INTERNATIONAL MONETARY FUND
WASHINGTON, D.C. 20431

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Mr. Konishi
Country Director
Asian Development Bank
Hanoi

July 26, 2010

Ayumi

Dear Mr. ~~Konishi~~,

Thank you for your request for an assessment letter for the SME development program which you will bring to your board in September. I have consulted with headquarters and they informed that the public information notice for the 2010 Article IV report, which will be issued this week, can be used as an alternative to an assessment letter.

I would be grateful if you could let me know if that is acceptable to your management.

With best regards,

Benedict Bingham
Senior Resident Representative

IMF Executive Board Concludes 2010 Article IV Consultation with Vietnam

Public Information Notice (PIN) No. 10/127
September 8, 2010

On July 28, 2010, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Vietnam on a lapse of time basis. Under the IMF's lapse of time procedures, the Executive Board completes Article IV consultations without convening formal discussions.

Background

Facing the downturn from the global crisis, Vietnam successfully supported growth in 2009, realizing a 5.3 percent growth, one of the better performances in developing Asia. However, the sizable stimulus measures resulted in elevated macroeconomic risks. The trade deficit deteriorated since the summer, and domestic residents dramatically shifted from dong assets into U.S. dollar assets and/or gold, leading to a substantial balance of payments deficit (8¾ percent of GDP) and significant depreciation pressures on the dong. The parallel market exchange rate fell to about 10 percent below the weaker end of the official band in late 2009, and by end-2009 gross international reserves (GIR) declined to about two months of imports projected for 2010.

In November 2009, the authorities shifted the policy priority from growth to macroeconomic stability. The dong was devalued by 5½ percent in November 2009 and by another 3½ percent in February 2010. Monetary tightening through liquidity squeeze in December, the termination of interest subsidy scheme for short-term loans at end-2009, and the liberalization of lending rates in early 2010 led to a slowdown in credit growth, affecting especially activity in construction and financial services. Most fiscal stimuli were also terminated at end-2009. Partly as a result, real GDP growth slowed in 2010 Q1.

In late March 2010, the government began to balance growth and stability, marking the largely successful exit from the substantial stimulus policies during 2009. Market confidence in the dong has been restored, and both interbank and parallel exchange rates appreciated back within the official band and have remained stable. Inflation is subdued, thanks largely to a decline in rice prices, and the trade deficit has been contained. Yet, the market does not seem fully convinced about the sustainability of the existing macroeconomic stability later in 2010, judging by the wide spreads between the overnight interbank rates and the rates for longer maturities especially beyond three months. Inadequate clarity on government policies, exemplified by repeated statements by the government to favor lower commercial lending and deposit rates, while lowering short-term interest rates through its open market operations, has undermined market confidence. Thus, the current macroeconomic stability does not appear robust. The immediate goal for the government is, therefore, to sustain market confidence and take the opportunity to rebuild GIR.

The near-term outlook hinges critically on maintaining current macroeconomic stability. In staff's baseline scenario, with the assumption that stability is maintained, real GDP growth for 2010 is projected to be 6½ percent, underpinned by buoyant private investment, consumption,

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

and non oil exports. Current inflation projection of 10.4 percent (y/y) for the year as a whole depends importantly on the development of commodity and food prices.[2] The current account deficit is expected to narrow to 9 percent of GDP in 2010, and short-term capital outflows (including the errors and omissions) are expected to moderate significantly, allowing a modest build up of reserves in 2010. This baseline scenario is most sensitive to domestic macroeconomic stability, which could be affected by perceived occasional incoherence between the government's policy stance and its public statements. External downside risks, including possible spillover effects from Europe, are expected to be manageable provided that macroeconomic management remains prudent.

Fiscal policy is on track of consolidation in 2010. The 2009 overall fiscal deficit is estimated to have widened to about 9 percent of GDP (from about 1 percent of GDP in 2008), mainly reflecting declines in oil revenues and a spending surge related to the stimulus package.[3] With most stimulus measures expiring at end-2009 and a favorable growth outlook ahead, the fiscal deficit is projected to narrow to about 6 percent of GDP in 2010, largely owing to a decline in total investment spending by 3 percentage points of GDP over 2009.

Bank profitability was supported by high loan growth and low loss provisioning in 2009, but in 2010 it may not reach such high levels. Average return on asset of the six largest banks, including four state-owned commercial banks (SOCBs), increased to an annualized 1.9 percent (1.5 percent in 2008). Noninterest income (e.g., gold trading) contributed to higher profitability in some private banks. However, in 2010, narrowing interest margin, higher provisioning costs, the moderation of credit growth, and the closure of gold trading could constrain profitability at some banks. At end-2009, nonperforming loans (NPL) declined to 2.0 percent (2.1 percent in 2008) according to the official report, partly due to rapid credit growth. However, pressure on credit quality, including of the large loan portfolio disbursed under the interest subsidy program, may translate into higher NPL down the road.

Executive Board Assessment

In concluding the 2010 Article IV consultation with Vietnam, Executive Directors endorsed staff's appraisal, as follows:

Vietnam has managed to ride out difficult challenges in recent years, which deserves international acknowledgment. As soon as an overheated economy in 2007, owing to rapid capital inflows, was successfully cooled down, an external demand shock triggered by the global crisis had to be countered in 2009 by a sizable stimulus package. As the stimulus policy began to threaten macroeconomic stability toward end-2009, a successful exit (monetary and fiscal tightening) was made. The fact that most fiscal measures were introduced with a sunset clause also helped the timely exit.

Macroeconomic stability is maintained for now. The policy tightening that started at end 2009 has stabilized economic and financial conditions, and helped restore market confidence, as evidenced by the stable dong exchange rates in both the interbank and the parallel markets. Whether the current stability can be sustained through the rest of 2010 and beyond depends on whether the government can maintain and enhance market confidence by limiting, for instance, deterioration in the trade deficit or a decline in the U.S. dollar liquidity in the financial system. Thus the repeated announcements by the government about the need to lower the commercial lending rates may be counter-productive.

Maintaining a solid economic recovery will require the government to prioritize among its multiple goals. The government has stated that in 2010 it aims at the growth target

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[2] Headline inflation in July slowed to 8.2 percent (y/y). While food prices increased, the decline in items such as construction materials and fuel contributed to the deceleration.

[3] Based on IMF definition, which differs from the national definition in, for example, the treatments of the local government surplus and off-budget investment spending.

(6.5 percent), inflation target (7 percent, now officially projected at 8 percent), credit growth target (25 percent), and money supply growth target (20 percent), while maintaining a stable dong exchange rate. It may be difficult to convince the market that the government can achieve all these objectives with relatively blunt policy tools, namely OMOs and budget, especially if there's no apparent hierarchy of objectives. A lack of coordination between monetary and fiscal policies, or the appearance thereof, would amplify market skepticism. The government, therefore, needs to convince market participants that its priority rests with macroeconomic stability. For this purpose, staff believes that maintaining the current stable exchange rate, and taking the opportunity to rebuild GIR, should be the immediate goal for the government. Once the government's credential for macroeconomic stability is established, and GIR is further built up, staff believes that the government will be able to adopt a more flexible exchange rate regime without risking resurgent devaluation pressures.

Monetary policy should be prudent and its effectiveness should be further strengthened. Further loosening, real or perceived, could disrupt the existing macroeconomic stability, and could inflict substantial damage to the growth prospect, not just for 2010, but even for the medium term. To enhance the effectiveness of monetary policy, the operational improvement in OMOs, and the gradual normalization of the interest rate, structure should also progress. The early indications are that the new SBV Law, approved in late June, strengthened operational authority of the SBV, though the details have yet to be clarified.

Exchange rate regime should be reformed over the medium term. In the medium term, a move from the current regime that focuses on the bilateral dong/U.S. dollar exchange rate to a system that is based on a basket of currencies including those of regional trading partners may be appropriate. In the process, a wide use of the U.S. dollar in the economy (partial dollarization) could be wound down. In addition, further exchange rate flexibility is encouraged once necessary infrastructure, particularly in terms of hedging instruments, is readily available for the private sector to manage foreign exchange rate risks effectively.

There is room for further reduction in the budget deficit in the medium term. In 2010, total investment spending is expected to decline by 3 percentage points of GDP from the 2009 level to about 11 percent of GDP. Staff believes that there is room for further reduction in investment spending, for example, by project prioritizing, increased cost efficiency, and the use of PPP and other innovative financing methods. This would enable the government to reduce both the budget deficit and the public and publicly-guaranteed debt levels over the medium term.

Strengthening the financial sector requires further reform. While welcoming the ongoing efforts to strengthen supervisory capacity, more could, and should be done. An FSAP is expected to help the authorities establish a reform agenda and a concrete timeline. One of the fundamental problems facing Vietnam is over-banking: while the introduction of the minimum capital requirement at end-2010 could promote consolidation of smaller banks, further streamlining should be pursued in the medium term. The equitization (privatization) of SOCBs should also be advanced. As the economy is driven more by market principles, the government is required to change its style of policy conduct. For instance, moral suasion could create distortions that need to be addressed later at a higher cost. Reforms of SOEs and SOCBs would not only provide a level playing field, but also raise the efficiency of the economy. Most importantly, transparency in government intentions, based on higher quality data published timely, should be further advanced to provide market players predictability.

Vietnam: Selected Economic Indicators, 2006–11 [1/]

Nominal GDP (2009): US$93.2 billion	GDP per capita (2009): US$1,068
Population (2009, est.): 87.2 million	Fund quota: SDR 329.1 million

	2006	2007	2008 Est.	2009 Est.	2010 Proj.	2011 Proj.
Real GDP (annual percentage change)	8.2	8.5	6.3	5.3	6.5	6.8
Saving and investment (in percent of GDP)						
Gross national saving	36.5	33.3	29.0	30.1	29.8	30.3
Private	28.1	27.0	21.4	25.6	25.8	25.3
Public	8.4	6.3	7.5	4.6	4.0	5.0
Gross investment	36.8	43.1	40.9	38.1	38.8	38.4
Private	26.7	32.6	31.0	23.9	29.1	29.4
Public	10.1	10.6	9.9	14.2	9.7	9.0
Consumer price inflation (annual percentage change)						
Period average	7.5	8.3	23.1	6.7	10.4	8.3
End of period	6.7	12.6	19.9	6.5	10.3	6.2
GDP deflator	7.3	8.2	22.1	6.0	10.6	9.0
General government (in percent of GDP)						
Revenue and grants	28.7	28.7	29.0	26.7	26.9	27.2
Of which: Oil revenue	8.6	6.9	6.0	3.6	3.6	3.7
Expenditure	29.1	30.6	29.8	35.6	32.8	31.5
Plan 2/	27.5	29.4	27.6	31.7	28.6	27.8
Off-budget, onlending and other 3/	1.5	1.2	2.2	3.9	4.2	3.7
Overall fiscal balance 4/	-0.4	-1.9	-0.9	-8.9	-5.9	-4.3
Non-oil primary fiscal balance 4/	-8.1	-7.7	-5.9	-11.1	-8.3	-6.7
Money and credit (annual percentage change, end of period)						
Broad money (M2)	33.6	46.1	20.3	29.0	24.5	28.4
Credit to the economy	25.4	53.9	25.4	39.6	25.0	30.9
Interest rates (in percent, end of period)						
Nominal three-month deposit rate (households)	7.9	7.8	8.1	10.7	...	...
Nominal short-term lending rate (less than one year)	11.8	11.8	11.5	12.7	...	...
Current account balance (including official transfers)						
(In billions of U.S. dollars) 5/	-0.2	-7.0	-10.8	-7.4	-9.4	-9.5
(In percent of GDP) 5/	-0.3	-9.8	-11.9	-8.0	-9.0	-8.1
Exports f.o.b. (annual percentage change, U.S. dollar terms) 5/	22.7	21.9	29.1	-8.9	14.5	16.9
Imports f.o.b. (annual percentage change, U.S. dollar terms) 5/	22.1	38.3	28.1	-13.3	16.2	14.3
Foreign exchange reserves (in billions of U.S. dollars, end of period)						
Gross official reserves, including gold	11.5	21.0	23.0	14.1	15.4	19.2
(In months of next year's imports of GNFS)	2.1	3.0	3.8	2.0	1.9	2.1

Nominal GDP (2009): US$93.2 billion		GDP per capita (2009): US$1,068
Population (2009, est.): 87.2 million		Fund quota: SDR 329.1 million

	2006	2007	2008 Est.	2009 Est.	2010 Proj.	2011 Proj.
External debt (in percent of GDP, using interbank exchange rate) 6/	31.5	32.3	33.5	40.7	40.8	41.3
External debt (in percent of GDP, using official exchange rate) 6/	31.6	32.6	32.5	39.5	38.3	…
Total public and publicly-guaranteed debt (in percent of GDP)	42.9	45.6	43.9	49.0	51.3	50.9
Dong per U.S. dollar exchange rate (end of period)	16,068	16,003	17,486	18,479	...	...
Nominal effective exchange rate (end of period) 7/	77.4	73.3	73.8	62.5	...	...
Real effective exchange rate (end of period) 7/	96.8	100.2	119.1	106.8	...	...
Memorandum items:						
GDP (in trillions of dong at current market prices)	974	1,144	1,485	1,658	1,953	2,273
Per capita GDP (in U.S. dollars)	724	835	1,048	1,068	1,178	1,312

Sources: Data provided by the Vietnamese authorities; and IMF staff estimates and projections.
1/ Figures in 2008–11 are staff estimates and projections unless otherwise indicated.
2/ 2010 expenditure projection assumes some spending out of expected revenue over performance.
3/ Includes costs of interest subsidy schemes in 2009 and 2010.
4/ Excludes VDB net lending.
5/ Includes gold imports in 2008 and gold re-exports in 2009.
6/ Includes private debt.
7/ 2000 annual average=100.