Viet Nam

Economic performance continues to be robust, with growth accelerating above 8% in 2005, fueled by surging private investment and strong domestic demand. The economy has benefited from higher global oil prices in recent years, but inflation has accelerated. The current account deficit remains manageable, with strong inflows of remittances and tourism receipts. The impetus to a higher growth trajectory stems from a steady transition to a market-based system and closer integration with world markets. These factors are likely to continue to underpin reforms and high rates of expansion into the future.

Economic performance

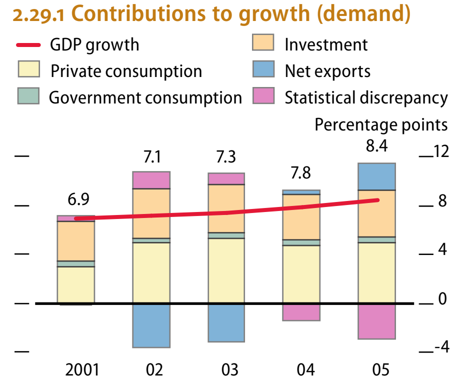
Growth accelerated to an estimated 8.1% in 2005 (against a government figure of 8.4%), the sixth consecutive year of increase. The healthy performance was achieved despite the adverse impact of avian flu, drought for part of the year, a more challenging export market for clothing, and rising prices of key imported inputs. Domestic demand was the main contributor to growth (Figure 2.29.1); exports also remained strong. Gross fixed investment continued to grow, reflecting improvements in the business environment. The investment-to-gross domestic product (GDP) ratio has now risen to 37.6% of GDP, up from 29% in 1998 (Figure 2.29.2). Consumption growth was vigorous in 2005, aided by higher farm incomes that reflected rising prices for key agricultural products, strong growth in employment in manufacturing and services, buoyant inward remittances, and salary raises for government employees.

From the production side, the industry and services sectors continued to drive growth (Figure 2.29.3). Industry's share in GDP rose once again to reach 41% in 2005, largely as a consequence of private sector expansion. Industrial growth is drawing on inexpensive labor and improved infrastructure. Manufacturing, which accounts for about half of industry's value added, has been a major contributor to gains in both output and employment, with output rising by 13% in 2005. Furniture and electronic goods account for a fast-rising share of total manufactured exports and, though growth of clothing and footwear decelerated, they are still important. Overall, the proportion of light manufactured goods in total exports increased from 36% in 2001 to an estimated 40% in 2005.

In comparison with overall industrial performance, mining growth has been modest, other than hydrocarbon production, a result of the combined effect of regulatory constraints to foreign investment in the sector, outdated technology, and government efforts to protect natural resources. Mining regulations were overhauled last year, so the sector is likely to attract more investment. The volume of crude oil output declined by almost 8% in 2005 as existing oil fields were run down; new fields have not yet come on stream.

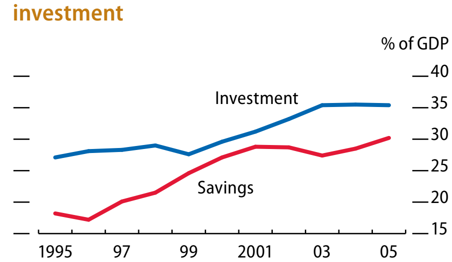
The services sector expanded by an estimated 8.2% in 2005, the

2.29.1 Contributions to growth (demand)



Source: General Statistics Office of Viet Nam.

2.29.2 Gross domestic savings and investment



Source: General Statistics Office of Viet Nam.

highest rate since the Asian financial crisis of 1997–98, reflecting buoyant performances in finance, tourism, trade, transport, and telecommunications. The growth of the financial subsector in recent years has spurred financial deepening. The ratio of broad money (M2) to GDP has risen from 58% in 2001 to about 80% in 2005. In the tourism subsector, the number of tourist arrivals has jumped by more than 1 million over 4 years to 3.5 million.

The share of agriculture in the economy continued to decline, to about 20% of GDP in 2005, although it still accounts for the majority of employment. Agricultural production rose by an estimated 3.7%, held back somewhat by drought and avian flu. Nonetheless, buoyant prices supported production with further diversification and commercialization. Production and exports of coffee, rubber, and cashews, as well as fisheries products, recorded strong growth.

The trade deficit narrowed to $4.5 billion in 2005, after a sharp widening in the trade gap in recent years (Figure 2.29.4). Total merchandise exports rose by 20% in value, below the 30% leap recorded in 2004 but still impressive and higher than the rise in imports. Textile and clothing exports rose at a modest 9.6% in 2005, compared with an average annual rate of about 30% in 2002–2004. Exports of wood products, electronic goods, and crude oil recorded higher growth (Figure 2.29.5), with the jump in international oil prices outweighing the decline in the oil export volume. (Viet Nam, a net oil exporter, exports the crude it produces and, lacking refinery capacity, imports refined petroleum products; Box 2.29.1)

With continuing strong growth in private remittances and tourism receipts, the current account deficit narrowed to 3.6% of GDP in 2005, reversing its recent trend. Net private remittances leaped by nearly $1 billion to $3.2 billion. Buoyant foreign direct investment (FDI) inflows

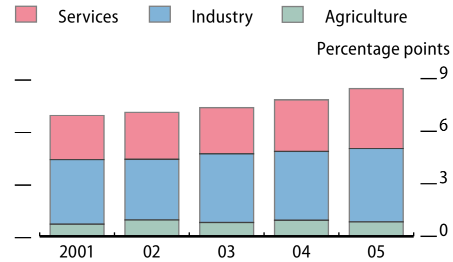
2.29.1 Twin effects of higher oil prices

Crude oil has become a major export earner for Viet Nam. Oil exports surged by 30% in dollar terms in 2005, despite a near 8% decline in volume, raising the share of oil in total exports to more than 20%. Net oil exports, after taking into account imports of refined products, increased from 3.5% of gross domestic product (GDP) in 2003 to 4.8% in 2005. Higher oil prices have also helped the fiscal balance; oil-related tax revenue rose by 46% in 2005 to 4.6% of GDP and accounted for 21% of total government income. The rise in revenue outstripped the cost of fuel subsidies, estimated at 1.5% of GDP in 2005.

Against this, high oil prices have added to inflationary pressures. Domestic prices of petroleum products were raised three times in 2005 to reduce the cost of subsidies and to promote energy efficiency. Although the direct impact on inflation was modest because oil accounts for only 3.3% of the consumer price index basket, the spillover effects were significant. For example, transport costs increased by 9%.

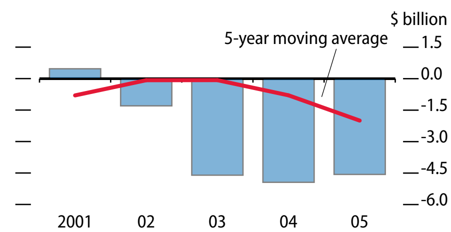
On balance, oil prices around current levels benefit the economy. This may change, though, if they turn out to have more than the currently predicted modest economic impact on Viet Nam's main investment and trading partners.

2.29.3 Contributions to growth (supply)



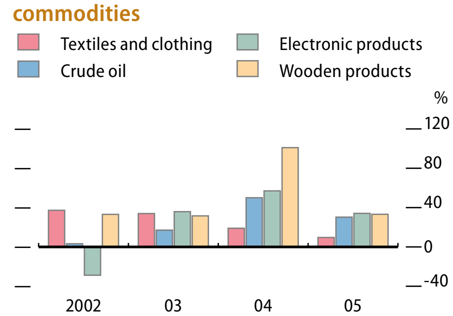
Source: General Statistics Office of Viet Nam, available: http://www.gso.gov.vn/default_en.aspx?tabid=468&idmid=3&ItemID=3231, downloaded 10 February 2006.

2.29.4 Trade balance



Sources: Asian Development Outlook database; staff estimates.

2.29.5 Export growth of selected commodities



Sources: General Statistics Office of Viet Nam, available: http://www.gso.gov.vn/default_en.aspx?tabid=501&thangtk=12/2005; CEIC Data Company Ltd., downloaded 1 March 2006.

of $2.4 billion also supported the balance of payments, resulting in a rise in gross official reserves to $7.7 billion (equivalent to about 2.6 months of imports). Reserves have doubled in the past 3 years.

Officially, the authorities use a managed float of the dong (D), though the exchange rate has seen little movement against the United States (US) dollar in the past 2 years, and depreciated in nominal terms by 1.0% in 2005 (Figure 2.29.6). Given higher domestic inflation, the exchange rate appreciated marginally in real terms in 2005. A more flexible exchange rate could help facilitate the structural adjustments needed to respond to changing international economic conditions.

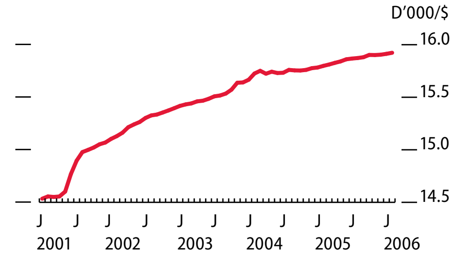
Higher food prices have helped push up inflation in recent years, to an average of 8.3% in 2005 (Figure 2.29.7). Other factors contributing to inflation include increases in import prices for oil products, steel, cement, and fertilizer, and in domestic prices of fuels, which spilled over into transport charges. Rapid growth in demand for workers in industry and services pushed up salaries for professionals, and for skilled (and some semiskilled) workers. With salary increases in the public sector (where wages rose by about 30% in October 2004), this fed inflation. From a measurement perspective, the official inflation figure may be understating price pressures because the Government regulates power and transport prices, among others.

Financial sector development and a robust economic outturn contributed to strong growth in monetary aggregates, prompting concerns about the impact of rapid credit expansion on inflation and on the quality of lending. The State Bank of Viet Nam, the central bank, has adopted a tighter policy in the past couple of years, with an increase in the reserve ratio of banks in July 2004, a 50 basis point increase each in the rediscount and refinance rates in January and April 2005, and a 25 basis point rise in the base rate in February 2005. Initial estimates indicate a decline in credit expansion from nearly 40% in 2004 to about 25% in 2005. Growth in broad money supply mirrored this, falling from 30% in 2004 to 27% in 2005.

The overall fiscal deficit has been held to a little over 2% of GDP in the past 2 years (Figure 2.29.8). Revenues have been strong at around 22% of GDP, helped by higher oil receipts, improvements in tax administration, and a growing number of tax-paying businesses in the formal sector. However, this may overstate fiscal strength because some expenditures, such as those of the Development Assistance Fund and other infrastructure funds, remain off budget, while directed lending by state-owned commercial banks (SOCBs) is still used as an instrument of policy. Furthermore, revenues from trade taxes may fall further in the near term on account of Viet Nam's commitments to the Association of Southeast Asian Nations (ASEAN) Free Trade Area (AFTA) to reduce tariff rates by end-2006, and tariff changes that may be required for its membership of the World Trade Organization (WTO).

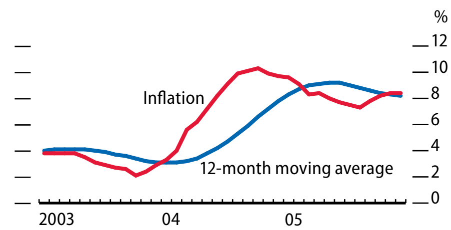
Reforms in the financial sector have improved the performance of many banks, and have enhanced public confidence in the banking system. Last year, the authorities issued new regulations to ensure that Vietnamese loan classifications meet international standards. Some joint-stock banks sold equity stakes to foreign banks. The Government is implementing measures to recapitalize and "equitize" (partly privatize)

2.29.6 Monthly nominal exchange rate



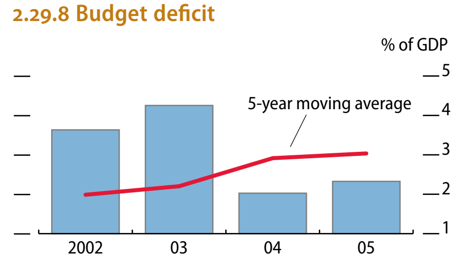
Source: Datastream, downloaded 3 March 2006.

2.29.7 Monthly inflation



Sources: General Statistics Office of Viet Nam, available: http://www.gso.gov.vn/default_en.aspx?tabid=501&thangtk=12/2005, downloaded 10 February 2006; International Monetary Fund, International Financial Statistics online database, available: http://ifs.apdi.net/imf/ifsBrowser.aspx?Branch=ROOT, downloaded 1 March 2006.

2.29.8 Budget deficit



Sources: Asian Development Outlook database; staff estimates.

some SOCBs. In November, the Foreign Trade Bank of Viet Nam (Vietcombank), one of the four largest SOCBs, which together account for about 70% of total assets in the banking system, issued convertible bonds to raise second-tier capital for its equitization this year. (See also Box 2.29.2.)

Official recognition of the private sector's contribution to economic activity is increasingly explicit, improving the prospects for further reforms toward a market-based economy. In 2005, the National Assembly passed a Unified Enterprise Law and a Common Investment Law, designed to boost private investment by reducing administrative barriers to business development and to facilitate WTO membership. Among other measures, these new investment laws, scheduled to come into effect in the middle of this year, aim to improve corporate governance in state enterprises; create a level playing field for state, domestic private, and foreign firms; and encourage private participation in industries that are not specified in a "negative list" (which should be clearer to investors than the previous "positive list" approach). Efforts to improve the business climate have helped generate strong growth in both domestic private investment and FDI. Some 38,100 private enterprises were newly registered in 2005, up from 14,400 in 2000. There now are about 200,000 private enterprises, with a total registered capital of about $19 billion.

Continuing a program to improve the performance of state enterprises, the Government reported that 600 of them were equitized in 2005 and another 100 were sold, merged, or dissolved. During 2001–2005, out of 5,655 state enterprises, 3,590 were restructured, of which 2,347 were equitized. Shares in equitized firms are usually sold to workers, managers, or other well-connected individuals, although the proportion issued to outsiders has been increasing. Progress in state-enterprise reform thus far has been mainly among smaller companies, with only modest advances made in divesting larger enterprises (those with a registered capital equivalent to more than $1.3 million). Consequently, this year's planned equitization of Vietcombank and the telecoms service company MobiFone—both large companies—would represent a major step.

The private sector has been the major source of jobs since the early 1990s. This employment generation, as well as the sustained overall economic growth, has reduced poverty sharply. The Viet Nam Household Living Standard Survey in 2004 showed the poverty rate falling from 58% in 1993 to 19.5% in 2004. Various social indicators, such as education levels and infant mortality, have also improved, reflected in an increase in the country's ranking in the United Nations Development Programme's human development index. (However, the rate of decline in poverty has been much slower in most ethnic minority groups than for the population as a whole.)

2.29.2 Domestic securities market

The Government issued its first international bond ($750 million) in October 2005, with its yield (7.125%) 256 basis points above comparable 10-year US treasuries. This was a smaller premium than for similar bonds issued by Indonesia and the Philippines.

Further evidence of Viet Nam's steadily improving prospects was seen when Standard & Poor's changed its credit rating outlook from BB- stable to BB- positive in October 2005. Bond and stock markets are gradually developing, albeit from a low base. Trading in government bonds is increasing, and the total outstanding value of these securities rose to the equivalent of about 3% of GDP in 2005. (The corporate bond market, in contrast, hardly exists.)

Dairy company Vinamilk listed shares on the Ho Chi Minh City Securities Trading Center, raising the number of listed companies to 34 at the start of 2006 from 24 at end-2004. Vinamilk is the largest listed company, with a valuation of roughly $530 million. A stock market was established in Hanoi last year to cater for the sale of equity in smaller businesses, but turnover is small.

Policy initiatives to promote development of the stock markets included an October 2005 increase in the foreign ownership limit in listed companies to 49% from 30%, a decision to work toward listing another 180 equitized state enterprises, and reforms under the new investment laws.

Economic outlook

The near- and medium-term forecasts for the economy assume that the Government will continue to implement market-oriented reforms by, for example, preserving macroeconomic discipline and further improving the investment climate, including enforcing the new investment laws. Fiscal prudence will necessitate further efforts to raise revenues and increase the transparency of off-budget expenditures. Progress with restructuring and recapitalizing SOCBs, along with reforms of state enterprises, is expected to help reduce distortions in credit allocation and to restrain credit growth, thereby easing inflationary pressures. It is assumed that Viet Nam will join WTO within the next couple of years, possibly in 2006. Forecasts for the agriculture sector in particular rest on the assumption that the country does not face a prolonged and widespread drought and that the spread of avian flu remains contained.

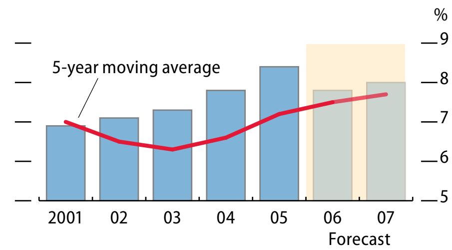
Prospects for 2006 and 2007

GDP growth is projected to consolidate at around 8% in the next 2 years (Figure 2.29.9). The momentum for domestic demand is likely to be maintained through sustained growth in FDI inflows, private remittances, and tourism receipts. FDI inflows will be supported by a 38% increase in FDI commitments to about $6 billion in 2005, and a $300 million investment in a semiconductor assembly plant, the first in the country, announced by Intel Corporation in early 2006. The new investment laws should provide additional incentives for businesses. In addition, the equitization of Vietcombank and MobiFone, if successful, will signal the authorities' commitment to increasing business efficiency and expanding the private sector.

On the production side, industry and services will continue to drive activity (Figure 2.29.10) with projected growth rates of 10% and 8%, respectively. An increasing share of industrial production comprises higher value-added goods, including computers and other electronic products for export markets. The textile and clothing sector will continue to face strong competition from the People's Republic of China and other competitors until Viet Nam joins WTO, when it will no longer be subject to quota restrictions on exports to the US (Box 2.29.3). Construction is likely to record strong growth with continuing high levels of investment in industrial, tourism, and real-estate developments as well as in infrastructure. The services sector will get additional stimulus from the Asia-Pacific Economic Cooperation forum summit this November. Agriculture is forecast to expand by 2.7% in the next 2 years, somewhat weaker than in the past 4 years because of softer prices expected for some agricultural commodities.

Exports will probably grow at slightly below the recent rate as world prices for certain commodities, such as rice, dip (Figure 2.29.11). Antidumping tariffs against exports of bicycles, footwear, and wood products by the European Union could hit exports, and clothing exports to the US are likely to remain under pressure. Prices of certain imported inputs, particularly steel and fertilizer, are expected to soften this year, so the growth in total imports will be restrained, as it was in 2005. Coupled with buoyant inflows of private remittances and tourism receipts, this should keep the current account deficit manageable. The balance of payments will likely be bolstered by FDI inflows, leading to further accumulation of official foreign exchange reserves. Continued efforts to contain credit expansion and a forecast easing in international prices of commodities, especially rice and other food items, should help damp inflationary pressures brought on by likely further increases in domestic

2.29.9 GDP growth



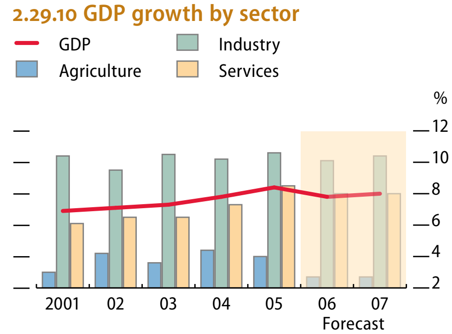
Sources: General Statistics Office of Viet Nam, available: http://www.gso.gov.vn/default_en.aspx?tabid=468&idmid=3, downloaded 10 February 2006; staff estimates.

2.29.1 Selected economic indicators

	2006	2007
GDP growth	7.8	8.0
Inflation	6.0	5.0
Current account balance (% of GDP)	-2.7	-2.8

Source: Staff estimates.

2.29.10 GDP growth by sector



Sources: General Statistics Office of Viet Nam, available: http://www.gso.gov.vn/default_en.aspx?tabid=468&idmid=3, downloaded 10 February 2006; staff estimates.

fuel prices and a probable increase in wages. Inflation is projected to be 5–6% over 2006 and 2007 (Figure 2.29.12).

Fiscal policy is expected to remain supportive of economic growth. In the near term, high world oil prices should continue to boost revenues, though receipts from trade taxes will decline when the country implements its AFTA and WTO commitments. Over the medium to longer term, collection of profit, income, and value-added taxes will have to be strengthened to contain the fiscal deficit, but tax collection will likely gain from continued rapid expansion in both the number and size of registered private firms, which will provide a much broader tax base.

The 10th Congress of the Communist Party will be held in the first half of 2006, followed by the induction of a new National Assembly. Party congresses are usually held every 5 years to agree on key policy directions and targets for the following period. A draft of the 5-year socioeconomic development plan to be put to the new National Assembly indicates a continued focus on transition to a market-oriented socialist economy. It includes more specific recognition of the role of the private sector and international economic integration than previous plans.

Medium-term outlook

The socioeconomic development plan for 2006–2010 envisages average annual GDP growth of 7.5–8.0%, with 3.0–3.2% in agriculture, forestry, and fisheries; 10.0–10.2% in industry; and 7.7–8.2% in services. One goal is to bring down poverty, using a new measure based on minimum income, to 15–16% of households by 2010 from 24% in 2004. These targets appear achievable, given the assumptions listed above. Inflation over this period is projected to average about 5% and the current account deficit about 3% of GDP.

To meet the challenge of greater competition in the face of the country's AFTA (and subsequently WTO) commitments, including allowing foreign firms to operate in the country, competitiveness will have to be honed. This will entail further elimination of structural weaknesses in state enterprises and the banking sector, development of adequate infrastructure and human resources, reduction of the regulatory cost of doing business, more efficient public service delivery, and continued macroeconomic stability. The economy will need to make a rapid transfer of workers into industry and services employment if it is to meet the targets in the 5-year plan. Currently, 57% of the labor force are employed in agriculture, accounting for 20% of GDP. Productivity in agriculture will need to increase if real incomes for these people are not to lose more ground, but it is probable that more farmworkers will migrate to other sectors. With the total labor force increasing by more than 1 million every year (Figure 2.29.13), employment generation is a challenge over the medium term.

Over 2006–2010, total investment is expected to reach an average of 38.5% of GDP, with a little over half of it originating in the domestic and foreign private sector. (The private sector provided 46% of all investment in 2001–2005.) Further improvement in the business environment should pave the way for greater private investment and employment. With investment performing such a significant role in the economy, assuring its quality is a significant policy issue and underscores the importance

2.29.3 End of quotas on textile and clothing exports

The abolition of global quotas on textiles and clothing was a setback for these industries in Viet Nam. Members of the World Trade Organization, including the People's Republic of China and India, were able to increase exports to the United States (US), which accounts for half of Viet Nam's textile and clothing exports, at the expense of Viet Nam and others that are not WTO members, and so remain subject to US quotas.

Consequently, growth in Viet Nam's textile and clothing exports slowed to just 0.1% in the first half of 2005. Exports recovered, in the second half, partly as a result of the reimposition of restrictions on exports from the People's Republic of China to the US and EU and partly on account of a more efficient system of domestic quota allocation. For all of 2005, textile and clothing exports rose by 9.6% (up about 9% to the EU, where quotas were removed, and up only 1.2% to the US).

These industries are significant for Viet Nam, accounting for 17% of total exports in 2004 and for large-scale employment. An expansion of textile and clothing production in 2002–2004 doubled their employment to 2 million workers, or 17% of total industrial employment in 2004. This suggests that accession to WTO, and the consequent increase in access to markets, will have substantial benefits for output as well as employment.

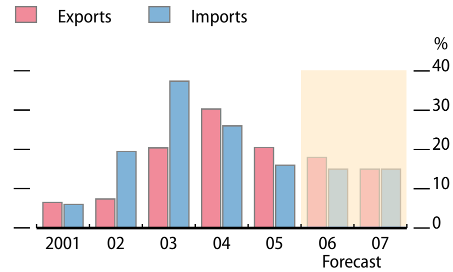
of improving financial intermediation with the reform of SOCBs and the development of stock and bond markets. The shift toward a higher share of private investment should improve the productivity of capital, since private companies will screen investments more rigorously, given their focus on profitability. In the public sector, the quality of (mainly infrastructure) investment may improve now that budget allocations are more transparent, with closer scrutiny by the National Assembly and People's Councils.

The restructuring of state enterprises is expected to enhance their productivity. Available data suggest that in 2003, 1,004 state enterprises (23% of the total) either incurred a negative return on equity or were insolvent. Another 1,153 (27%) earned a 10% or more return on equity. This suggests that payoffs to reform within the sector, either through liquidation or bringing the laggards closer to good practice, are high. A study involving the World Bank has found that the productivity and earnings of enterprises in Viet Nam generally pick up sharply after equitization.

AFTA and WTO commitments are likely to preserve the momentum toward domestic reforms. Further removal of tariff and nontariff trade barriers and barriers to FDI will facilitate the introduction of new technology, increased productivity, and the development of a more competitive economy. Moreover, when it does join WTO, Viet Nam will be eligible for most-favored nation treatment by WTO members and no longer be subject to quotas—a crucial point for the textile and clothing industry (as well as footwear to some degree).

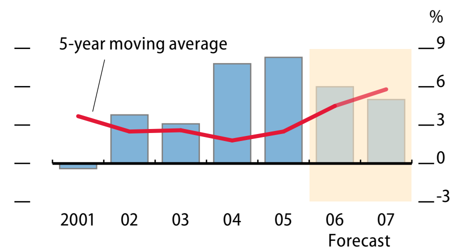
Domestic risks to the scenario outlined above include a possible slippage in the Government's commitment to implementing reforms and controlling corruption, which would discourage investment. This risk currently appears low, considering the AFTA and WTO commitments, acceleration in recent years of the restructuring of state enterprises, financial sector development, promotion of the private sector, and current action to control corruption. The authorities are also more explicit in recognizing the benefits of further market-oriented reforms, as indicated in policies outlined in the socioeconomic development plan for 2006–2010. Another risk is that the authorities may attempt to buy growth with directed lending through SOCBs. Strong credit expansion would also put upward pressure on inflation and could lead to higher levels of nonperforming loans, particularly as banks and the state-owned Development Assistance Fund have limited risk-management capability. A third potential problem is a shortage of power, given a high 14–15% estimated annual growth in demand. A reliance on hydropower generation, which accounts for 56% of power supply, leaves the energy sector vulnerable. A prolonged drought in 2005 led to utilization rates at some hydropower facilities falling to around 20%. Failure to meet energy demand and to reduce reliance on this type of power could undermine growth.

2.29.11 Export and import growth



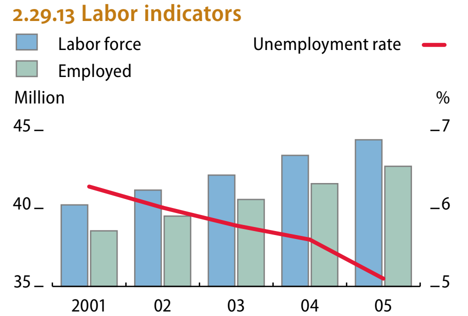
Sources: Asian Development Outlook database; staff estimates.

2.29.12 Annual inflation



Sources: General Statistics Office of Viet Nam, available: http://www.gso.gov.vn/default_en.aspx?tabid=462&idmid=2&idmid=2&ItemID=4031, downloaded 10 February 2006; *Asian Development Outlook* database; staff estimates.

2.29.13 Labor indicators



Sources: General Statistics Office of Viet Nam; available: http://www.gso.gov.vn/default_en.aspx?tabid=467&idmid=3&ItemID=3304, downloaded 10 February 2006; staff estimates.