MACROECONOMIC AND DEBT SUSTAINABILITY ASSESSMENT[1]

A. Summary Conclusions

1. **Macroeconomic conditions have stabilized.** The economy now enters its fourth year of macroeconomic stability with strengthening external trade and capital inflows, and increasing levels of foreign exchange reserves. Inflation fell to 4.1% in 2014, the lowest level in 10 years. Easing price pressures have allowed the central bank to cut policy rates, boosting private sector credit growth. The medium term outlook remains positive, with economic growth expected at 6.1% and 6.2% in 2015 and 2016, respectively. However, a return to more rapid rates of economic growth remains hampered by slow-moving structural reforms and global uncertainty.

2. **Low risk of external debt distress.** Based on the LIC Debt Sustainability Analysis (DSA), Vietnam is at low risk of external debt distress as public and publicly guaranteed (PPG) external debt, and total public debt remain below vulnerability thresholds and benchmarks under the baseline scenario.[2] However, overall debt is becoming a concern due to an increase in domestic debt and prospects for loose fiscal policy going forward. Public debt indicators are significantly higher than in the previous DSA, and are projected to worsen in the medium-term before beginning to decline. Specifically, the PPG debt ratio is expected to rise to around 60 percent of GDP in 2017 before falling to around 48 percent of GDP at the end of the projection period. The ratio of debt service to revenue is also projected to rise throughout most of the projection period as the level of concessionality of Vietnam's debt is projected to decline. A scenario that keeps the primary fiscal deficit fixed at its 2013 level would result in unsustainable debt dynamics. An alternative scenario that simulates banking sector distress could also bring the present value (PV) of debt-to-GDP ratio above the benchmark for public debt for most of the projection period.[3]

B. Macroeconomic Assessment

3. **Viet Nam's economic outlook continues to improve**. Economic growth lifted to 6.0% in 2014, up from 5.4% in 2013 and 5.2% in 2012. Private consumption accelerated by almost a percentage point to 6.1%, reflecting improved consumer sentiment. Investment also strengthened in 2014 as gross capital formation rose by 8.9%, spurred by a 16% increase in foreign direct investment (FDI) disbursements and lower domestic interest rates. In parallel, inflation continues to decelerate, reaching an average 4.1% in 2014, the lowest in 10 years, owing to better food production and lower global prices for oil and commodities. By the end of 2014, inflation was just 1.8%. On the external front, the current account recorded its fourth consecutive surplus, estimated at $8.1 billion or 4.4% of GDP helping to rebuild foreign exchange reserves to around 3 months of import cover.

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[1] This debt sustainability assessment is based on International Monetary Fund Staff Report for the 2014 Article IV Consultation. This assessment was prepared by the staffs of the International Monetary Fund and the International Development Association in consultation with the Asian Development Bank.

[2] Vietnam's policies and institutions, as measured by the World Bank's Country Policy and Institutional Assessment, averaged 3.78 over the past three years, placing it as a "strong performer." The relevant indicative thresholds for this category are 50 percent for the present value (PV) of the debt-to-GDP ratio, 200 percent for the PV of the debt to-exports ratio, 300 percent for the PV of the debt-to-revenue ratio, 25 percent for the debt service-to-exports ratio, and 200 percent for the debt-service-to-revenue-ratio. These thresholds are applicable to public and publicly guaranteed (PPG) external debt.

[3] This DSA was prepared jointly by Bank and Fund staff, in consultation with the Asian Development Bank (ADB). The debt data underlying this exercise were provided by the Vietnamese authorities and donor partners. Data beyond end-2013 are staff estimates and projections.

4. ADB expects growth to edge upwards over the next two years with growth forecast at 6.1% and 6.2% in 2015 and 2016, respectively. Better economic performance in the major industrial economies— particularly the US, Viet Nam's biggest export market—will spur exports, although this positive effect will be partly offset by slowing growth in the People's Republic of China (PRC). In particular, exports of manufactured products will continue to expand, given that 76% of last year's disbursed FDI was directed into manufacturing. Expanded employment, low inflation, and growth in remittances, which reached almost $10 billion last year, will further bolster private consumption. Restrictions on foreign investment in real estate will be eased from July 2015, which should support other measures taken by the government to revive investment in property. In the medium term additional impetus for trade and investment should come from new trade agreements, including Viet Nam's integration into the Association of Southeast Asian Nations (ASEAN) Economic Community from late 2015, and the planned easing of restrictions on foreign ownership of property and companies listed on the stock exchange.

5. On the back of this improving economic outlook, Moody's Investors Service raised Viet Nam's sovereign credit rating by one notch to B1, and Fitch upgraded its rating to BB–, citing improved macroeconomic stability and stronger external accounts. These actions supported the government's sale of $1 billion in 10-year bonds at an annual coupon rate of 4.8%, the lowest rate of its three issuances of offshore debt denominated in US dollars since 2005.

6. Yet, while Viet Nam's economic performance slowly improves, a number of structural factors continue to limit its ability to reach its full growth potential and re-establish a trajectory that will allow it to reach upper middle income status. To enhance coordination among government agencies and local authorities in implementing financial restructuring plans, and in NPL resolution in particular, an Inter-ministerial Steering Committee led by a Deputy Prime Minister was set up in March 2014. The government also approved new laws to guide divestment of SOE assets and accelerate their commercialization, and to establish an asset management company to address the large overhang of NPLs. The number of SOEs equitized or partly privatized has increased into 2014. However, the government has so far been unable to meet targets for the number of SOEs equitized, and NPL resolution has been slow to gain momentum. Over the longer term, lifting Viet Nam towards upper middle income status will depend heavily on involving more domestic firms in global value chains so they can benefit from foreign funding and technology and gain access to global markets, as well as generate spillover benefits to the whole economy.

C. Debt Sustainability Assessment

7. **Debt distress is not imminent but indicators signal increasing risk.**[4] Current indicators place Vietnam at low risk of debt distress. For external debt, Vietnam's current account surpluses and foreign direct investment flows help keep the risk of debt distress well below benchmark levels. However, for total public debt, the fixed primary balance stress test indicates that maintaining primary deficits at their current level going forward would increase the present value of debt relative to GDP to unsustainable levels. In addition, domestic interest rates and/or private external debt could increase as public financing pressures build. A worst case scenario stress test for the public debt (a one-time nominal depreciation of 30 percent in the first year of the projection period) would bring the present value of debt relative to GDP to within 10 percent of the threshold level for debt distress in 2016–18. A bank distress scenario

[4] This DSA covers the public and publicly guaranteed external debt and the domestic debt of the general public sector, including the central government, local governments and state-owned enterprises (SOEs).

that adds 15 percent of GDP to the public debt in two years would bring the public debt above the threshold for most of the projection period. This highlights the increasing vulnerability of Vietnam's current debt path, particularly to a large debt shock.

8. The government broadly agrees that the risk of external debt distress remains very low, but the profile of public debt has worsened relative to last year. The government stated that the recent increase in public debt is necessary to finance ongoing public investment projects, but recognizes that it is reaching levels that warrant increased attention. Nevertheless, the government noted that the debt ratio remains well below the 65 percent of GDP limit that has been imposed by the National Assembly. Should debt continue to rise as in the baseline, the government would begin a consolidation. The government recognizes the risks surrounding the strategy to address banking and SOE reforms, but continued to emphasize that budget resources would not be used to recapitalize banks or restructure SOE debt.

9. **Underlying Assumptions.** The assumptions for this DSA differ from the previous DSA in a number of areas.[5] First, the current DSA assumes slightly higher near-term growth. Specifically, the current DSA assumes real GDP growth rising gradually to 6 percent through 2020 in line with potential, and then declining in the long term to 5½ percent as the demographic dividend abates and the economy matures. The previous DSA had real GDP growth rising to 5½ percent through 2020, and stable thereafter. In addition, the current DSA assumes lower inflation in line with the lower inflation outcome for 2013 and projections for a continued negative output gap in the medium-term, closing only gradually. However, the current DSA assumes higher net borrowing levels by the government continue in line with a loose fiscal policy through 2017 that brings the debt ratio to 60 percent of GDP, before beginning a gradual consolidation thereafter. The authorities' financing strategy going forward relies increasingly on domestic debt, as they have emphasized the need to develop the domestic debt market. In addition, as the concessionality of external debt is reduced in line with Vietnam's graduation from low-income status in 2017, the advantage of accessing external debt will diminish. The previous DSA assumed a fiscal consolidation starting in 2013.

10. **Public debt DSA.** Public debt remains below the thresholds for distress in the baseline, but without a gradual consolidation the risk of debt distress could rise rapidly. Public sector debt is projected to increase in nominal terms, reaching around 60 percent of GDP by 2017. As noted above, the assumptions underlying this scenario are that a gradual consolidation takes place such that the debt ratio begins to decline after reaching this level from 2020 forwards. The

[5] Real GDP growth is projected at 5.6 percent in 2014, and rising gradually to 6 percent in 2018–2020. After 2020 growth is projected to decline gradually to 5½ percent as the demographic dividend dissipates and the economy matures. Inflation is projected to decline gradually from its level of 6 percent in 2013 to 4½ percent in the medium- and long-term. The current account is expected to remain in surplus in the near-term due to strong export growth related to foreign direct investment and demand from major trading partners. In the medium-term the current account is expected to deteriorate as the economy recovers, and reach the deficit "norm" of 4½ percent in the long term, mostly financed by continued FDI flows. The capital and financial account surplus is projected to continue to be negative in 2014, but should stabilize in the medium-term at a surplus of around 3½ percent of GDP related to FDI inflows and a gradual expansion and opening of the domestic capital market. Reserve coverage is expected to remain at around 2½ months of imports in 2014, but to rise to about 3½ months of imports by 2016 and stabilize at this level thereafter. The effective average interest rate on foreign borrowing is expected to be about 2 percent in 2014 reflecting the concessionality of borrowing in the short-term, but to rise to about 3½ percent in the long run. Net borrowing by government is projected to be high in 2014, and continue at a high though declining level through 2017, to bring the debt ratio to around 60 percent of GDP. It is expected to decline in the long run, to bring the overall debt ratio to around 48 percent of GDP by 2034. The primary deficit is expected to be around 5 percent of GDP in 2014 and to decline gradually to around 2 percent of GDP in 2019. Maturing international bonds are assumed to be rolled over. Contingent liabilities or exceptional financing are not assumed in the baseline scenario.

ratio of the PV of debt to GDP also rises before beginning a gradual decline. However, at all times it is below the benchmark of 74 percent of GDP.

11. **Continuing deficits and currency devaluation increase vulnerability.** A scenario that maintains the fiscal deficit at 4 percent of GDP (2013) would result in the present value of debt to GDP becoming unsustainable and rising throughout the projection period. Under an alternative scenario, a one-time nominal depreciation of the exchange rate by 30 percent in the first year of the projection period (the most extreme shock), would cause a 10 percentage points increase in the present value of debt to GDP to just below the benchmark in 2016–18 before beginning to decline thereafter. Under a historical scenario stress test, the ratios of the present value of debt to GDP, exports and revenue would all become negative over the long-term. This scenario projects a debt ratio based on real GDP growth, the GDP deflator, the non-interest current account and sets new FDI flows at their 10-year historical average. This outcome reflects the historical non-interest current account surplus, the high level of FDI inflows and the high grant element of Vietnam's external debt in the last 10 years.

12. **Banking sector distress would likely breach the benchmark.** The scenario assumes an additional 15 percent of GDP in liabilities are absorbed by the government as part of a banking recapitalization over the first two years of the projection period. GDP growth is assumed to fall to 3 percent in both years before returning to its baseline path. Additional debt is assumed to be domestic and on similar terms to the current domestic debt (five years maturity and 7 percent coupon). Under this scenario the present value of debt to GDP would hit the benchmark of 74 percent around 2019 and remain above the benchmark for most of the projection period. The present value of debt to revenue ratio would increase to over 350 percent, and the debt service to revenue ratio would rise to over 70 percent in the long-term. These ratios would be higher if financing conditions were less favorable.

13. **External DSA.** Under the baseline scenario, the ratio of the present value of PPG external debt to GDP is projected to decline in the long-term, and to remain well below the relevant thresholds. In addition, the ratio of the present value of PPG external debt to exports and to revenue also declines gradually during the projection period and remains well below the relevant thresholds. The debt service to revenue ratio is projected to rise in the medium-term before declining gradually, largely because the grace period for recent borrowing is ending and revenue growth is projected to slow down. If remittances are included in the denominator of the debt indicator calculations, these results continue to hold.

14. **Level and composition of debt**. Vietnam's public debt has risen in recent years. Total PPG debt (domestic and external) increased to an estimated 57.3 percent of GDP in 2014 while domestic PPG debt increased to 30.9 percent of GDP. Recent increases in PPG domestic debt are due to fiscal financing requirements in 2013 and 2014 which were moderately higher than projected. On the other hand, external debt has been relatively stable. At end-2014, total external debt (including private sector debt) amounted to 37.3 percent of GDP, while public and PPG external debt represented 26.4 percent of GDP.

15. On the domestic side, marketable and nonmarketable securities (bonds) represent approximately 13 percentage points of GDP while loans and advances from private sector financial institutions represents 6 percentage points of GDP. The domestic publicly guaranteed debt of the SOEs represents an additional 6 percentage points of GDP. Domestic debt is in local currency and the effective nominal interest rate has remained at around 5 percent between 2010 and 2013. The government issues bonds in the domestic market with an average term of

3.8 years (2013) and a coupon ranging from 7.5 to 9 percent. These bonds are held primarily by banks, with a small proportion (about 7 percent of the outstanding stock) held by nonresidents.

16. On the external side, debt owed to multilateral creditors represents 11 percent of GDP, debt owed to bilateral creditors represents 9½ percent of GDP, while debt to commercial creditors represents only 1 percent of GDP.[6] The publicly guaranteed debt of SOEs held by commercial creditors represents 5 percent of GDP. Total private external debt is estimated at 5.6 percent of GDP.

[6] Approximately 12 percent of PPG external debt has a grant element.