Viet Nam

The policy tightening adopted to curb high inflation in 2011 also slowed economic growth. The authorities loosened monetary policy a notch in early 2012, and signaled that further easing is likely if inflation trends down. It is indeed seen receding this year, but then edging up again next year. GDP growth is forecast to remain subdued, before picking up in 2013. Beyond macroeconomic stabilization, the government needs to address risks in the financial sector.

Economic performance

Confronted at the start of 2011 with soaring inflation and rapidly depleting foreign reserves, the government adopted a package of monetary and fiscal tightening measures—Resolution 11—that were sustained through the year. Policy tightening started to rein in inflation and damped economic growth, to 5.9% for the year (Figure 3.31.1) as investment fell and consumption growth moderated, more than offsetting an improvement in net exports.

Investment declined by 9.2% owing to high lending rates and cuts in public infrastructure investment, both elements of the policy tightening. Gross capital formation as a ratio to GDP moderated to 38.7%, the lowest in 4 years.

Private consumption decelerated to 4.4% as high inflation eroded real incomes. Public consumption growth slowed to 7.2%, reflecting the firmer fiscal stance. Net exports, by contrast, strengthened in 2011 as exports grew faster than imports, making a major contribution to GDP growth.

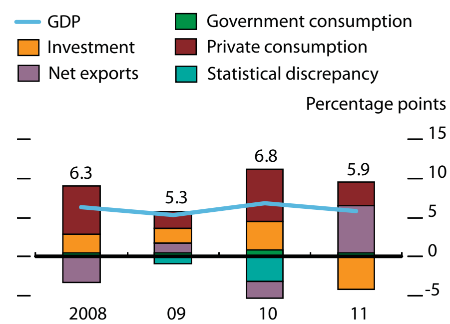
From the production side, a 7.0% expansion in services made the biggest contribution to total growth (2.9 percentage points). Wholesale and retail trading and hotels and restaurants both grew by about 7.5%, the latter supported by a 19% increase in visitor arrivals.

Stronger exports of manufactured goods underpinned an 8.3% expansion in manufacturing. However, construction fell by 1.0% due to cuts in public investment and curbs on lending for property. Better weather, strong commodity prices, and solid export demand for high-quality rice drove a 4.0% pickup in agriculture.

Inflation climbed to a 2011 peak of 23.0% year on year in August (Figure 3.31.2). It was driven by rising food prices, the lagged impact of high credit growth in 2010, exchange rate devaluations, and hikes in administrative prices of electricity and fuel. Food prices shot up by 34.1% year on year in August. Subsequently, food prices eased and, coupled with the impact of the policy tightening, brought inflation down, although it was still high at 14.2% in March 2012.

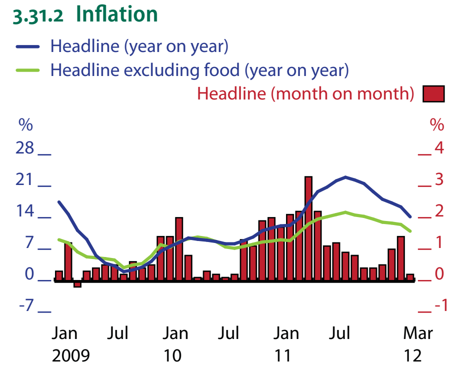
Policy tightening by the State Bank of Viet Nam (SBV, the central

3.31.1 Contributions to growth (demand)



Source: General Statistics Office.

3.31.2 Inflation



Source: General Statistics Office.

This chapter was written by Dominic Mellor, Chu Hong Minh, and Nguyen Luu Thuc Phuong of the Viet Nam Resident Mission, ADB, Ha Noi.

bank) was a combination of curbs on credit and money supply, hikes in bank reserve requirements and interest rates, and open-market operations. The repo rate—the cost of borrowing by commercial banks from the SBV on short-term open market operations—was ratcheted up from 10% to 14% in 2011, and the refinancing rate from 9% to 15%. The reserve ratio for banks' United States (US) dollar deposits was doubled to 8.0% for terms of less than 12 months and tripled to 6.0% for terms of 12 months or more.

As inflation trended down, real interest rates on dong deposits rose but remained negative. Liquidity shortages at some banks prompted them to offer deposit interest rates close to 20%, above a 14% cap imposed by the SBV. The average rate for borrowing in dong rose to 22% in July 2011, before easing to 19% by March 2012.

High borrowing costs, central bank administrative controls, and weak business sentiment pulled back growth in credit to 14.3% year on year by the end of 2011, from a rapid 32.4% in 2010 (Figure 3.31.3). Tighter liquidity contained growth in M2 money supply to 12.1% in 2011, slowing from 33.3% the previous year.

Most commercial banks met a year-end deadline to limit credit outstanding to "discouraged" activities including property, marketable securities, and consumer credit to 16% of total lending. The overall portion of credit to discouraged activities was estimated at 11.3% at end-2011.

The government stabilized the dong exchange rate through the monetary tightening, coupled with a large one-step devaluation in February 2011 and administrative measures such as caps on US dollar deposits and restrictions on the use of gold and foreign currency. Still, over the year, the dong depreciated by 10% against the US dollar (Figure 3.31.4).

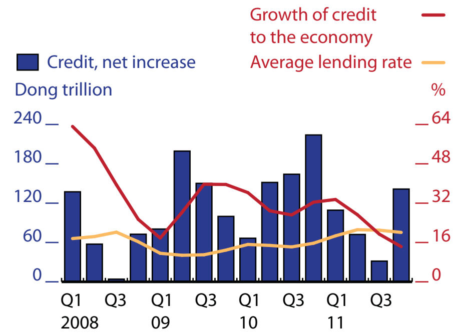
Fiscal tightening involved cuts in expenditures, mainly capital works, and gains in revenue. The government raised operating expenditure on education, health, and social security, but total spending, both on-budget and off-budget, is estimated to have declined in real terms last year. High prices for domestically produced oil contributed to the increase in revenue, as did the impact of inflation and exchange-rate movements. As a result, the budget deficit narrowed to 4.4% of GDP, from 5.6% in 2010 (Figure 3.31.5). Using an international fiscal definition, the deficit was estimated at 4.0% of GDP.

With robust exports, the government met its objective of greatly shrinking the trade deficit in 2011. Merchandise exports (up by 34% on a balance-of-payments basis) and imports (up by 26%) each totaled about $97 billion. High oil prices propelled exports of crude oil by 46% (using customs data) and exports of agricultural products by 30%. Shipments of manufactured goods rose by 35%, shielded from the impact of the global downturn because they are mainly low-value added manufactures. Currency depreciation buffered exports from rising domestic costs.

Imports decelerated owing to lower demand for raw materials and other production inputs for export industries, the cooling of private consumption, and currency depreciation. Also, the government restricted imports of some consumer goods.

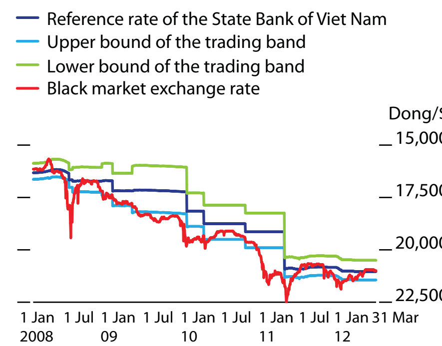
The current account turned to a small surplus (0.2% of GDP), the

3.31.3 Credit growth and lending rate



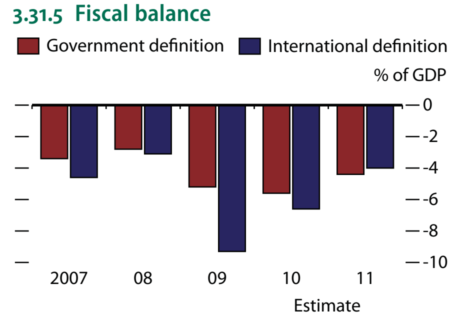
Sources: State Bank of Viet Nam; Ho Chi Minh Securities Corporation.

3.31.4 Exchange rates



Sources: State Bank of Viet Nam; ADB observations.

3.31.5 Fiscal balance



Note: International definition includes off-budget spending and onlending, but excludes principal debt repayments and revenue and expenditure carried forward. It estimates revenue and expenditure for 2010 and 2011 that is not yet recorded (fiscal accounts for these 2 years are still incomplete).

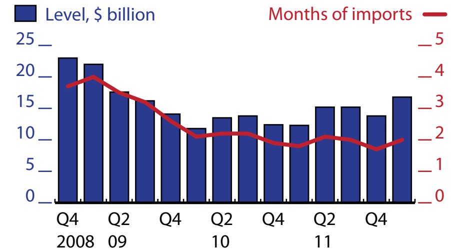
Sources: Ministry of Finance; ADB estimates.

first surplus in 10 years. That reflected the smaller trade deficit and a 10% increase in remittances (to about $8.7 billion). Portfolio investment inflows were below 2010 levels at an estimated $1.4 billion (the VN index of share prices dropped by 27% in 2011) and foreign direct investment was slightly lower at about $6.5 billion.

These capital inflows contributed to a rebuilding of international reserves by an estimated $1.4 billion to $13.8 billion in 2011. Favorable foreign exchange market conditions in the first quarter of 2012 enabled the SBV to further increase reserves, to an estimated $16.8 billion, equivalent to about 2 months of import cover (Figure 3.31.6).

Monetary tightening led to liquidity stress in some banks last year. Three small banks facing liquidity problems merged in December 2011 under the supervision of the SBV, which provided liquidity support to the merged entity and instructed a state-owned commercial bank to provide it with credit.

3.31.6 Gross official reserves



Notes: Data exclude government foreign exchange deposits at the State Bank of Viet Nam and the foreign exchange counterpart of swap operations. Import data are on free-on-board basis.

Sources: State Bank of Viet Nam; ADB estimates.

Economic prospects

The government, attempting to expand the economy while bringing down high inflation, targets a modest acceleration in GDP growth in 2012 (to 6.0–6.5%) and much lower inflation (under 10%). Fiscal and monetary statements suggest some easing in policy settings. The budget indicates that on-budget public spending could rise by about 6% in real terms (compared with a decline in 2011) and the fiscal deficit target in 2012 is widened slightly from last year to 4.8% of GDP.

The SBV is targeting credit growth of 15–17% in 2012, slightly faster than 14.3% recorded in 2011, and the goal for growth in M2 money supply is 14–16%, up from last year's outcome of 12.1%. The authorities have directed banks to continue to limit lending for property, securities, and consumer credit to 16% of loan portfolios.

Credit growth ceilings this year are bank-specific, depending on a range of financial soundness indicators. Weaker banks have a lower ceiling for credit growth than others. Strong banks with higher credit growth ceilings hold an estimated 90% of total banking assets.

In March 2012, the SBV responded to the gradual easing of inflation by lowering the refinancing and discount rates by 100 basis points (Figure 3.31.7) and reducing the ceiling on dong deposit rates from 14.0% to 13.0%. The monetary authorities indicated that further easing depends on inflation trending down toward the target (and the forecasts below assume this will be the case).

The SBV introduced central bank bills of 1–6-month terms to improve liquidity management, and used these securities to sterilize bank reserves created by foreign exchange purchases.

Preliminary data indicate that GDP grew by 4.0% in the first quarter of 2012, decelerating from 6.1% in the fourth quarter of 2011. Industrial production increased by 4.1% year on year. Credit contracted by 2.5% during the first 2 months of this year. In further signs of sluggish economic activity, merchandise imports grew by 7% in the first quarter.

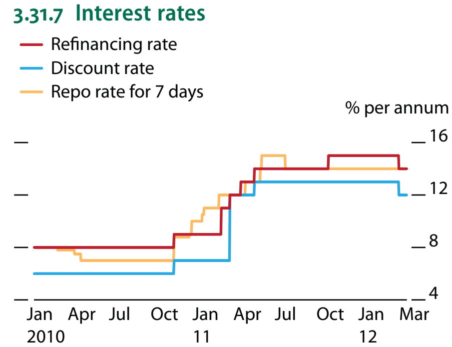
Private consumption in 2012 will get support from easing inflation. Investment will likely remain subdued, given uncertainties about the health of the financial sector, and government capital spending

3.31.1 Selected economic indicators (%)

	2012	2013
GDP growth	5.7	6.2
Inflation	9.5	11.5
Current account balance (share of GDP)	-1.5	-2.2

Source: ADB estimates.

3.31.7 Interest rates



Source: State Bank of Viet Nam.

is expected to be flat. Growth in exports will slow from 2011, owing to weaker world trade, although Viet Nam should benefit from the expected gradual pickup in the United States, its biggest export market.

On the balance of these factors, GDP is forecast to grow by 5.7% in 2012 (Figure 3.31.8). Growth is expected to pick up to 6.2% in 2013, owing to the improved global outlook for trade and investment and likelihood of easier monetary policy next year.

Inflation is forecast to trend down this year, reflecting the policy tightening and high base set for the consumer price index in 2011. Food price inflation is abating. Weather conditions for agriculture were generally favorable in the first quarter of 2012 and global food prices are projected to ease this year. However, the government raised administered fuel prices by 3–12% in March. Average inflation this year could ease to just under double digits, provided policy settings are kept sufficiently firm. (Core inflation, which excludes food and energy, will be more persistent, though.) Year average inflation in 2013 is seen quickening to 11.5%, in tandem with economic growth and on expectations of higher global food prices and hikes in domestic electricity and fuel costs.

The current account is forecast to record a deficit equivalent to 1.5% of GDP in 2012 and 2.2% in 2013, largely due to subdued exports.

This outlook would be at risk if the government were to ease policies at a pace unsettling the foreign exchange market. Real savings of dong depositors have been eroded by negative interest rates over a prolonged period. The cumulative "errors and omissions" in the balance of payments, estimated at $18 billion in 2009-2011 (Figure 3.31.9), reflects large volumes of foreign currency and gold outside the banking system.

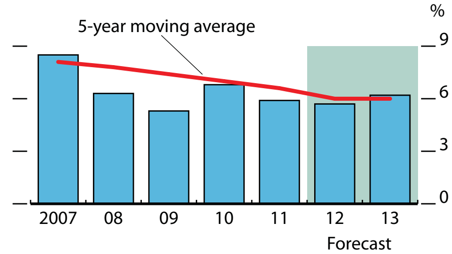
Lowering interest rates too quickly could put the dong under renewed pressure. This would undermine macroeconomic stabilization efforts, erode investor and consumer confidence, and undermine foreign reserves. Vulnerabilities in the banking system also pose a risk. Business confidence and the financial system would be shaken if problems at small banks were to spread.

While foreign reserves have been rebuilt, they are still low, making the economy vulnerable to external shocks. On the fiscal side, the costs of recapitalizing banks, restructuring state-owned enterprises (SOEs), and raising civil service wages to compensate for rapid inflation puts at risk public capital spending. The ratio of current to capital expenditure increased significantly last year. Additionally, an increasing proportion of government spending is being channeled off budget (Figure 3.31.10), raising public financial management risks.

The authorities will need to accelerate reforms of SOEs if they are to raise the efficiency of this large sector of the economy, a prerequisite for lifting average GDP growth to 7–8%, the target of the Socioeconomic Development Strategy 2011-2020. Reform efforts so far have focused on small to medium-sized SOEs. The government has committed to draw up restructuring plans for 21 large state groups to make them more commercially oriented. It wants to reduce by about half the number of SOEs to 690 by 2015, and then to 200 by 2020, through full or part privatization.

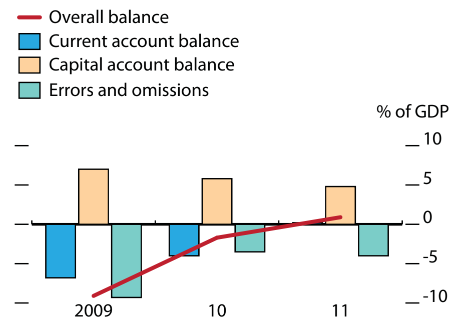
Concerned about SOEs expanding into areas unrelated to their

3.31.8 GDP growth



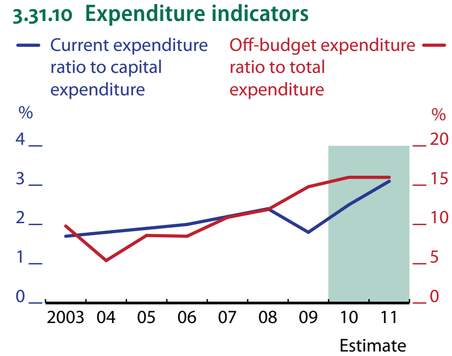
Source: Asian Development Outlook database.

3.31.9 Balance-of-payments indicators



Sources: State Bank of Viet Nam; ADB estimates.

3.31.10 Expenditure indicators



Note: At end-March 2012, the government had yet to finalize fiscal accounts for 2010.

Sources: Ministry of Finance and ADB estimates.

core businesses, the government has banned them from making such investments. Increased transparency of the financial performance of state enterprises would provide a strong signal to the market that the government was committed to reforms.

Policy challenge—financial sector restructuring

Rapid growth in lending over several years, followed by the squeeze on credit in 2011 and exacerbated by downturns in property and equities markets, have added to stresses for banks. The ratio of nonperforming loans to total loans increased to an estimated 3.4% (Figure 3.31.11), although it would be much higher under international accounting standards. This rising ratio and the risk profile of some bank balance sheets, particularly those with exposure to unprofitable and overstretched SOEs, raises questions about capital adequacy, particularly for small banks. The dangers are compounded by shortcomings in risk management at banks and weaknesses in the regulatory and supervisory framework.

A 16% increase in US dollar borrowing in 2011 heightened foreign exchange risk for banks. The SBV increased surveillance of foreign currency lending. From May 2012, it will restrict foreign currency lending only to firms engaged in export and import activity; it will also reduce limits on banks' foreign exchange positions.

Uncertainty over the financial health of banks has unsettled investors and hampered interbank market operations. A Financial Sector Assessment Program, to be conducted by the International Monetary Fund and World Bank at the request of the Vietnamese authorities, suggests they intend to address weaknesses in the banking system. The assessment, expected in the first half of 2013, will give recommendations for financial sector restructuring.

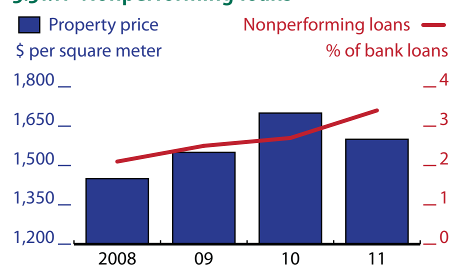
In March 2012, the government outlined a plan that includes injecting capital into banks and encouraging strong banks to acquire weaker ones. Officials said part-privatization of state-owned commercial banks will be accelerated and bank capital requirements raised. Funding and timing of the bank recapitalization have not been disclosed in detail. The government wants to see, over the next few years, one or two state-owned commercial banks well placed to compete against other banks in Southeast Asia.

Safeguarding the banking sector is the immediate priority. The longer-term requirement is to develop a diversified and efficient financial system that can mobilize funding to meet the 7–8% economic growth target.

The government has already this year approved a plan to revamp the securities market. It covers development of the government and corporate bond markets, a restructuring of the two stock exchanges as well as securities firms, and an improved payment and settlement system for securities. Under the plan, policies are to be formulated to encourage more domestic and foreign investors in securities.

These complex reforms, which will take years to complete, would benefit from coordination with the proposed restructuring of SOEs.

3.31.11 Nonperforming loans



Note: Property price is the average price of high and medium-priced condominiums.

Sources: State Bank of Viet Nam; CB Richard Ellis; ADB estimates.