Viet Nam

A third consecutive year of 8%-plus growth was led by strong expansion of investment and consumption. The rapid growth has strained resources, as shown by a surge in imports, infrastructure bottlenecks, skilled-labor shortages, and inflation, which accelerated to over 19% year on year by March 2008. The authorities have tightened monetary policy and allowed some exchange rate flexibility to rein in price rises, and are initiating fiscal measures. These steps, plus weaker external demand, should pull back growth this year. In 2009, inflation is expected to moderate and GDP growth pick up. Challenges are to control inflation, maintain stability of the banking system, and ease the infrastructure constraints.

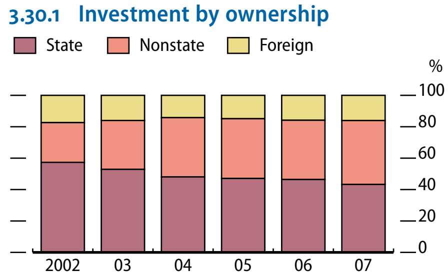
Economic performance

The economy maintained robust growth at 8.5% in 2007, above the 7.8% average of 2002–2006. Accession to the World Trade Organization (WTO) in January 2007 added impetus both to growth and to market-oriented reforms, resulting in strong domestic demand. Investment grew by 16% to reach 40.4% of GDP, one of the highest rates in Asia. Much of the expansion came from domestic private investors, whose share of overall investment rose to about 40% in 2007 (Figure 3.30.1) as the country continued its transition to a market-based economy. Foreign direct investment (FDI) approvals rose to about $20.3 billion, with disbursements of $4.0 billion (two thirds higher than in 2006). Consumption, boosted by wage increases and remittance inflows, also continued to grow strongly. Nominal retail sales of goods and services climbed by 23.3% (Figure 3.30.2). Strong domestic demand spurred a surge in imports, causing net exports to subtract from GDP growth.

On the supply side, industry grew by 10.6% and was again the main contributor to GDP growth. Private industry expanded by 20.9%, outpacing the state sector. Within industry, manufacturing (by far its largest subsector) grew by 12.8%. Fueled by the strong domestic demand, the output of utilities also increased, by about 12%. In contrast, mining output fell by 2.0% (Figure 3.30.3) as the biggest oil field in the country becomes depleted. Services grew by 8.7%, led by strong performances in the trade and finance, and hotel and restaurant, subsectors (the latter helped by buoyant tourism).

Agricultural output was hurt by drought, avian flu, and livestock diseases, offset in part by strong growth in fisheries. The sector as a whole grew by 3.4%, a little below the recent trend. Significantly higher production of natural rubber and cashew nuts was the result of increased plantings and gains in productivity. Agriculture's share of the economy continues its long-term decline (it was just under one fifth in 2007) as

3.30.1 Investment by ownership



Source: General Statistics Office of Viet Nam, available: http://www.gso.gov.vn, downloaded 25 February 2008.

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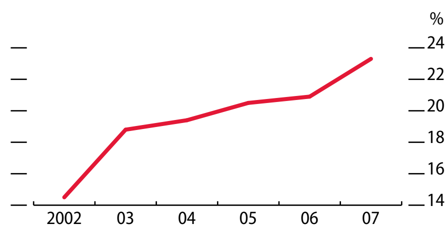
3.30.2 Growth of retail sales of goods and services (nominal)



Sources: General Statistics Office of Viet Nam, available: http://www.gso.go.vn; CEIC Data Company Ltd.; both downloaded 25 February 2008.

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This chapter was written by Dao Viet Dung of the Viet Nam Resident Mission, ADB, Hanoi.

industry and services expand rapidly, but it still accounts for a little over half of total employment.

Buoyant investment, coupled with higher international commodity prices, prompted a steep 35.5% increase in nominal merchandise imports ($60.8 billion) in 2007 (Figure 3.30.4). Capital goods (17% of the total), soared by 56.5%, reflecting the import of aircraft and equipment for large projects such as the Dung Quat oil refinery. Manufacturing, particularly clothing, depends heavily on imported inputs. Consequently, growth in manufactured exports triggered matching growth in imports of raw materials and intermediate goods. Imports of consumer goods, too, rose.

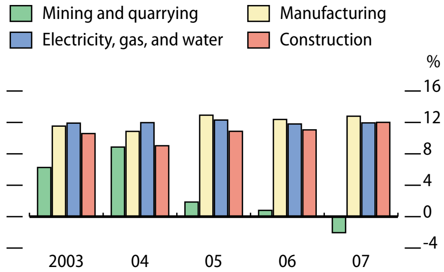
Growth in merchandise exports decelerated slightly from 2006, to a still-solid 21.5% ($48.4 billion) in 2007. Clothing and textiles exports, benefiting from the end of quotas following WTO accession, rose by 33.4%. Wooden furniture, one of Viet Nam's fastest-growing exports, grew by 22.3%. Buoyant global commodity prices boosted the value of exports of coffee and pepper by about 50% each. Exports of higher value-added products are making a mark as FDI fuels the construction of export-oriented factories. Reflecting this, exports of electronics and computers increased to $2.2 billion in 2007, up from about $500 million in 2002.

With imports outpacing exports, the trade deficit widened to a record $12.4 billion in 2007 (Figure 3.30.5) and the current account deficit pushed out to an estimated 8.0% of GDP. While this was largely the result of a surge in capital goods imports and other inputs for export production, the widening gaps raised concerns that increasing reliance on short-term financing, including trade credits, poses risks in the context of global financial market uncertainties. Strong inflows of FDI, remittances, aid, and portfolio investment contributed to a surplus in the overall balance of payments, and to a rise in gross official reserves to $20.8 billion, equivalent to 14 weeks of imports.

The impact on money supply of the surging capital inflows was only partly offset by sterilization operations by the State Bank of Viet Nam, the central bank. As a result, money supply (M2) growth accelerated to 46% in 2007. Credit soared by 54% (Figure 3.30.6), significantly above the central bank's 25% target. High levels of liquidity, underpinned by strong domestic demand, pushed inflation up to 12.6% by December. Food prices (42.8% of the consumer price index) rose sharply during the year. Major reasons were outbreaks of poultry and pig diseases that reduced meat supplies and price hikes for imported food. Costs of building materials and rents gathered pace because of booming demand for real estate. Furthermore, the Government raised prices for electricity, coal, and gasoline.

Acting to drain excess liquidity, the State Bank increased issuance of bills and raised the reserve-requirement ratio for banks from 5% to 10% in June. Foreign exchange policy was also adjusted. For 3 years the dong had been managed with the result that it depreciated against the United States (US) dollar by about 1% a year. In 2007, the Government allowed more flexibility in the exchange rate by widening the dong's daily trading band against the US dollar from 0.25% to 0.5% in January and further to 0.75% in December. Given the weakening US dollar and strong capital inflows, the dong appreciated by 0.4% against the US dollar from October 2007 to February 2008 (Figure 3.30.7).

3.30.3 Industry growth by subsector



Source: CEIC Data Company Ltd., downloaded 25 February 2008.

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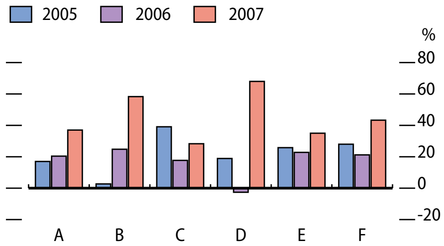
3.30.4 Merchandise import growth (total and major categories)



A = total imports; B = machinery and spare parts; C = petroleum; D = steel products; E = garments; F = electronic products.

Source: CEIC Data Company Ltd., downloaded 25 February 2008.

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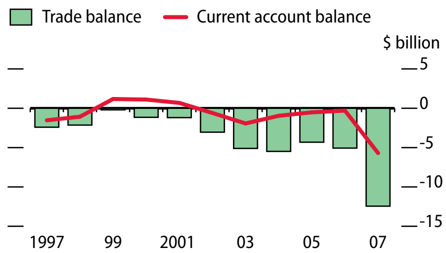
3.30.5 External indicators



Source: CEIC Data Company Ltd., downloaded 25 February 2008.

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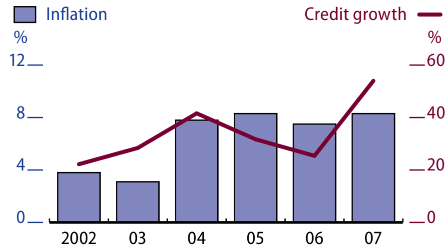
In another decision aimed at easing inflation pressure, import tariffs on 18 groups of commodities were cut in August.

Employment created by the expansion of industry and services, mainly in the private sector, brought the unemployment rate down from 4.8% in 2006 to 4.6% in 2007. Shortages of skilled labor, causing steep salary increases and high staff turnover rates, have become a constraint to business in Viet Nam, joining the list of bottlenecks that includes inadequate roads, ports, and power generating capacity.

Buoyant economic growth has propelled government revenues—they rose by 16.4% in 2007. Corporate income tax and value-added tax contributed 77% of the total. Revenues from oil grew strongly because of higher prices received for the nation's crude oil exports. (Viet Nam is a net oil exporter, shipping out crude and importing petroleum products.) Expenditures increased by 17.9%, with significant increases in spending on infrastructure and education. Fiscal policy was expansionary in 2007. The fiscal deficit widened to 4.9% of GDP from 4.1% in 2006. (Including onlending, mainly to state-owned enterprises, the deficit was estimated at 6% of GDP.) Public and publicly guaranteed debt rose slightly to 43.4% of GDP.

After a year when the stock market boomed (the VN Index of share prices soared by 144% in 2006), the market surged higher in the first 2 months of 2007. That prompted concerns about a price bubble and excessive lending for share purchases. The central bank imposed limits on lending to buy stocks. That move, combined with concerns about high market valuations, started a decline in share prices that accelerated in early 2008 when monetary policy was tightened. The VN Index was down by 55% in late March 2008 from its peak reached in March 2007 (Figure 3.30.8). More state-controlled companies issued shares and listed on the stock market during 2007.

3.30.6 Prices and credit



Sources: International Monetary Fund, *Country Report* No. 07/387, available: www.imf.org; General Statistics Office of Viet Nam, available: www.gso.gov.vn, downloaded 25 February 2008.

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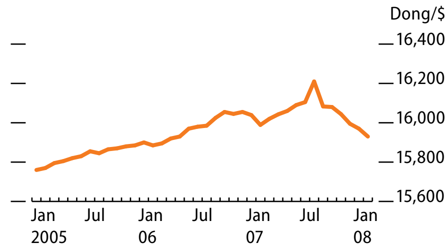
3.30.7 Nominal exchange rate



Source: CEIC Data Company Ltd., downloaded 25 March 2008.

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Economic prospects

The forecasts assume that the Government will follow policies that gradually rein in rapid inflation and maintain overall macroeconomic stability. Such policies were evident early in 2008 as the authorities aimed to pull back credit growth to 30% or less. The State Bank of Viet Nam in January raised bank reserve requirements from 10% to 11% and lifted official interest rates for the first time in more than 2 years (its base rate by 50 basis points to 8.75% and its refinancing rate by 100 basis points to 7.5%). However, these official interest rates are well below the inflation rate and have limited impact on market rates.

In a direct move to drain liquidity, the State Bank required banks to buy the equivalent of $1.3 billion of 1-year Treasury bills. Banks were also directed to be more cautious in lending for shares and real estate. These tightening measures pushed up overnight interbank market rates to over 30% at times during February, and deposit rates jumped as banks competed for funds. Subsequently, the State Bank imposed a 12% cap on dong deposit rates.

In March 2008, the central bank again widened the daily trading band for the dong against the US dollar, to 1%, and indicated that the

3.30.1 Selected economic indicators

	2008	2009
GDP growth	7.0	8.1
Inflation	18.3	10.2
Current account balance (% of GDP)	-10.3	-9.4

Source: Staff estimates.

band would widen to 2% at some time in the future. The currency appreciated by 0.3% against the US dollar in the first 2 months of 2008.

Also in March, the Government initiated fiscal tightening measures including cuts in non-critical expenditures and closer scrutiny of public investment projects as part of its effort to contain inflation. It also indicated that it would lower its 8.5–9.0% GDP growth target for 2008.

The investment momentum built up in recent years as a result of structural reforms and WTO accession is expected to be maintained this year. FDI approvals grew strongly by 56% in January–February 2008 from the year-earlier period. However, the monetary tightening has, among other things, made it difficult to convert US dollars into dong, which will likely delay disbursement of some FDI. Consequently, investment growth is forecast to slow in 2008 and Viet Nam's high investment rate is expected to decline to 34% of GDP in 2008. Consumption growth, too, is seen slowing, because higher prices for basic staples will likely damp other spending. Net exports are likely to remain contractionary.

On balance, economic growth is expected to moderate to 7.0% in 2008 (Figure 3.30.9), before it picks up to about 8.1% in 2009 if the authorities ease the monetary tightening by then and if a recovery in external demand emerges.

Prolonged cold weather in the north of the country early in 2008 damaged crops and pushed up food prices. At the same time, the Government raised the price of diesel fuel by 36%. Adding to demand pressures, salaries of public employees were increased from January 2008. Driven by higher prices for food and housing, inflation surged to 19.4% year on year in March (Figure 3.30.10), the highest in more than a decade. The policy tightening is expected to gradually help contain inflation in the second half of 2008, but it might still be in the region of 16% by December. Year-average inflation is forecast at 18.3%, slowing to 10.2% in 2009 (Figure 3.30.11)

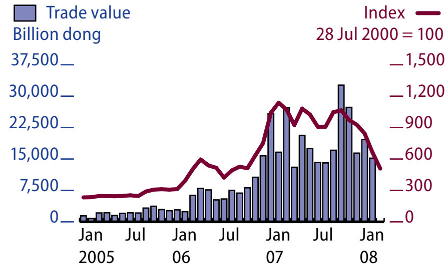
The slowdown in global trade is expected to trim nominal export growth to about 18% this year. Import growth is seen decelerating from 2007's unusually high rate, but will likely exceed export growth. (Official estimates for the first quarter of 2008 showed the trade gap more than quadrupled from the year-earlier period to $7.4 billion as imports shot up by 63% and exports rose by 23%.) The current account deficit is forecast to widen to about 10% of GDP in 2008. Inflows of FDI, aid, and remittances should keep the overall balance of payments in surplus.

Development challenges

Years of rapid growth have strained available resources and caused imbalances and overheating in parts of the economy. This is shown by the surge in imports, infrastructure constraints, shortages of skilled labor, and very high inflation. The immediate challenge is to bring down inflation before expectations build to such a degree that high inflation becomes persistent. This would impair investment and economic growth over the medium term. Living standards, particularly for the poor, are already suffering.

Measures aimed at curbing inflation will slow growth in the short term. The tightening of monetary policy has also put considerable strain

3.30.8 Ho Chi Minh stock exchange indicators



Source: CEIC Data Company Ltd., downloaded 24 March 2008.

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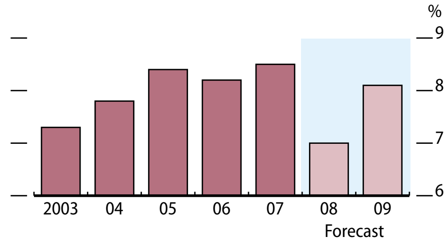
3.30.9 GDP growth



Sources: CEIC Data Company Ltd., downloaded 25 February 2008; staff estimates.

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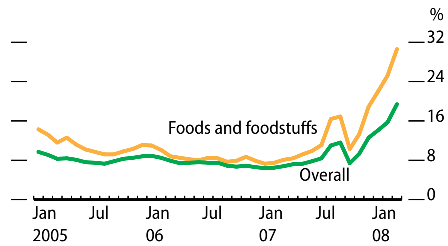
3.30.10 Monthly inflation



Source: CEIC Data Company Ltd., downloaded 25 March 2008.

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on the financial sector, which is at an early stage of development and has many weaknesses. Furthermore, the fiscal tightening, if it reduces investment in infrastructure and education, could damage medium-term growth prospects.

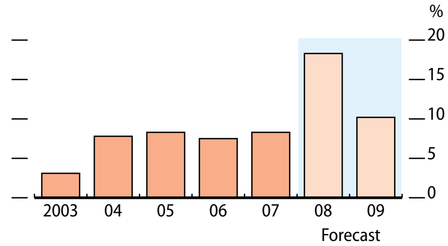
A policy mix of monetary and fiscal tightening, as well as greater exchange rate flexibility, could bring down inflation without putting an excessive burden on the financial sector and causing a sharp slowdown in growth. Careful selection of public expenditure priorities (especially public investment) is needed if medium-term prospects are to be enhanced.

Managing the strong inflows of foreign capital will remain a challenge for both macroeconomic management and for the banking system, especially as some banks expanded rapidly during the high-growth years, straining their management capacity. In addition, increased lending (with high-priced stocks and real estate as collateral) has implications for banks' asset quality, particularly during a period of monetary tightening. Moreover, the liquidity squeeze has raised funding costs for banks, and may erode their net interest margins. Standard & Poor's has stated that a prolonged squeeze would worsen structural weaknesses in banking.

The medium-term challenge will be to ratchet growth up again, while keeping inflation under control. To this end, the economy needs to increase the supply of skilled workers, improve efficiency of public investment, and continue market-oriented reforms, all the while investing further in infrastructure. The Government's capacity for macroeconomic policy management is an area that requires attention, including development of the monetary policy framework. Greater policy coordination among agencies is essential. The policy agenda for reform of the banking system should include strengthening prudential regulation and supervision, encouraging consolidation, and accelerating the entry of foreign operators.

Even with these challenges, the medium- and long-term economic prospects are good.

3.30.11 Annual inflation



Sources: Asian Development Outlook database; staff estimates.

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