Viet Nam

Macroeconomic turbulence intensified in the first several months of 2008 due to a combination of external and internal factors. Inflation accelerated, the trade deficit widened, and the currency came under downward pressure. In response, the Government adopted measures to stabilize the situation. Economic growth slowed in the first half of 2008, and the overall economic situation started to improve at midyear. Growth is now expected to be lower, inflation higher, and the current account deficit wider in both 2008 and 2009 than forecast in April this year. Risks to the projections are tilted to the downside. Still, medium- to long-term economic prospects remain good.

Updated assessment

According to preliminary official statistics, GDP grew by 6.5% in the first half of 2008, below the rates recorded in recent years (Figure 3.10.1). Anti-inflation measures taken by the Government restrained growth in investment and halted the expansion of construction. Manufacturing continued to grow robustly, although at a slower pace than in recent years. Output of crude oil fell to 290,000 barrels per day from 312,000 barrels in 2007 as some oil fields neared depletion and the Government tried to conserve oil for future domestic processing. Overall industrial output expanded by 7.0% in the first half, moderating from more than 10% in the past 5 years.

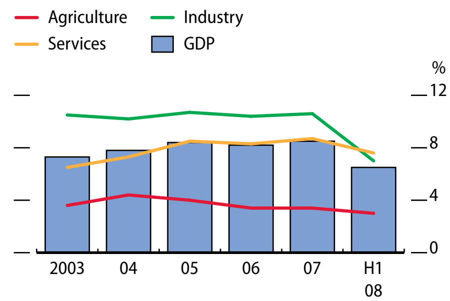
Services grew by 7.6%, from around 8% in recent years. Growth of transport, storage, and communications services picked up, in part due to rapid expansion of merchandise trade, whereas growth of other services, particularly those related to real estate, slowed. Agriculture (including forestry and fisheries) recorded modest growth of 3.0% in the first half of the year, slowing from 3.4% in 2006 and 2007. The winter–spring rice harvest was bountiful and fisheries performed strongly, but forestry and animal husbandry were stagnant, the latter hit by pig and poultry epidemics in late 2007–early 2008.

Inflation on a year-on-year basis accelerated to 20.3% for the first half of 2008, and reached 28.3% in August (Figure 3.10.2). The principal causes were expansionary fiscal and monetary policies over several years, the rise of world commodity prices, and some supply-side jolts to food prices early in the year caused by the pig and poultry epidemics and bad weather. The price index for food items, with a combined weight of almost 43% in the consumer price index, soared by 44.2% in the 12 months to August 2008. Rising prices for food, in particular, hurt living standards for low-income earners in cities (Box 3.10.1).

Merchandise exports on a free on board basis grew strongly by 31.8% in January–June 2008, mainly reflecting higher world prices for Viet Nam's export commodities. Indeed, the volume of exports of crude oil,

This chapter was written by Bahodir Ganiev of the Viet Nam Resident Mission, ADB, Hanoi.

3.10.1 GDP growth by sector



Source: General Statistics Office of Viet Nam, available: http://www.gso.gov.vn, downloaded 29 August 2008.
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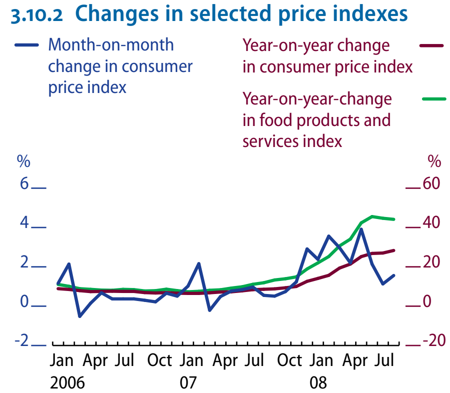
3.10.2 Changes in selected price indexes



Source: General Statistics Office of Viet Nam, available: http://www.gso.gov.vn, downloaded 29 August 2008.
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3.10.1 Impacts of recent increases in world food and fuel prices

Viet Nam is a net exporter of food, selling about 4.5 million tons of rice, 1.2 million tons of coffee, and significant amounts of seafood, cashew nuts, fruit, vegetables, and tea each year. It imports about 1.3 million tons of wheat and large amounts of dairy products.

It also exports crude oil and imports refined products. Until recently, these exports were greater than the imports, and Viet Nam was a net oil exporter. In the first half of 2008, however, the value of oil-product imports exceeded the value of crude-oil exports, turning the country into a net oil importer.

Accordingly, recent increases in world food and fuel prices have had a mixed impact on the economy. On the one hand, they boosted the value of exports, incomes of food and oil producers, and government revenues. On the other, they contributed to the soaring value of imports and the widening trade and current account deficits. Government controls over domestic fuel prices limited the impact of surging world fuel prices on inflation, but higher global food prices had a large impact.

To limit the upward pressure on inflation from rising world prices, the Government froze domestic fuel prices in late March 2008, imposed a temporary ban on new contracts for rice exports in April, and raised export taxes on crude oil and coal in May and June. It also lowered its target for rice exports in 2008 from 4.5 million tons to 3.5 million tons and set minimum prices for rice exports. State enterprises importing fuel for domestic distribution reportedly lost about $900 million in the first half of this year because of the large gap between world and domestic fuel prices.

More recently, however, some of these measures have been reversed, at least partly. Domestic prices of fuels were raised substantially in July, lifting them close to prices in neighboring countries, both to cut the cost of subsidies and to reduce smuggling. For example, the price of gasoline was put up by 31%, although it was trimmed by 10.5% in August as global oil prices eased. The Government also raised the target for rice exports this year to 4.6 million tons in August, following a bumper winter–spring harvest and declines in domestic rice prices.

At the household level, higher food prices have increased both expenditure on food and income from food production, so their net welfare impact has varied. Households that are net consumers of food have lost out, whereas those that are net producers have benefited. Since most urban households are net consumers of food, the urban population as a whole has suffered. By the same token, the rural population as a whole has benefited because most rural households are net producers of food.

Using 2006 household survey data and assuming that there are no substitution and indirect effects, research commissioned by the World Bank (Vu and Glewwe 2008) has found that a 10% rise in food prices in Viet Nam makes 88% of urban households worse off, compared with 46% of rural households. For the country as whole, it increases average household welfare by 1.7% and reduces the poverty rate by 0.6 percentage points, even though it makes 56% of households worse off. The reason for this apparent paradox is that net food producers on average gain more than net food consumers and poor households tend to be net food producers.

By contrast, the welfare effect of higher fuel prices has been negative for most households. In the case of net food consumers, it has exacerbated the adverse impact of increased food prices. In the case of net food producers, higher fuel prices have offset—at least partly—the net positive effect of increased food prices because they raise prices of agricultural inputs, such as fertilizers.

The Government provides social assistance to poor households and communities with a relatively high poverty incidence through various fairly well-targeted programs. It increased budgetary expenditure on these programs to the equivalent of 1.7% of GDP in the first half of 2008, from 0.8% in all 2007. However, the poverty lines that are used in classifying households into poor and nonpoor have not been adjusted for the high inflation this year. As a result, many (particularly urban) households that have been pushed into poverty by high inflation do not at present receive assistance.

Reference

Vu, Linh, and Paul Glewwe. 2008. "Impacts of Rising Food Prices on Poverty and Welfare in Vietnam." Paper commissioned by the World Bank.

coal, and many agricultural products declined or grew moderately, yet their export values rose considerably. Imports (cost, insurance, freight basis) surged by 60.3%, nearly double the pace of exports, due to a combination of higher world prices and increased import volumes. Unlike exports of crude oil, imports of refined oil products increased in both volume and value terms (Figure 3.10.3).

Reports that import taxes would be raised on goods such as cars and motorcycles, and expectations that the dong might be devalued

significantly, fueled precautionary and speculative imports. The volume of imports of gold, cars, motorcycles, steel, urea, paper, and cotton increased by 30–414% in the first half. Imports of machinery and equipment also rose strongly. Consequently, the trade deficit widened to $14.8 billion in the first 6 months, a wider gap than was recorded for all 2007 (Figure 3.10.4). The current account deficit was an estimated 25.0% of GDP in January–June 2008, more than double the year-earlier level.

Increased inflows of foreign direct investment (FDI) and disbursements of official development assistance financed most of the current account deficit. The overall balance of payments recorded a small surplus. Gross official reserves increased slightly from $21.0 billion at the beginning of the year to $21.4 billion at end-June 2008 (Figure 3.10.5).

Early in the year, the authorities relied primarily on monetary policy to rein in inflation and the trade deficit. The State Bank of Viet Nam raised its policy interest rates (base rate, discount rate, and refinancing rate) and increased reserve requirements for banks in early February, and imposed a ceiling on deposit rates in late February. It also issued central bank bills in March, which commercial banks were required to buy. These measures had a limited immediate impact on inflation and the trade deficit, but put a great strain on the banks.

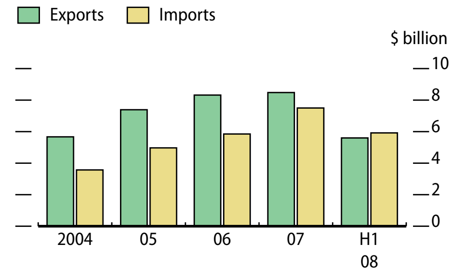
In April, the Government essentially changed its top policy priority from maintaining high rates of economic growth to curbing inflation and the trade deficit. The central bank hoisted policy interest rates, thereby raising a ceiling on lending rates, in May and again in June (when it lifted the base rate to 14.0%). The ceiling on deposit rates was abolished.

Moreover, the Government tightened fiscal policy as well as control over what had become an aggressive investment expansion by state enterprises. It increased some taxes (such as a tariff and excise tax on cars and export taxes on oil and coal) and stepped up tax collection efforts. It slashed administrative and capital expenditures (but raised targeted social assistance). Public investment projects, including those of state enterprises, were reviewed, and in many cases canceled or postponed. State enterprises reportedly suspended almost 610 projects worth $2.1 billion in the second quarter of 2008. Accordingly, the fiscal balance turned from a deficit of 5.5% of GDP in 2007 to a surplus of 0.4% of GDP in the first half of 2008 (Figure 3.10.6).

The dong came under strong downward pressure in June, after official statistics showed inflation rising sharply in May and a big trade deficit in January–May. At that time, international rating agencies downgraded the outlook for Viet Nam from stable to negative. Several foreign analysts predicted that the economy faced a balance-of-payments crisis and that the authorities would devalue the currency. With interest rates negative in real terms, stock prices weak, and the real estate market cooling, investors switched significant funds from dong-denominated assets into foreign exchange, gold, and other goods that could serve as a hedge against inflation and dong devaluation. Demand for foreign exchange surged and the black market exchange rate depreciated substantially (Figure 3.10.7).

The Government responded swiftly. The central bank adjusted its reference exchange rate by about 2.3% in several steps, widened the dong's daily trading band against the dollar from 1.0% to 2.0% (around the reference rate), and increased the supply of foreign exchange in the

3.10.3 Exports of crude oil and imports of oil products



Source: General Statistics Office of Viet Nam, available: http://www.gso.gov.vn, downloaded 29 August 2008.

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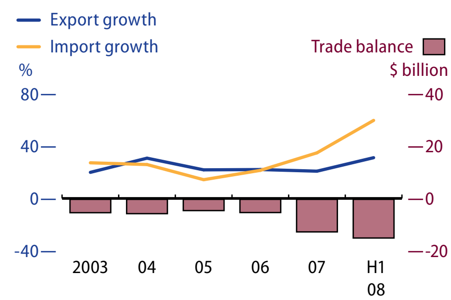
3.10.4 Annual trade indicators



Source: General Statistics Office of Viet Nam, available: http://www.gso.gov.vn, downloaded 29 August 2008.

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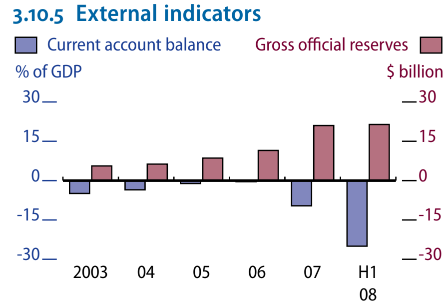
3.10.5 External indicators



Sources: State Bank of Viet Nam local data releases; staff estimates.

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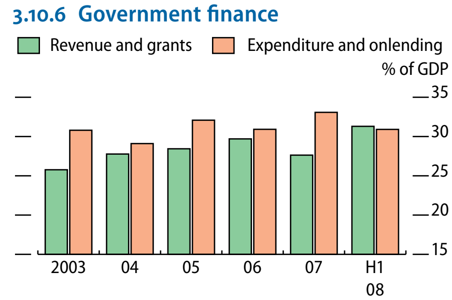
3.10.6 Government finance



Note: Expenditure and onlending data include off-budget items.

Sources: Ministry of Finance local data release; staff estimates.

Click here for figure data

official market. The Government also made a commitment not to devalue the dong sharply, and issued data that showed that the conditions for a balance-of-payments crisis were not in place. By late July, the foreign exchange market had stabilized and the black market rate fell close to the central bank's reference rate. In other signs that the macroeconomic situation was improving, money supply growth slowed to an annualized rate of 8.5% in the first half of 2008 from 46.1% in 2007 and monthly inflation, especially food price inflation, slowed significantly in June and July. Although administered fuel prices were raised substantially in the second half of July (Box 3.10.1 above), monthly inflation in August was not much higher than in July, and food price inflation moderated further.

As expectations of a substantial devaluation subsided, precautionary and speculative imports declined and capital started moving back into dong-denominated assets. Partly for this reason, growth of imports decelerated markedly in May–August 2008, and the monthly trade deficit narrowed from $3.4 billion in March to less than $1 billion in July and August (Figure 3.10.8). Bank deposits in dong increased and interest rates declined in July and August. The yield on the 5-year government bond dropped to less than 17% by mid-August, after rising to about 20% in mid-June from 8–9% early in the year (Figure 3.10.9). The VN Index of the Ho Chi Minh Stock Exchange recovered to over 500 in the second half of August, having plunged by about two thirds to 366 in the 8 months to June.

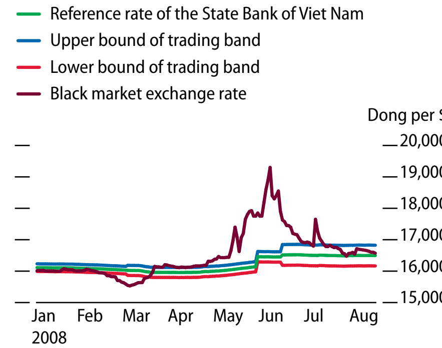
In a sign that foreign investors remain optimistic about Viet Nam's prospects, new FDI commitments rose to $45.3 billion in January–July 2008 from $20.3 billion in all 2007 (Figure 3.10.10). Licenses were issued for several multibillion-dollar FDI projects in the oil and gas sector, heavy industry, and services.

Prospects

The baseline assumptions for the rest of 2008 and 2009 are that the Government will continue to give precedence to curbing inflation over stimulating growth until inflation is reduced to single digits; the central bank will continue strengthening prudential supervision of banks and—if any bank becomes financially distressed—will act swiftly to prevent a systemic banking crisis; the Government will further improve timely disclosure of economic data to reduce rumors in financial and commodity markets; there will be no sharp adjustments in the reference exchange rate; Dung Quat oil refinery (the country's first, with capacity to process 140,000 barrels of crude oil a day) will start operating in early 2009; there will be no major damaging domestic supply-side shocks; and the external environment will evolve in accordance with the expectations of this *Update*.

On these assumptions, the macroeconomic situation is expected to improve further. Nevertheless, the GDP growth forecast for 2008 is taken down to 6.5%, (Figure 3.10.11) from 7.0% in April, given that the outcome for the first half was in some respects worse than expected and that the external outlook has deteriorated since April. The anti-inflation measures will further slow growth of domestic demand in the second half relative to the first. Domestic fixed investment will decelerate or even decline as a

3.10.7 Dong exchange rates vs dollar



Sources: State Bank of Viet Nam local data releases; staff observations.
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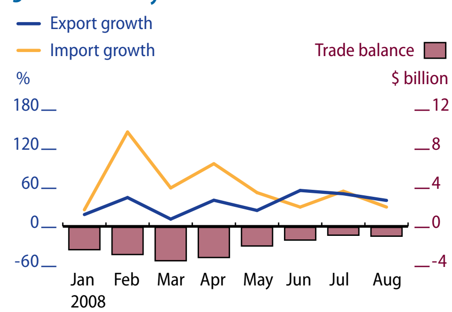
3.10.8 Monthly trade indicators



Source: General Statistics Office of Viet Nam, available: http://www.gso.gov.vn, downloaded 29 August 2008.
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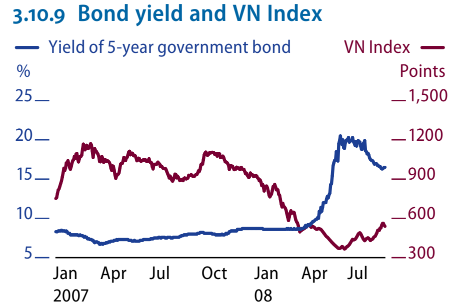
3.10.9 Bond yield and VN Index



Sources: Bloomberg; CEIC Data Company Ltd.; both downloaded 29 August 2008.
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result of the cuts in many public projects, the cooling real estate market, and the rise in the cost of borrowing. As expectations of persistent high inflation and sharp devaluation subside, firms will draw down inventories that were built up in the first half.

Growth of consumption will slacken primarily because of a reduction in government consumption. Import growth will decelerate on slowing investment and consumption and falling inventories. At the same time, the anticipated weakening of external demand and a further decline in crude oil production will moderate export growth. Net imports of goods and services will grow at a slower pace than in the first half of 2008 but—for the whole year—will increase substantially relative to 2007.

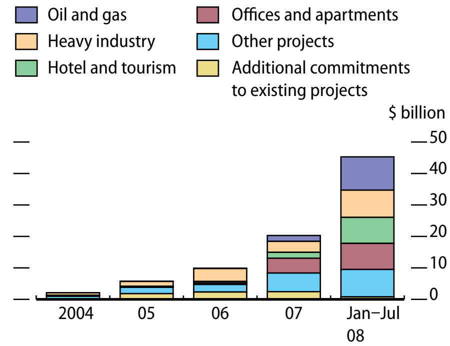
GDP growth in 2009 is now forecast to moderate further, to 6.0%, instead of rebounding as projected in *Asian Development Outlook 2008 (ADO 2008)* in April. This is because the Government is expected to maintain an anti-inflation stance, and external demand is likely to remain sluggish. Growth of consumption and domestically financed investment is likely to slow further next year. Net imports of goods and services will shrink, largely on a narrowing of the merchandise trade deficit. This will not, however, fully offset the slowdown in growth of consumption and investment. FDI inflows will remain strong, but their growth will be increasingly constrained by the capacity of the economy to absorb them.

Inflation on a year-on-year basis is expected to peak at more than 30% in November, and then decline fairly fast. For all 2008, inflation is forecast at 25.0%, up from 18.3% in *ADO 2008* because of higher than expected inflation in the first half. Significant price pressures will continue into 2009, maintained by the higher fuel prices and likely wage increases. The forecast for year-average inflation in 2009 is raised to 17.5%, from 10.2%.

The current account deficit for this year is now forecast at 13.5% of GDP, compared with the April forecast of 10.3%. As discussed above, import growth should decelerate in the second half, but exports will also soften, keeping the full-year trade gap wide. Strong inflows of FDI and other foreign capital will keep the overall balance of payments in surplus. Next year's current account deficit is now projected at 7.0% of GDP (against 9.4% in *ADO 2008*). Exports of crude oil will fall because of the continuing decline in output and the scheduled start of domestic oil processing. Other exports will grow at a slower pace than in 2008, due to weaker external demand. Growth of imports will decelerate significantly as aggregate demand moderates and imports of oil products decrease. Inflows of FDI and portfolio investment are expected to be more than enough to finance the current account deficit.

Risks to this outlook are tilted to the downside. Weaknesses in the banking system pose a potential threat to continued improvement of the macroeconomic situation. Some banks have low levels of capital and weak risk-management capacity, and their lending decisions are not always based on commercial considerations. Nonperforming loans can be expected to increase in the context of the declines in stock and real estate prices, hikes in interest rates, and general slowdown in economic growth. Concerned about such weaknesses, the State Bank of Viet Nam is strengthening prudential supervision and has suspended licensing new banks so that it can focus on supervising existing ones. If a bank becomes

3.10.10 New foreign direct investment commitments



Sources: General Statistics Office of Viet Nam, available: http://www.gso.gov.vn; staff estimates.
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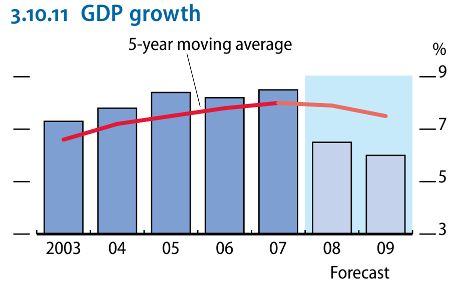
3.10.1 Selected economic indicators (%)

	2008		2009	
	ADO 2008	*Update*	*ADO 2008*	*Update*
GDP growth	7.0	6.5	8.1	6.0
Inflation	18.3	25.0	10.2	17.5
Current acct. bal. (share of GDP)	-10.3	-13.5	-9.4	-7.0

Source: Staff estimates.

3.10.11 GDP growth



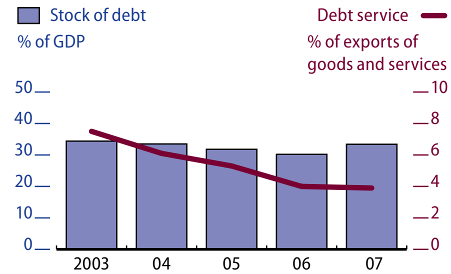
Sources: Asian Development Outlook database; staff estimates.
Click here for figure data

financially distressed, the central bank is likely either to provide liquidity support, or initiate a merger with a healthier bank, (or both), to ensure that the bank does not cause a systemic crisis.

There is a risk that—as inflation eases, the trade deficit narrows, and growth moderates further—the authorities may loosen monetary and fiscal policies and boost public investment to spur growth. If this occurs, GDP growth and inflation would be higher and the current account deficit wider in 2009 than now forecast.

Despite the challenges, the medium- to long-term growth prospects remain good. Accession to the World Trade Organization in 2007 has provided a long-term impetus to economic and institutional reforms that will enhance efficiency and growth prospects. These reforms have slowed somewhat in 2008 because of the macroeconomic turmoil and unfavorable market conditions for privatizing state enterprises, but are likely to pick up once the economic situation stabilizes and market conditions improve. Furthermore, FDI inflows have surged in recent years. External debt is moderate; the stock increased to 33.4% of GDP by end-2007 from 30.2% a year earlier (Figure 3.10.12). Concessional medium- and long-term loans from development agencies account for most of the debt, while short-term debt is estimated at less than 1% of GDP. External debt service amounts to about 4% of exports of goods and services.

3.10.12 External debt



Sources: Ministry of Finance local data releases; State Bank of Viet Nam local data releases; staff estimates.

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