage growth slowed in 2011.



Source: EAP Economic Update, May 2012

11. Despite the moderation in economic growth in the near term, poverty is expected to decrease further. The number of people living on less than $2 a day in the EAP region is estimated to decrease to 487 million by 2013, roughly half the number of people living in poverty in 2002 (figure 5). However, the large number of people coming out of poverty in China account for the bulk of this reduction. Going forward though, in China as well as other parts of EAP, gains in poverty reduction are expected to slow, reflecting the slower growth prospects of the region in the aftermath of the financial crisis and the increasing dispersed nature of poverty within each country.

Figure 5. Poverty in EAP region is expected to decrease further…



Sources: PovcalNet and World Bank staff calculations

PART II

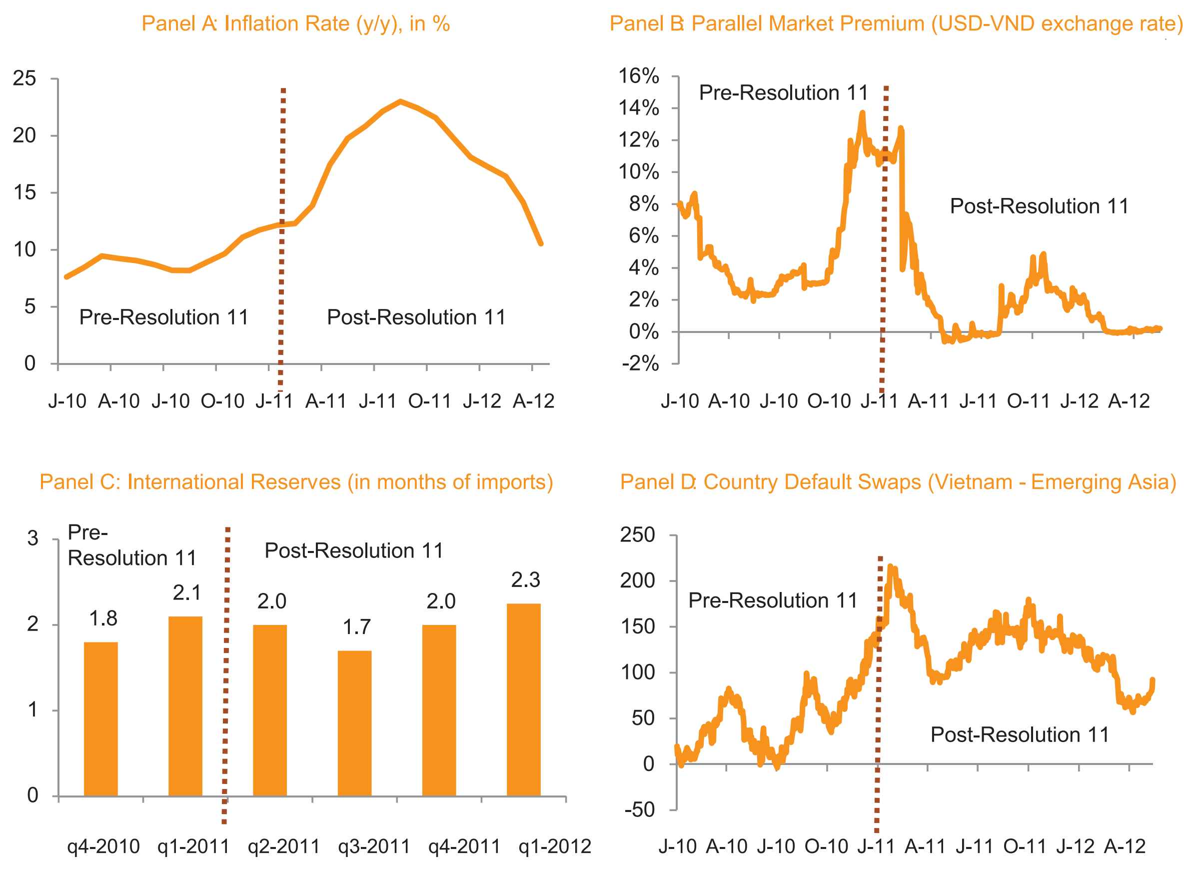
VIETNAM: RECENT ECONOMIC DEVELOPMENTS

A. Regaining Macro Stability

12. Vietnam entered 2011 in a phase of heightened macroeconomic vulnerabilities. This was characterized by the high and rising inflation rate, extreme volatility in the foreign exchange market, rapidly dwindling international reserves, a sharp rise in country risk following default by one of its biggest state-owned enterprises, high level of fiscal and trade deficits, and weaknesses in the banking and corporate sectors (see figure 6). These vulnerabilities and the absence of a persuasive strategy to address them led to progressive weakening sentiments towards the country's economic prospects.

13. In February 2011, the Government announced a series of measures to stabilize the economy and to ensure social stability. The dong was devalued by 9.3 percent against the US dollar and the trading band was narrowed from ±3 percent to ±1 percent. Resolution 11, which was the key policy statement to stabilize the economy, called for slowing down the growth of credit, de-dollarizing the economy, reducing the level of fiscal deficit, restructuring state-owned enterprises and shielding poor households from the hike in energy prices. These policy measures were articulated by the top leadership of the country, and were implemented in earnest and supplemented by additional policies as necessary (see box 1).

Figure 6: Macroeconomic Indicators Before and After Adoption of Resolution 11



Source: SBV, GSO, IMF, World Bank Staff

14. Despite initial skepticism about the effectiveness of Resolution 11, with hindsight there is little doubt that it succeeded in stemming the tide of instability and helping the Government to rebuild its economic management credentials. Headline inflation (y/y) has fallen for the ninth consecutive month—from a peak of 23% percent in August 2011 to 8.3 percent in May 2012. At the same time, the exchange rate premium has been close to zero, international reserves are gradually building up and the country risk premium has steadily declined in the past twelve months (figure 6).

Box 1: Lessons from Successful Implementation of Resolution 11

The Government of Vietnam has often been criticized for its penchant for growth stimulating policies and its slow response to stabilize the economy. But some of that perception has changed in recent months following the steadfast implementation of Resolution 11. Why did Resolution 11 succeeded in stabilizing the economy, while previous such attempts had failed? We draw the following six lessons from the way Resolution 11 was designed, announced and implemented.

- *Technical consistency.* The monetary and fiscal policy stance in Resolution 11 was consistent and mutually reinforcing—both attempted to curb inflationary expectations—much more so in the past. It also did not make use of conflicting language, such as describing the policy stance as 'cautious' and 'flexible' at the same time.

- *Supported by the top leadership.* Resolution 11 enjoyed strong support from the top leadership and the Government, the National Assembly and the Party, all of whom came out strongly to endorse the measures announced in Resolution 11.

- *Wide consultation.* The specific measures announced in Resolution 11 were debated in the Cabinet, discussed in the Central Committee and consulted with national scholars, provincial authorities, private sector and the development partners. It was widely welcomed in the media and by the general public.

- *Championed by key ministries.* Though not fully articulated, it was clear which agencies would be responsible for implementing which part of the resolution. SBV was responsible for monetary and banking sector policy, MOF for fiscal policy (recurrent side), MPI for identifying wasteful projects and cutting public investment, and MOLISA to implement the subsidy scheme.

- *Better inter-agency coordination and implementation.* The broad dissemination campaign in all provinces and line ministries helped to create a stronger foundation for an effective coordination among agencies, especially in achieving fiscal consolidation.

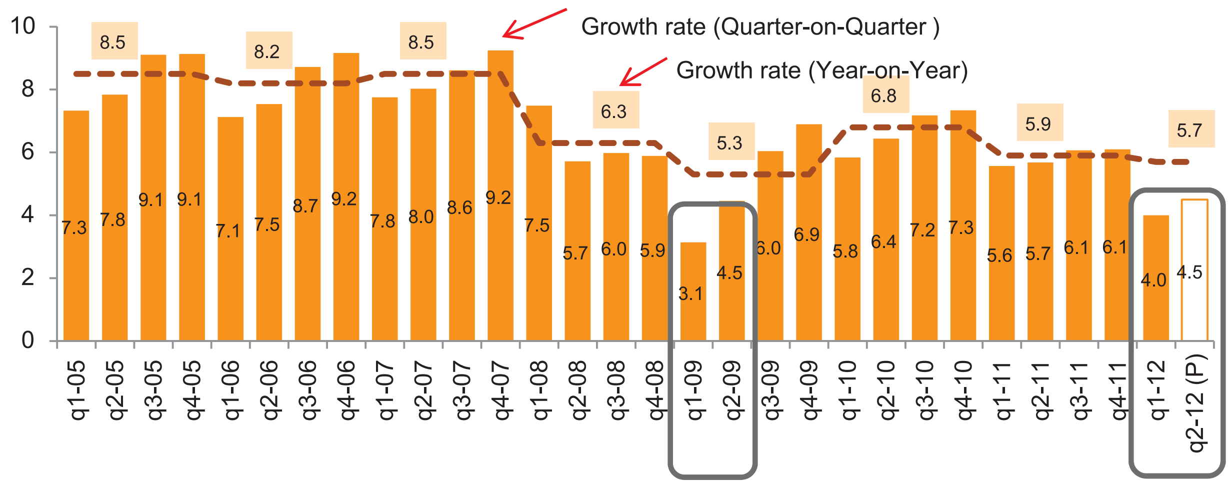
- *Effective communication.* Significant effort was made by top leaders to explain and communicate the various elements of Resolution 11 to the public, including through regular briefing for the media and hearings by the National Assembly.

While the implementation of Resolution 11 was not perfect—more progress was made on the monetary side than on the fiscal side, SOE reforms were not initiated on time—it does provide a relatively successful model for the design and implementation of the Government's future reform program.

B. A Period of Sluggish Growth?

15. Vietnam's economy appears to be slowing down in recent months, with below five percent growth rate likely for the first two quarters of 2012. Real GDP growth has been on a downward trend, decelerating from 6.8 percent in 2010 to 5.9 percent in 2011 and to a low 4 percent in the first quarter of 2012 (figure 7). According to the Ministry of Planning and Investment, the second quarter growth rate is expected to be around 4.5 percent—though one has to assume that this is a projection and not an estimate as it was announced nearly seven weeks before the end of the second quarter.

Figure 7: Real GDP growth (Q1:2005 to Q2:2012)



Source: GSO, World Bank staff estimates

16. While there has been a general slowdown in the economy, some sectors have been particularly hard hit. The sector that has contributed most to the slowdown is construction, which registered a -3.9 percent growth during Q1:2012 (see table 2). Some slowdown in the construction sector was inevitable given inflated property prices, speculative money and over-investment in the sector in the past few years, but the decline seems to have been exacerbated by a tight credit policy that specifically targeted the property sector and a slowdown in public investments[3]. Similarly, the manufacturing sector, especially the small and medium enterprises, which are more dependent on domestic credit for working capital and expansion than larger enterprises, have also done less well. Nearly 18,000 enterprises have either closed, been liquidated or temporarily suspended their operations during the first four months of 2012—a 9.5 percent increase compared to the same period in 2011. In contrast, the export-oriented enterprises, especially the foreign enterprises, appear to be doing rather well, as shown by the continued robust growth in exports (see Section II.D).

17. The growth in agriculture and services sectors has also slowed down. Rice output in the Mekong Delta in Q1-2012 reached 10.7 million tons – a moderate increase of 1.9 percent compared to the last year harvest. Falling demand for rice exports has negatively impacted output. The government had to buy 1 million tons of paddy in the Mekong delta to protect farmers from falling prices. Livestock has suffered from various diseases due to an extended spell of cold weather. Pork consumption has fallen because of perceived use of less hygienic farming techniques in selected provinces. Exports of coffee from Central Highlands have also been affected because some coffee trading companies are facing financial difficulties. The services sector is also facing difficulties. High inflation has led to slowing private consumption, even during the traditional New Year celebrations in 2011. Finally, stagnation in the real estate sector has impacted negatively on brokerage and trading businesses, their output contracting sharply in Q1-2012.

[3] For example, Resolution 11 limited banks' exposure to real estate and security market (referred to as the non-productive activities) to 22 percent of total credit by June 30, 2011 and to 16 percent by December 31, 2011. This was done primarily to curb speculation in property and stock markets.

Table 2: Sources of Growth: 2007- Q1:2012

	2007	2008	2009	2010	2011	Q1-2011	Q1-2012
Total GDP	8.5	6.3	5.3	6.8	5.9	5.6	4.0
Agriculture, forestry & fishery	3.4	4.7	1.8	2.8	4.0	3.7	2.8
Industry & construction	10.6	6.0	5.5	7.7	5.5	5.7	2.9
Industry	10.2	8.0	4.0	7.0	7.4	5.7	4.0
o/w Manufacturing	12.8	9.8	2.8	8.4	8.3	6.1	3.1
Construction	12.0	-0.04	11.4	10.1	-1.0	4.4	-3.9
Services	8.7	7.4	6.6	7.5	7.0	5.9	5.3

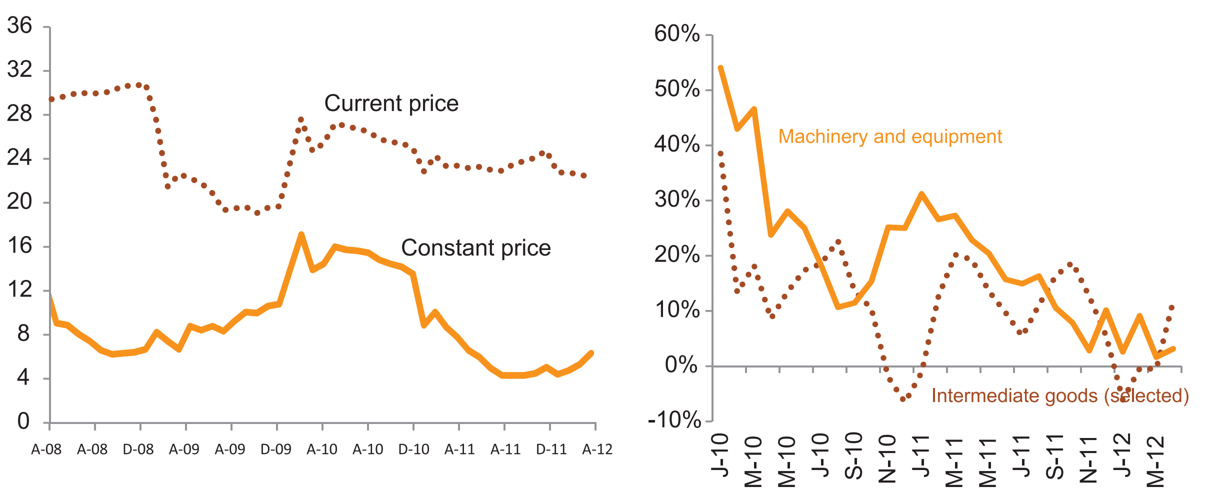
Source: GSO

18. The movement of a number of other correlates of output also points toward a growth slowdown. Industrial production in the first four months of 2012 has slowed to 4.3 percent compared to 10 percent in the same period in 2011 (figure 8). At the same time, inventory of key industrial products has seen a sharp increase. The retail sales index, an indicator of private consumption, grew by only 6.1 percent in real terms compared to about 7.7 percent during the same time in 2011. The growth of imports of capital goods, a barometer of future investment activities, has also registered a slowdown in recent months.

Figure 8: Signs of a Growth Slowdown?

Panel A: Growth in retail trade, %

Panel B: Growth rate of imports, % (month moving average)

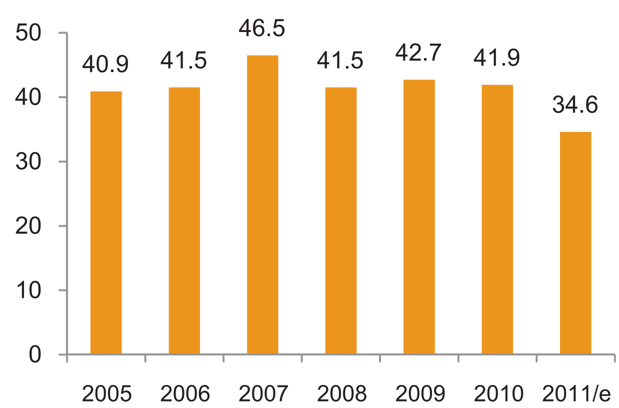


Source:GSO, MPI and World Bank Staff estimates.

19. A major source of the growth deceleration is the slow growth in public and private investment, as the government prepares to move the economy away from factor accumulation to productivity as the key source of growth. With slowdown in credit growth and efforts to restructure public investment, total investment has fallen sharply—from 41.9 percent of GDP in 2010 to 34.6 percent in 2011 (panel A, figure 9). The decline has been uniformly shared between state budget, state-owned enterprises and private sector. And within the private sector, while domestic private enterprises have scaled back their investment plans, the disbursement from foreign firms has not slowed down significantly. However, the commitment of foreign investors has declined in recent months (panel B, figure 9) — a source of major concern, since Vietnam is looking for new sources of growth and will require infusion of foreign capital to restructure its state–owned enterprises and banking sector.

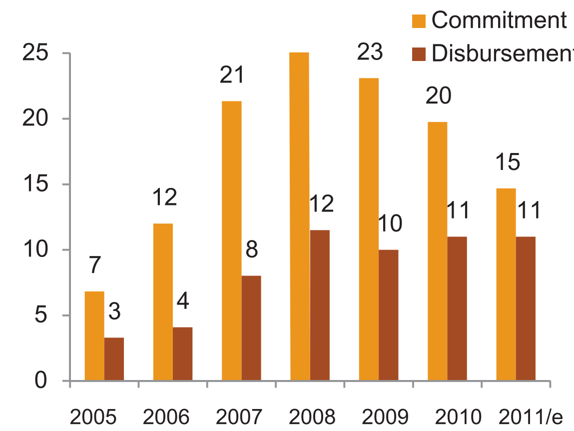
Figure 9: A Slowdown in Investment

Panel A: Trend in total investment (% GDP)



Source: GSO

Panel B: FDI– committed and disbursed ($ bn)



Source: GSO

20. The growth slowdown in Vietnam needs to be viewed through the prism of several developments at home and abroad. The global economy as well as the East Asia regional economy are both expected to slowdown in 2012 than in 2011—reflecting weaknesses in the external environment and slower than expected recovery from the financial crisis. Given the structure of Vietnam's economy—high trade to GDP ratio, large share of foreign investment in total investment, and sizeable level of remittances—it is unlikely to remain immune from global developments for an extended period of time. At the same time, efforts to stabilize the economy through tight monetary and fiscal policies and the ongoing restructuring agenda are having adverse effects, including closure of enterprises and loss of jobs—though not stabilizing the economy would have led to even bigger losses.

21. Nevertheless, a below five percent growth rate during the first-half of 2012 is likely to reignite the "growth versus inflation" debate in Vietnam. Such a debate in our view misses the larger point of why Vietnam has entered a phase of sluggish growth. Vietnam's growth rate has been trending downward for the last 5-6 years, largely on account of the slow pace of structural reforms. Inefficiencies in state-owned enterprises, banks and public investments are a drag on the country's long-term growth potential. So whilst fiscal stimulus and higher credit growth may lead to a cyclical upturn in the growth rate in the short-run, there is no substitute to structural reforms to unleash a productivity-led growth and a permanent stimulus to the longer-term growth potential of the country.

C. Impressive Poverty Reduction, Yet New Forms of Vulnerabilities

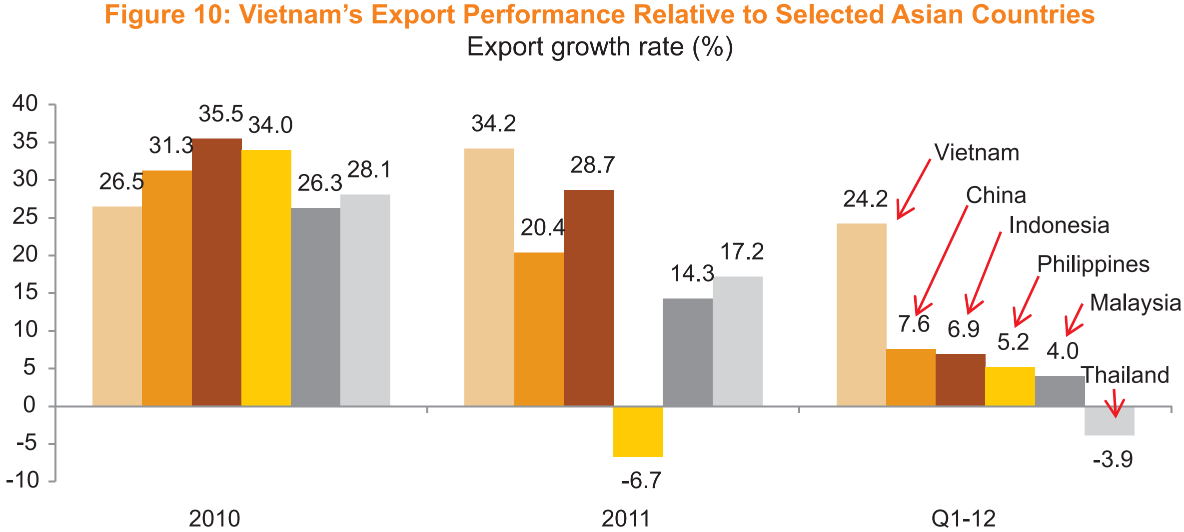
22. The latest household survey results show that along with continued fall in poverty headcount ratio, there has been steady progress on other dimensions of well-being. Vietnam has made impressive progress at reducing poverty over the past two decades. The 2010 VHLSS confirms that this progress has continued, albeit at a slower pace than before. Since the GSO-WB poverty line that has been used monitor progress since the early 1990s is low by international standards, the forthcoming 2012 Poverty Assessment proposes an updated GSO-WB poverty line for 2010 (VND 653,000 person/month or $2.24 person/day 2005 PPP). Judged by this new standard, 20.7 percent of the population is regarded as poor in 2010, including 6 percent of people living in urban areas and 27 percent in rural areas – significantly lower than countries with similar per capital income, e.g., India, and Nigeria. Other impressive results of 2010 VHLSS survey include primary school completion rate at 96 percent, infant mortality rate at 14 per thousand live births, and life expectancy at 74.8. Similarly, 89 percent of Vietnamese households owned TVs (compared to 56 percent in 1998); 85 percent owned an electric fan (68 percent in 1998); 43 percent owned a refrigerator (9 percent in 1998), and 76 percent owned at least one motorbike.

23. The pace of poverty reduction, however, is slowing, and new forms of vulnerabilities are arising, linked to external global events, rising macro instability and slower growth. At the time of global economic crisis in 2008/09 and then in recent months many workers have lost jobs; others have received lower wages and reduced working hours due to reduced demand. Farmers have complained about rising costs of agriculture inputs, and reduced profit margins. Households in urban and peri-urban areas have been particularly hard hit by high food price inflation, and remittances from urban migrants have fallen[4]. Poverty has become increasingly concentrated among ethnic minority populations, who comprise only 15 percent of the population but nearly half the remaining poor and two-thirds of the extreme poor. And in recent years, better off households have benefitted more from the growth process than the rest of the population, resulting in rising income inequality.

D. Exports Optimism

24. Vietnam's growth pessimism stands in sharp contrast with its robust export performance in recent years. As shown in figure 10, at 34.2 percent in 2011, Vietnam recorded the highest rate of export growth in developing East Asia, with China coming at a distant second. The same performance has been repeated in the first four months of 2012, though Vietnam's overall growth of exports has declined as explained below. Interestingly, since 2010, Vietnam has witnessed dramatic growth in higher value-added manufacturing products such as phones, computers and electronics—a category in which most other developing East Asia seems to be doing less well.

Figure 10: Vietnam's Export Performance Relative to Selected Asian Countries



Source: EAP Economic Update, May 2012, World Bank

25. There has been a moderation in export growth during the first four months of 2012, though the decline has been confined to mostly primary sector products. As shown in table 3, Vietnam's total exports grew by 22.1 percent in the first four months of 2012, while exports of crude oil, rice, coal and other agricultural commodities, registered either negative or near-zero growth rates. The volume of crude oil exports decreased by 14.7 percent because of production constraints, causing export value to fall by 3.1 percent despite high export prices. Rice exports were down by 28.1 percent in volume terms and 27.8 percent in value terms. Similarly, the unit price of rubber fell by about 32 percent compared to the same time last year, contracting the total export value by 8.3 percent.

[4] *Participatory Monitoring of Urban Poverty in Vietnam*, Fourth Round Synthesis Report, October 11, Oxfam, and Action Aid

Table 3: Export performance has been robust

	Value (US$ billion), 2011	Growth in %		
		2010	2011	4M/2012
Total export value	**96.9**	**26.4**	**34.2**	**22.1**
Crude oil	7.2	-20.0	45.5	-3.1
Non-oil	89.7	32.0	33.4	24.6
Rice	3.7	21.9	12.6	-27.8
Other agricultural commodities	9.0	35.1	39.9	0.5
Seafood	6.1	18.0	21.9	13.3
Coal	1.6	22.3	1.3	-12.2
Garment	14.0	23.7	25.3	14.7
Footwear	6.5	26.0	27.9	9.3
Electronics & computers	4.7	29.9	30.1	98.6
Phones and accessories	6.9	138.7	98.4	154.0
Handicraft (including gold)	3.2	5.3	-3.6	7.1
Wood products	3.9	32.3	13.7	20.5
Other	30.0	49.0	44.6	24.3

Source: General Department of Customs

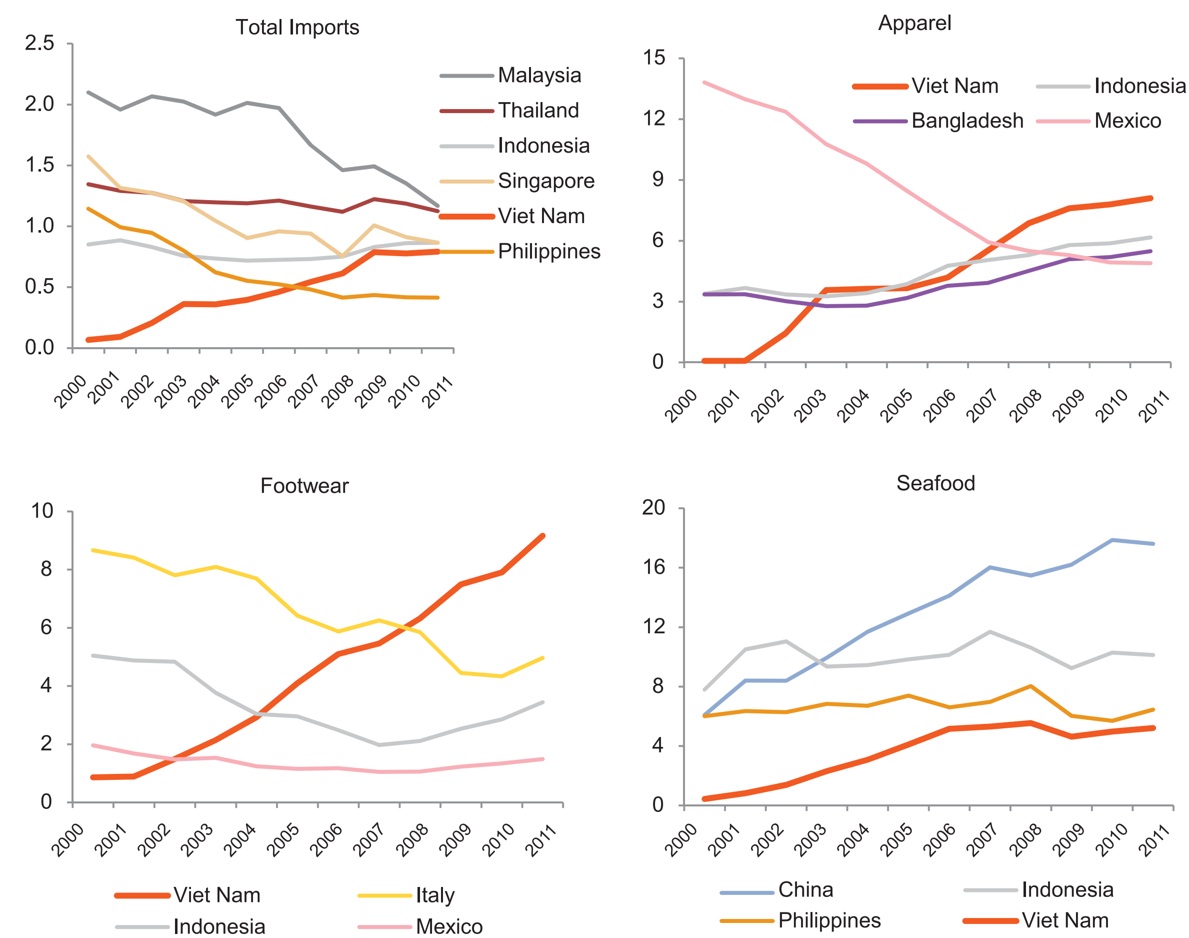
26. At the same time labor-intensive and low valued-added manufacturing items remain Vietnam's main exports and the country is steadily making inroads into high value added manufacturing products. Garment exports increased by 14.7 percent in the first four months of the year. The United States remains the largest destination for Vietnamese garments, accounting for 52 percent of total garment exports. With production starting in a number of phone and accessories companies such as Samsung, Foxconn, and Nokia (under development), the export of cell phones and accessories have shown enormous growth in the last two years, albeit from a low base. In the span of a few years, cell phones and related accessories have become the second largest export item from Vietnam (after garments), accounting for 10.5 percent of total exports. With garment exports growing at 14.7 percent in the first four months of 2012, while phone and accessories are growing at 154 percent over the same time period, the latter is likely to emerge as the single largest export item from Vietnam in 2013.

27. Vietnam's rise as a growing exporter of electrical and electronic products comes at a time when East Asia as a region has been doing less well in this sector. In particular, regional exports of computers and office machines remained almost flat, growing 2.4 percent in nominal value terms in 2011 compared to around 30 percent growth in the case of Vietnam. Similarly, the regional export growth rate of electrical machinery and appliances and telecommunications apparatus and equipment was at 40-60 percent of their pre-crisis average, while in Vietnam this category grew at 98.4 percent in 2011. The Philippines, which is the most dependent on electronics exports in EAP, posted the region's poorest export performance last year. It appears that Vietnam, despite its recent problem with macroeconomic instability, is able to attract and retain foreign firms with long-term interest in high value manufacturing products such as electronics, computers and phones.

28. The dynamism of Vietnamese exports in the global market place can be also seen through its growing market share in the Unites States. Vietnam and the United States signed a bilateral trade agreement (BTA) in July 2000 and Vietnam acceded to the WTO in January 2007. Since then, Vietnam has done well in exploiting the benefits of these trade agreements and has steadily increased the market share of its main export items relative to key competitors. In 2011 Vietnam became the 26th largest source of merchandise imports for the United States, with its total exports increasing by

21 times in nominal terms between 2000 and 2011. Vietnam holds the second highest market-share in apparel and footwear (after China) and fifth highest market share in seafood among US import partners (see figure 11). A large part of these exports are produced by foreign firms, sometimes American, but often from South Korea, Taiwan, Singapore and Japan. These firms have invested significantly in Vietnam to take advantage of its low wages, young and educated labor force and business friendly environment.

Figure 11: Vietnam's Merchandise Exports in the U.S Market



Source: U.S. Department of Commerce

29. Vietnam's export destination remains diversified, with no individual country or region accounting for more than one-sixth of its exports. While the US remains Vietnam's largest export destination, its share in Vietnam's total exports has been coming down in the past three years (table 4). At the same time, the share of exports going to Japan and Europe has steadily climbed. In the first quarter of 2012, exports to Japan rose by nearly 55 percent on account of crude oil, transportation parts, and seafood. This is in part because Japan's domestic production has been affected due to the earthquake and tsunami. Vietnam has also succeeded in sending a larger part of its exports to non-traditional markets in South Asia and Africa. Vietnam is currently negotiating the Trans-Pacific Partnership (TPP), which could provide a fresh boost to Vietnamese exports, especially through access to new markets in Latin America.

Table 4: Vietnam Export Destinations

	Share of total (%)			Growth (%)		
	2010	2011	q1-12	2010	2011	q1-12
China	10.1	11.5	10.1	35.3	52.2	27.6
Japan	10.7	11.1	10.7	22.0	39.5	54.8
USA	19.7	17.5	19.7	24.8	18.9	21.5
EU	15.7	17.0	15.7	21.1	45.3	25.2
ASEAN	14.4	14.0	14.4	13.2	30.7	23.6
East Asia (excl. Japan)	8.3	9.0	8.3	41.7	46.1	24.6

Source: General Department of Customs

30. **Total imports grew slowly at around 3.6 percent in the first four months of 2012.** This is mostly related to slowing growth, and in particular to falling demand for construction material. Imports of machinery and equipment by foreign firms remained strong—growing by 34 percent. However imports by domestic firms decreased by 21 percent, reflecting a strong consolidation of public as well as private investment. Imports of raw materials and intermediate goods (fertilizer, animal feed, cotton, fiber, fabrics) have also decreased, reflecting falling domestic demand and growing inventory. Imports of automobiles and motorbikes fell sharply partly because of a hike in taxes and fees on private vehicles to deal with chronic traffic congestion in large cities. The slowdown of growth rate of imports in general reflects the broader slowdown of the economy.

Table 5: Import performance

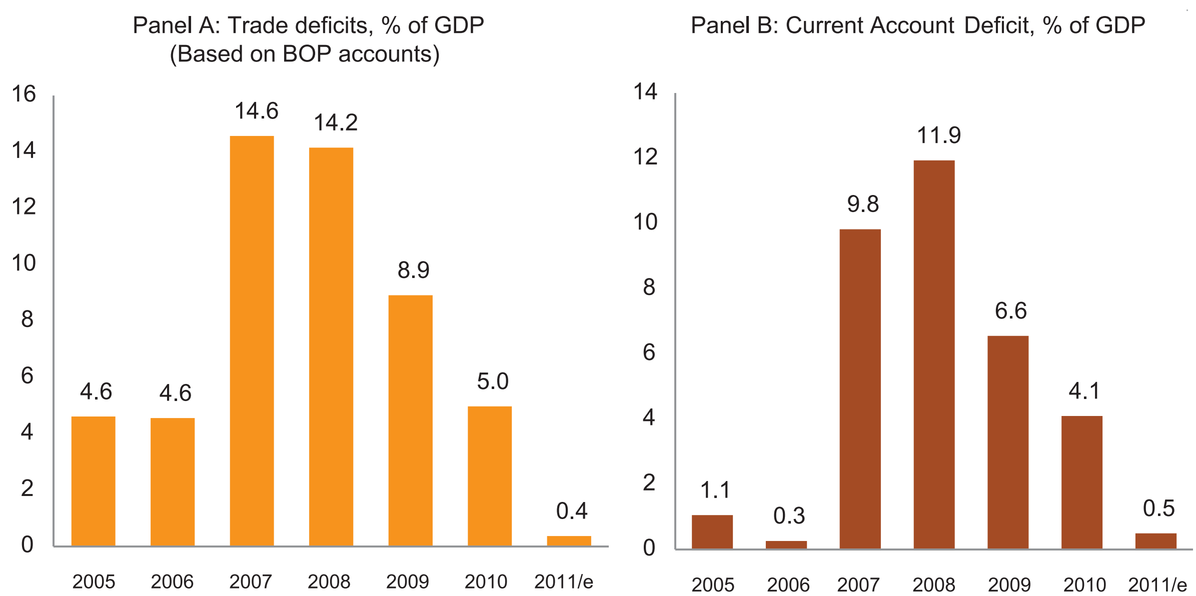
	Value ($bn)	Growth (%)		
	2011	2010	2011	4M/2012
Total import value	106.7	21.2	25.8	3.6
Petrol and gasoline	9.9	-2.8	61.6	-16.9
Machinery and equipments	15.3	8.0	13.0	0.1
Garment and leather materials	2.9	35.7	12.5	1.1
Computer and electronics	8.0	31.7	53.1	98.7
Steel	6.4	14.8	4.5	-0.8
Fertilizer	1.8	-13.9	46.1	-21.9
Plastics	4.8	34.2	26.1	-2.2
Fabrics	6.7	26.9	25.5	-3.5
Chemicals	2.7	30.4	27.2	10.5
Chemical products	2.4	30.0	16.6	0.8
Pharmacy	1.5	13.3	19.3	13.3
Fibers and weaving yarns	1.5	45.1	30.4	-17.7
Pesticides	0.6	12.4	16.6	0.8
Cotton	1.1	71.9	56.1	-34.3
Paper	1.1	20.1	15.4	2.6
Automobiles	3.1	-5.2	6.8	-37.4
Other	36.9	35.1	26.6	7.1

Source: General Department of Customs

E. Narrowing of Trade and Current Account Deficits

31. Vietnam has been quite successful in narrowing its large trade and current account deficits, which once used to be considered a key source of macroeconomic vulnerability. The trade deficit (based on BOP definition) has come down to 0.4 percent of GDP in 2011 from a peak of 14.6 percent in 2007 (panel A, figure 12). Similarly, the current account deficit has narrowed from 11.9 percent of GDP in 2008 to 0.5 percent of GDP in 2011 (panel B, figure 12). The correction has been particularly large in 2011, with strong performance in exports, relatively slower growth in imports and strong remittances. The deficit is expected to remain at a moderate level of about 1.5 percent of GDP in 2012 and largely financed by non-debt creating FDI inflows, official development assistance (ODA) and private remittances. Improved current account deficit has also helped the SBV to shore up foreign exchange reserves to about 2 months of import cover by the end of Q1-2012 .

Figure 12: Improving External Balances

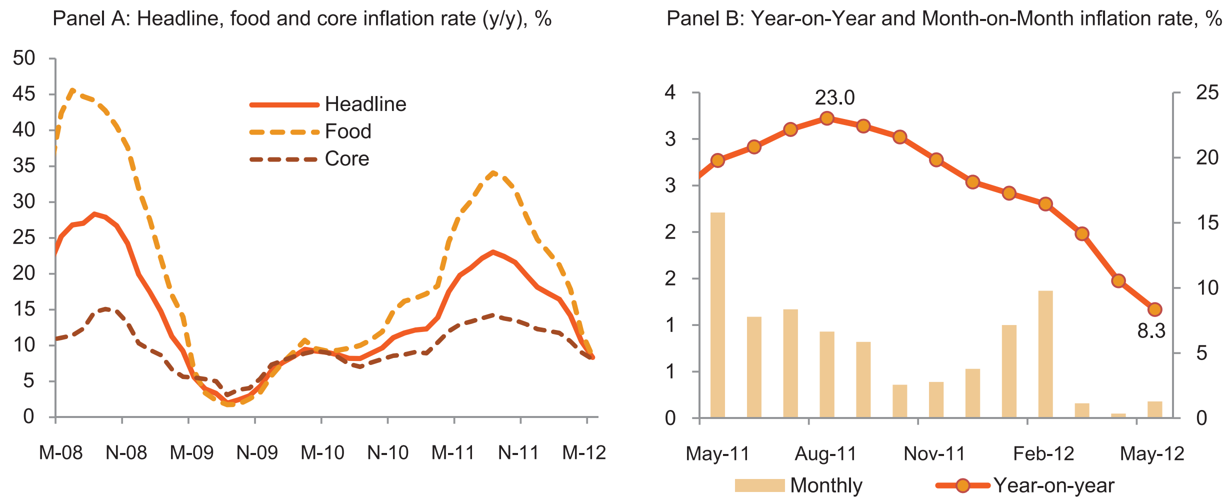


Source: SBV, IMF and WB

F. Rapid Rise and Fall of Inflation

32. Inflation has been falling as rapidly as it went up last year. High commodity prices, delayed withdrawal of stimulus measures and inability to raise interest rates in a timely manner in late 2010 led to a steady increase in inflation during the first half of 2011. Headline and food inflation peaked at 23 and 34 percent respectively in August 2011 (panel A, figure 13). But as the impact of Resolution 11 started to take hold after a 4-5 month policy lag, inflation began a downward spiral. In May 2012, it fell to 8.3 percent – the lowest rate in 18 months. Easing of food prices has contributed the most in overall disinflation. While year-to-year inflation has fallen for nine consecutive months, the month-on-month inflation, which suffers from seasonality bias and hence an imperfect measure of the general level of prices, rose during the lunar new year months and then fell during the second quarter of 2012 (panel B, figure 13).

Figure 13: Inflation Rate Has Been Steadily Climbing Down (in %)



Source: General Statistics Office

33. The decline in the inflation rate can be largely attributed to sound macroeconomic management by the government. There is an uncanny similarity between the last inflation episode—when inflation peaked at 28.3 percent in August 2008 and plummeted to 5.6 percent in May 2009—and the current one. But there is also a critical difference. In 2008/09, global commodity prices, especially the price of crude oil plunged from around US$150 per barrel to less than US$40 per barrel in the space of a few months. The current disinflation episode, however, has not coincided with a favorable global price situation. This leads one to conclude that domestic policies as enunciated in resolution 11 were primarily responsible for bringing inflation down to single digits.

34. The current price stability however cannot be taken for granted, with inflation expected to reverse its downward trend during the second half of 2012. The planned move to liberalize the price of key inputs such as energy, fuel and coal could contribute to cost-push inflation. The rise in minimum wages for civil servants as part of the Government's wage reform policy will also add to the demand pressure. And the gradual relaxation of monetary policy by SBV will generate more demand, albeit with a lag, and therefore could cause inflationary pressure to reemerge 3-4 months down the road. There is, therefore, only a very small probability that inflation will continue to fall till the end of 2012 and end the year below 5 percent.

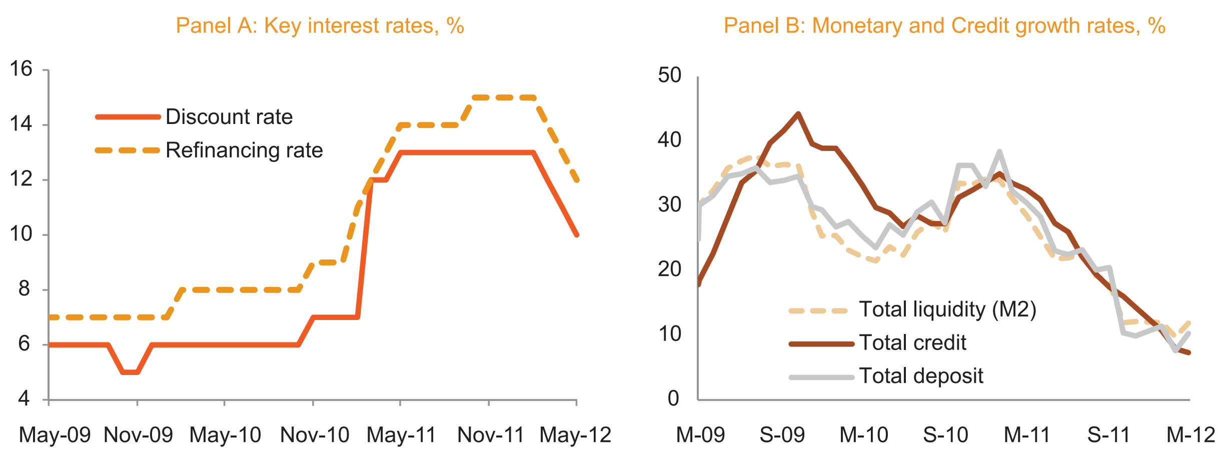
G. Adjusting the Monetary Policy Stance

35. In a transition economy with limited policy options, the authorities have found it exceedingly difficult to balance the twin objectives of supporting economic growth and fighting inflation. In 2011 this was done by introducing a mix of monetary policy instruments and administrative measures. As part of Resolution 11, SBV pursued a tight monetary policy by announcing a lower target for credit growth in 2011 (20 percent, as opposed to 32 percent realized in 2010 and 40 percent in 2009), restricting lending to "risky sectors" such as real estate and stock trading, putting a ceiling on deposit rates for both local and foreign currencies, and hiking policy rates by 600 basis points (panel A, figure 14). However credit growth declined rapidly to 14.3 percent by the end of 2011 and continued its decelerating trend in the first four months of 2012 when credit contracted by nearly 1 percent, raising concerns of a credit crunch (panel b, figure 14).

36. With inflation firmly trending downward, SBV has started to adjust its monetary policy stance. SBV lowered its key policy rates by 300 basis points during the past eight weeks - the

discount rate and refinancing rate fell to 10 and 12 percent, respectively. It is anticipated that the rates will be cut further in each quarter through the course of 2012. The cap for dong deposit was also reduced from 14 percent to 11 percent. The rules on lending to real estate and for private consumption were relaxed. SBV encouraged commercial banks to lower lending rates and promote credit for production, agriculture and rural development, exports, and small and medium enterprises. SBV also lowered the foreign exchange position limit of credit institutions and branches of foreign banks by day-end to 20 percent, from the current level of 30 percent. The foreign exchange position limit would be calculated by measuring the ratio of total foreign exchange to the institutions' equity capital for the previous month. The move is aimed at preventing commercial banks from hoarding foreign currencies and generating more dong liquidity to the banking system.

Figure 14: Tight Monetary Policy Stance of SBV



Source: The State Bank of Vietnam

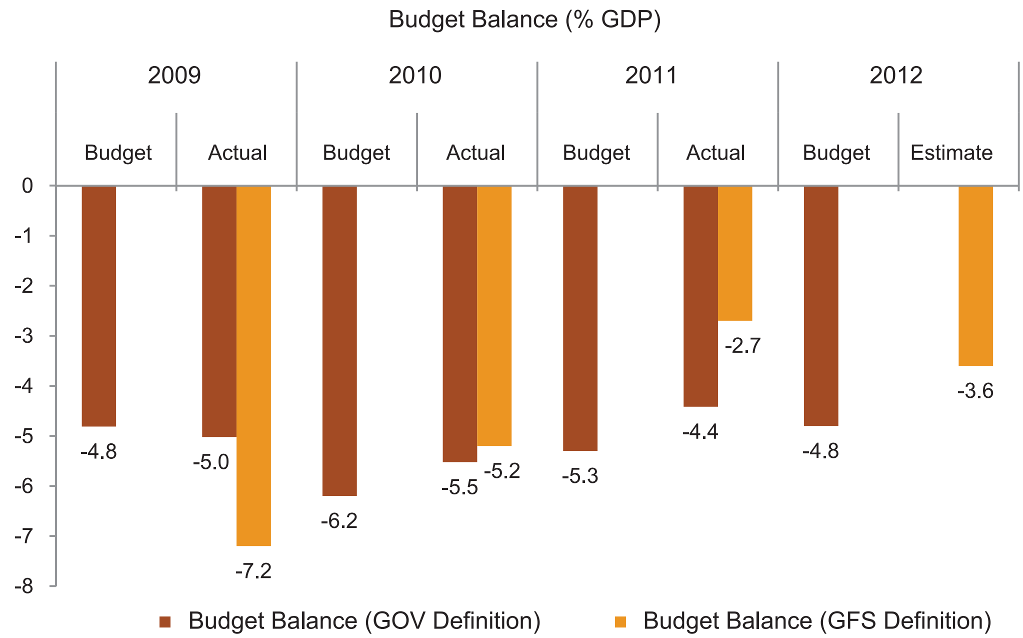
37. With gains from macroeconomic stabilization still recent and fragile, especially in an external environment that is fraught with uncertainty, the authorities need to be careful not to shift to an expansionary stance too rapidly. Given Vietnam's history of premature loosening of policy, there are reasons to exercise caution. First, there is a 3-4 months lag between policy change and outcome, which means the effect of recent expansionary policy will be felt by the end of the third quarter of 2011 not only through higher growth, but also higher inflation. Second, with lingering inefficiencies in state-owned enterprises and weaknesses in the banking system, stimulus measures will contribute to preserving an inefficient growth model that is fueled by rapid credit expansion, going against Government's own desire to move towards a more productive and competitive economy. Therefore future policy course needs to be carefully balanced so as to support growth without sacrificing the gains of macroeconomic stabilization.

38. Recently, SBV raised its efforts to move towards inflation targeting. To do so, the following conditions would be needed, among others: (i) the central bank has to have a clear mandate to make inflation targeting the primary objective of monetary policy and is publicly accountable for meeting this objective; (ii) the inflation target will not be subordinated to other objectives and monetary policy will not be dominated by fiscal priorities; (iii) the central bank has adequate policy instruments to be able to influence inflation. At the moment, SBV seems to have limited scope to implement monetary policy using market-based indirect instruments to manage inflation, although this has long been its declared objective.

H. Significant Fiscal Correction

39. The Government has indicated that it intends to continue fiscal consolidation efforts, particularly by targeting more efficient public investment. The overall deficit fell from 5.2 percent of GDP in 2010 to an estimated 2.7 percent in 2011 (see figure 15). This was in part due to strong revenue performance, including an initial conservative estimate of oil revenue. Corporate Income Tax and Value Added Tax (together around 55 percent of total revenue) grew at 29 and 19 percent respectively between 2010 and 2011, despite tax holidays (rate cuts, deferred payment) granted to over three hundred thousand enterprises. Total capital spending (including off-budget) declined slightly by 0.4 percent (and from 12 percent of GDP to 9.4 percent) over the same period. This latter result is in part a consequence of Government efforts to rationalize capital spending.

Figure 15: Fiscal Balance: International versus Vietnamese Definition



Source: Ministry of Finance, IMF and World Bank Staff estimates.

40. The 2012 State Budget, approved by the National Assembly in December 2011, highlights six priorities, including: fiscal discipline; increasing the relative share of social expenditure and enhancing public investment efficiency; equitization and oversight of State Owned Enterprises; accountability of decentralized service delivery units; reducing price volatility; and efficiency of public administration. Total revenue is estimated at VND 740.5 trillion (25.2 percent of GDP and up 9.8 percent from 2011 estimated collections). Corporate income tax and VAT are estimated to grow by 11.8 and 21.7 percent respectively, and revenue from crude oil is estimated at VND 87 trillion (12 percent of total revenue and 3 percent of GDP), assuming $85 per barrel. Two new tax measures were introduced in January 2012: Environmental Protection Tax and Non-Agricultural Land Use Tax. Though Government intends to maintain certain tax holidays in 2012 - foregone revenue is estimated at VND 5,410 billion[6]. Other tax breaks and cuts have also been announced including: pilot VAT refund scheme for foreign visitors; tax breaks for domestic securities' investors; duty exemption on selected construction materials; duty cuts for gas and other energy imports.

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5 The term "deficit" in this note corresponds broadly to the "overall balance" defined in the IMF Government Finance Statistics Manual 2001 and represents the net borrowing requirement of government. Some differences between these deficit data and those of the IMF and the Government occur because of data limitations and different assumptions.

6 Press report, Lao Dong: "Vietnam to Cut Tax Breaks to $258.4 million in 2012," January 4, 2012.

41. The 2012 State Budget commits the Government to further rationalize public investment, and increase the relative share of social spending. Total Government expenditure is estimated at VND 896 trillion (30.4 percent of GDP and 16 percent growth from 2011 spending estimate), of which VND 651 trillion is recurrent expenditure (22.1 percent of GDP and 21.7 percent growth from 2011 estimate), and VND 245 trillion is capital expenditure (8.3 percent of GDP and 3.1 percent growth from 2011 estimate). As part of Government's policy on salary reform, the base salary for public servants will increase from VND 830,000 per month to VND 1,050,000 per month starting May 1, 2012. Social spending is around one third of total planned spending, out of which education accounts for 47 percent, social protection for 29 percent, and health 17.5 percent. Government policy is to allocate 20 percent of total spending on education and to ensure that the health budget increases by at least the same rate as the overall budget.

Box 2: Improving Budget Credibility: Progress and Challenges

The credibility of the Budget and transparency of fiscal policy intentions are critical for market confidence and macroeconomic stability. There is growing cross-country evidence on the links between fiscal transparency and credit ratings, fiscal discipline, and the efficiency of government expenditure. Budget credibility is particularly important given the relatively big role that the public sector plays in the Vietnamese economy.

Budget credibility depends on a range of factors including: the quality of fiscal projections, the comprehensiveness of budget coverage, the realism of assumptions underlying the budget, the extent to which fiscal risks from sources outside the formal budget have been taken into account, and, more broadly, the way in which these issues are presented in the annual budget documents.

The Government is taking steps to address these questions in its reform program, though current weaknesses increase the difficulty of assessing the State Budget. Consistent underestimation of Government expenditure and revenue dilute the reliability of the budget plan and its links to the medium-term development strategy, which economic actors use for decision-making.

42. The Government has maintained fiscal discipline in line with Resolution 11 to control inflation and stabilize the macro economy. Although spending has increased quickly (average of 18.4 percent per year between 2009 and 2011), this was in part due to the fiscal stimulus. Preliminary estimates show that Government has made an effort to reign in capital spending growth. In addition, the 2012 Budget limits the level of discretionary spending from revenue collected above the planned amount. The 2012 Budget deficit is estimated at 3.6 percent of GDP, a slight increase from an estimated 2.7 percent in 2011. Vietnam has a current fiscal surplus, even though this has declined over time – projected to fall further from 3.5 percent of GDP in 2011 to 1.6 percent in 2012.

43. The above assessments, however, are subject to revision given changes by the time final accounts are prepared, and in light of revenue under-estimation. Revenue mobilization and spending have, on average, been 18 and 15 percent higher than budgeted between 2009 and 2011 (based on budgets versus the second and first budget estimates for 2010 and 2011 respectively, and in the final accounts for 2009). The difference in outturn rises by the time the final accounts are prepared. These issues impact on the credibility of the budget, which the Government is trying to address (see Box 2).

I. Manageable Level of Public Debt, But Growing Risks from Contingent Liabilities

44. Vietnam's level of public debt is sustainable, but there is growing recognition that contingent liabilities pose considerable threat. Total outstanding Government and Government Guaranteed external debt increased by nearly 50 percent from 2008 ($21.8 billion or around 21 percent of GDP) to end of 2010 ($32.5 billion or 32.7 percent of GDP) due to the Government's fiscal stimulus package. Although debt to the external private sector rose from around $3 billion in 2008 to $5.4 billion in 2010, more than 80 percent of Government and Government Guaranteed external debt is long-term and concessional from official creditors. Domestic public debt has gone from around 18 percent of GDP between 2006 and 2008, to around 21.5 percent of GDP in 2010, also due to the fiscal stimulus.

45. Vietnam is assessed at low risk of debt distress. The Present Value of Government and Government Guaranteed external debt is estimated at around 27 percent of GDP, considerably lower than the 50 percent of GDP threshold for external debt sustainability. The Present Value of public sector debt (i.e. including domestic debt) is closer to 50 percent of GDP. Although there may have been some increase in short-term borrowing from the private sector as noted above, the Government has also indicated that it intends to repay these as early as possible. The primary fiscal deficit narrowed from 4.5 percent of GDP in 2010 to 2.4 percent in 2011, even though it is expected to widen to 3.6 percent of GDP in 2012. Maintaining the current course of fiscal consolidation is essential for debt sustainability. It will help to shelter against potential exchange rate shocks, slowing exports due to falling global demand, and declining sources of concessional financing.

46. Despite manageable levels of debt, contingent liability risks from State Owned Enterprises and the financial sector are significant. Implicit obligations, which are not captured under government and government guaranteed debt statistics, are a source of uncertainty. The authorities are stepping up efforts to collect reliable and up-to-date information on contingent liabilities in the SOE sector and to monitor and manage potential fiscal risks associated with borrowing by SOEs. The financial sector restructuring plan should also help to stem systemic crisis.

J. Developments in the Banking Sector

47. In recent years the performance of the banking sector has been significantly affected, first, by macroeconomic instability and then by changes in monetary policy to stabilize the economy. High inflation has lead to severe maturity mismatch between deposit and loan terms as 90 percent of banking sector deposits have 30 days or lower maturity period (in lesser known banks this ratio can be as high as 97 to 98 percent). Negotiated interest rates and pervasive deposit shifting became a norm until SBV cracked down on such practices in its Instruction No. 2. And after many years of high credit growth, Vietnamese banks had to adjust to a life of slow or negative credit growth. As a result, the banks have not been able to expand their medium and long-term loan portfolio and often preferred lending to large and known borrowers at the expense of SMEs.

48. The concerns about the quality of bank assets have intensified, given the financial health of some of the key borrowers – the real estate sector and SOEs. Official non-performing loans (NPLs) have increased from 2.2 percent of assets at end-2010 to 3.6 percent in March 2012, but are likely to be higher if measured by internationally accepted standards. There is skepticism about the true magnitude of problem loans as real estate lending is officially reported to account for only one tenth of the portfolio and real estate related (i.e. properties as collateral) loans are reported to account for 60 percent of the portfolio. The cap of 16 percent exposure to non-productive sectors at the end of 2011 put an end to not only new loans to real estate activities, but also disbursement of already

committed loans. With the real estate market frozen, sharply falling prices and closure of some real estate firms, banks have found it increasingly difficult to keep NPLs under control. The SBV recently loosened the regulations on exposure to non-productive sector by removing nearly one-half of the real estate borrowers from the “non-productive” category. Almost all consumers lending has been excluded from the restriction so that commercial banks have more flexibility in extending credits.

49. Since late October 2011, the government has taken a number of measures to address the systemic risks in the sector as well as to improve its efficiency and safety. In December 2011, it announced the merger of three banks that had considerable non-performing loans (SCB, TinNghia bank, Ficombank), with BIDV acting as a facilitator (under SBV’s guidance and back-up). In Q1 2012, SBV announced its determination to radically restructure the 8 weakest commercial banks, which were included in Group 4 according to its classification of banks (Group 4 banks are the ones with the weakest balance sheet and were given a credit ceiling of 0 for 2012). So far there has been only one M&A case, with SH Bank, a medium-sized bank, acquiring Habubank, a small bank with serious NPL problems. The most concerted effort thus far in this respect is the Prime Minister’s Decision 254 on "Restructuring credit institution system in the 2011-2015 period.” The Decision provides a broad framework to deal with weak banks and sets out a number of targets to be achieved by 2015. The decision also presents restructuring options including letting the SBV directly acquire the equity of weak banks, increasing the ownership limit for foreign banks in domestic credit institutions, encouraging healthy banks to buy good quality assets and loans from weak banks, and allowing banks to sell their bad debts to the Debt and Asset Trading Company (DATC). However, actual implementation of the Plan and which restructuring option to consider and the related implications are still under discussion.

50. There are numerous challenges in implementing the restructuring plan successfully. While the soft aspect of restructuring such as capacity building, risk management or corporate governance enhancements can be felt more clearly, the portfolio quality of banks under stress has been questionable and therefore, diagnostic capacity and tools to understand the scope of problems are absolutely necessary in the near term so that potential costs of the restructuring process can be appropriately estimated and relevant resources can be mobilized in the outlined roadmap. If weak and non-performing financial institutions are not properly encouraged to exit through M&A or managed bankruptcy, they are likely to weaken the system further, and as such, restructuring costs could escalate considerably down the road. Therefore, a detailed contingency planning framework (crisis preparedness) may need to be developed.

51. The importance of a multi-agency coordination framework cannot be understated in the restructuring process. At the same time, consultation and cooperation between multiple stakeholders are also important since the ultimate responsibility for implementation of the plan lies more with the financial institutions. In relation to this, group interest can be an obstacle as cross-holding by the corporate sector in the banking sector is still pervasive, although the SBV has issued relevant regulations in order to appropriately limit adverse impact from various stakeholders on the restructuring decisions for a financial institution. Needless to say, more transparency and disclosure is critical but currently still limited in minimizing possible risks and negative impacts due to information asymmetry. The banking legal and regulatory framework is currently not at par with international best practices and standards. Adequacy of the bankruptcy and corporate restructuring framework is still an issue and needs to be revisited.

PART III

RESTRUCTURING AGENDA AND MEDIUM TERM PROSPECTS

52. Vietnam's medium-term economic prospects will be determined by two divergent factors. On one hand, with inflation coming down rapidly, the government is gradually moving to a more accommodative policy mode to support growth as seen by the 300 basis point reduction in interest rates since late-March. It has also announced a mini fiscal stimulus for enterprises (see box 3). These steps will begin to inject liquidity, support investment and within a lag of 3-4 months their impact on the real economy will be felt. On the other hand, the slow progress on the restructuring agenda and the potential cost of restructuring the banks and enterprises, along with an uncertain global economy, will hurt sentiment and moderate growth.

Box 3: Resolution 13/NQ-CP

Resolution 13, which was issued on May 10, 2012, aims to provide both direct and indirect support to the business sector and includes the following measures:

- Postponing VAT obligations: VAT obligations for the second quarter of 2012 is postponed for 6 months for SMEs and labor-intensive enterprises in production, manufacturing, processing of agricultural, forestry and fisheries products, textile and garments, electronic components, construction of socio-economic infrastructures. SMEs operating in lottery, real estate, securities, banking and finance, and insurance are not eligible.
- Lowering the 2012 land rent by 50 percent: This measure is applicable for enterprises in trading and services as per Decision 2903/QD-TTg issued in November 23, 2011.
- Extension (up to 12 months) of deadlines for paying land use fees for developers facing financial hardship: The PPCs will consider and decide the specific extension time for individual (or a group of) projects after reporting to the corresponding People's Council.

- Other cost reduction measures that will be proposed to the National Assembly for review and decision: This includes a 30 percent reduction of 2012 CIT for SMEs and labor-intensive enterprises in production, manufacturing, processing of agricultural, forestry and fisheries products, textile and garments, electronic components, construction of socio-economic infrastructures. SMEs operating in lottery, real estate, securities, banking and finance, and insurance are not eligible.

- Demand stimulus: Mobilization of 2 trillion VND for concretization of rural canals, construction of rural roads, and pumping stations for agriculture.

- Accommodating monetary measures. The SBV will further reduce lending rates, and provides support to rural areas, SMEs, enterprises in export and supporting industries. It also intends to implement measures for debt restructuring to create favorable conditions for lending to enterprises and accelerate the restructuring process for commercial banks.

The package as outlined by Resolution 13 is much smaller than the economic stimulus package adopted in 2009. The package is estimated to cost 29 trillion VND, and its fiscal impact will be 9 trillion VND.

53. We expect growth to remain sluggish during 2012 and to fall marginally relative to 2011. While. Vietnam's economy is slowing down, the situation is not as dire as it was in 2009, when the economy grew at 5.3 percent. Certain sectors, especially exports, are still growing rapidly compared to a sharp across the board slowdown in 2009. Therefore the contribution of net exports to growth should be significantly higher in 2012 than in the past. Second, the impact of the accommodative monetary stance will start to show results during the last two quarters of the year, which together account for 55 percent of annual output. In line with our growth expectations, we also expect inflation to reverse its downward trend during the last quarter and end the year in the 8-9 percent range.

Table 6: Key Macroeconomic Indicators

	2009	2010	2011/e	2012/f	2013/f
Real GDP (%change y-y)	5.3	6.8	5.9	5.7	6.3
Consumer price index (% change, year-end)	6.5	11.8	18.1	8-9	6.0
Government balance, general (% GDP) 1/	-7.2	-5.2	-2.7	-3.6	-2.8
Public sector debt (% GDP) 2/	51.2	54.2	48.8	49.0	47.7
Current account balance (% GDP)	-6.6	-4.1	-0.5	-1.6	-1.4

1/ Includes off-budgetary items
2/ public and publicly-guaranteed debt

54. In the medium-term, implementing a credible restructuring program can provide the best stimulus the economy needs. In October 2011, the Government announced its intention to restructure state-owned enterprises, the public investment regime and the financial sector. Blueprint for reform in each of these areas already exist. For example, MPI is working to develop a restructuring plan for public investment including the formulation of a Decree on medium-term investment planning, a new law on public investment, and a law on spatial planning. A report by National Steering

Committee for Enterprise Restructuring and Development (NSCERD) was published in December 2011 with ambitious targets for SOE equitization. It was followed by a draft restructuring plan for SOEs for 2011-15 prepared by MOF's Steering Committee, which includes measures on management and supervision of state capital and performance monitoring of SOEs. Decision 254 on "Restructuring credit institution system in the 2011-2015 period" provides a framework to deal with weak banks. But what has so far been missing is a 'restructuring roadmap' with a clear timetable and an effective oversight mechanism for implementing it. Announcing such a roadmap and steadfastly implementing it, as was done with Resolution 11, could be the most effective stimulus package for a middle-income Vietnam.

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