# Viet Nam

The economy stabilized in 2012 as previous policy tightening suppressed inflation and bolstered external accounts. Subdued economic growth prompted an easing of monetary policy last year, but lending was constrained by problems in banks. GDP growth is forecast to edge up this year and next, with inflation in the high single digits. Sustaining foreign direct investment inflows and maintaining competitiveness requires intensified efforts to reform banking, state-owned enterprises, and the business environment.

## Economic performance

GDP growth ebbed to 5.0% in 2012 (Figure 3.31.1), the slowest in 13 years, as fiscal and monetary tightening in 2011 continued to have an impact into last year. While the policies took a toll on growth, they achieved sharp reductions in inflation and a more stable exchange rate, and they contributed to a record current account surplus and to rebuilding foreign reserves.

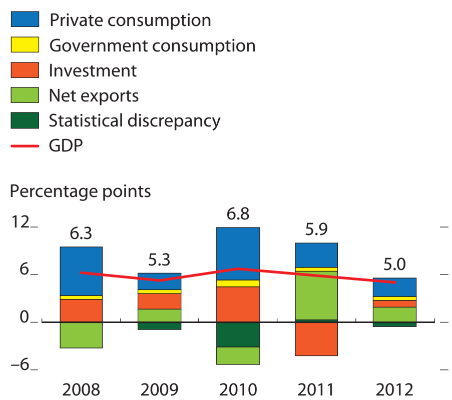
All sectors—agriculture, industry, and services—recorded slower growth in 2012 than in 2011. Manufacturing decelerated to 4.5%, reflecting weak domestic demand, high inventories, and reduced bank lending. Construction grew by a modest 2.1% after contracting in 2011 when the government squeezed credit and cut public investment. Services expanded by 6.4% to make the biggest sector contribution to GDP growth last year. Tourism-related services benefited from 9.5% growth in visitor arrivals, though this was a slowdown from 2011. Agriculture grew by just 2.7%.

From the demand side, growth in private consumption eased to 3.4% owing mainly to a weaker labor market. About 116,000 businesses closed in the past 2 years. Investment grew by 2.2%, a turnaround from its contraction in the previous year. Foreign direct investment (FDI) inflows remained substantial, but private domestic investment was dampened by weak credit growth. The government brought forward some planned capital spending, which lifted public investment. Strong exports and sluggish imports meant net exports made a significant contribution to GDP growth for the second consecutive year.

The stabilization policies, together with good domestic harvests and soft global food prices, tamed inflation in 2012. It decelerated sharply from over 20% year on year in October 2011, bottoming out at 5.0% in August 2012 (Figure 3.31.2). On a year-average basis, inflation receded to 9.2%, half the rate of 2011.

Steep declines in inflation allowed the State Bank of Viet Nam, the central bank, to lower its refinancing and discount rates, and its caps on short-term deposit rates, by 600 basis points (Figure 3.31.3). It also increased its limit on credit growth for some banks and reintroduced,

**3.31.1 Demand-side contributions to growth**




*Source:* General Statistics Office of Viet Nam.
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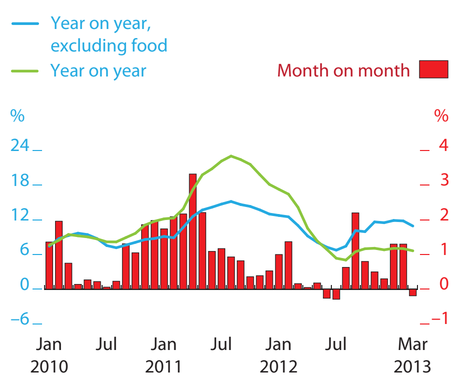
**3.31.2 Monthly inflation**




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

then later lowered, a ceiling on bank lending interest rates for priority industries. Nevertheless, growth in credit estimated at 8.9% last year was the slowest for many years and fell short of the central bank's 15%–17% target (Figure 3.31.4).

Broad money supply (M2) increased by 22%, above the central bank's target of 14%–16%, suggesting sufficient liquidity but lack of demand for credit. Banks were cautious in extending credit due to their impaired balance sheets, illustrated by rising nonperforming loans (NPLs), and their concerns about the financial health of borrowers and other banks. Firms and individuals hesitated to take on debt at a time of weak domestic demand and a declining property market. Lending for consumption, real estate, and marketable securities was only 4% of total lending, well below the 16% cap on lending for these activities introduced by the central bank in 2011.

The Viet Nam dong, after depreciating against the US dollar for several years, traded within its official exchange rate band for most of 2012 (Figure 3.31.5). The more stable exchange rate mainly resulted from lower inflation, positive real interest rates, stronger external accounts, a cap on US dollar deposit interest rates, and lower domestic gold prices.

Fiscal stimulation of the economy was relatively modest in 2012. The government brought forward capital spending and made some concessions on taxes and fees. Budget spending relative to GDP was little changed from 2011 while tax revenue declined on this basis. The budget deficit widened slightly to 4.8% of GDP. On-budget capital spending as a share of total budget outlays fell from an average of 30% in 2008–2011 to 22%, in part a result of higher salaries in the public sector. Off-budget expenditures and lending was funded through domestic bond issuances.

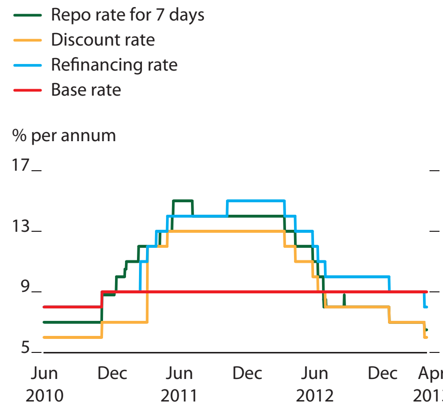
High liquidity allowed the government to boost its net issuance of government bonds to the equivalent of about 3.6% of GDP, from 1.2% in 2011.

Strong growth in exports and subdued imports produced a record trade surplus estimated at $10 billion on a balance-of-payments basis. Merchandise exports rose by 18.2%, a much stronger performance than other countries in Southeast Asia. Viet Nam became the world's biggest exporter of rice and coffee in 2012. Manufactured exports rose steeply, reflecting the start of operations of foreign-invested factories making mobile phones, computers, and other electronics. Customs data show the proportion of high-tech products in total exports has climbed to 18% from 4% in the past decade (Figure 3.31.6).

Merchandise imports increased by 7.5% on sluggish domestic demand. The trade surplus, coupled with tourism receipts and remittance inflows, contributed to a current account surplus estimated at 6.4% of GDP, a huge turnaround from 4 years earlier, when the current account recorded a deficit of 11.9% of GDP. Together with higher capital inflows, these developments helped rebuild foreign reserves to an estimated 2.6 months of goods and services imports (Figure 3.31.7). FDI inflows rose by 11% to an estimated $8.4 billion, medium and long-term loans by 19% to nearly $4 billion, and portfolio investment by 36% to $2 billion.

The government continued to grapple with banking sector problems. Banks reported in October 2012 that NPLs were about 4.8% of total loans, but based on closer surveillance of the banking system the central bank estimated that the ratio of bad loans was 8.8% at midyear. It trimmed that

**3.31.3 Interest rates**




*Source:* State Bank of Viet Nam.
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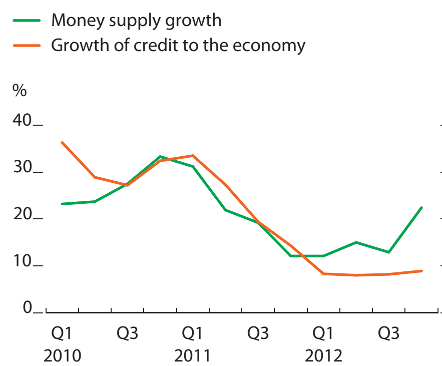
**3.31.4 Credit and money supply growth**




*Sources:* State Bank of Viet Nam; ADB estimates.
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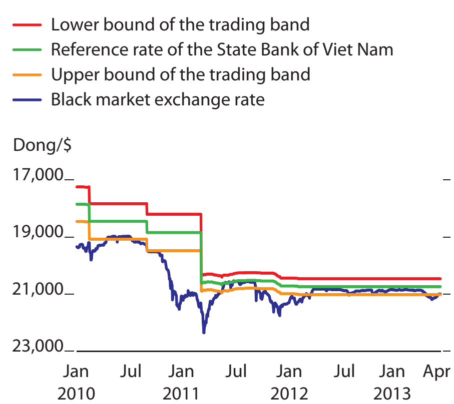
**3.31.5 Exchange rate**




*Sources:* State Bank of Viet Nam; ADB observations.
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estimate to 6.0% in February 2013. Independent analysts estimate that NPLs could be in double digits using international accounting standards (Figure 3.31.8). NPLs have proliferated because of rapid growth in lending over several years followed by the squeeze on credit in 2011, the downturn in the economy and property market, and poor performances by some highly leveraged state-owned enterprises (SOEs).

In March 2012 the government approved a reform plan to strengthen the banking system through mergers, recapitalization, the adoption of international prudential standards, and improvements in bank supervision. Several financially stressed banks were merged, and the authorities disclosed additional data on the health of the banking system. However, there was little progress on recapitalizing banks or resolving NPLs. The capital adequacy ratio of the banking system fell to 13.6% in January 2013 from 14.6% in April 2012. While this ratio is still well above the 9% floor set by the authorities, banks' capital positions may be weaker than reported if they have underestimated NPLs and not made adequate provision for them.

The government also outlined a plan to improve SOEs' disclosure, governance, and operations. More information on this strategy is scheduled to be disclosed in 2013.

Moody's downgraded Viet Nam's credit rating to B2 from B1 in September 2012, citing banking system weaknesses and lower economic growth. Standard & Poor's has a long-term rating for Viet Nam of BB– and revised its outlook to *stable* from *negative* in June 2012. Meanwhile Fitch, which has a B+ long-term rating, affirmed its *stable* outlook rating in January 2013.

## Economic prospects

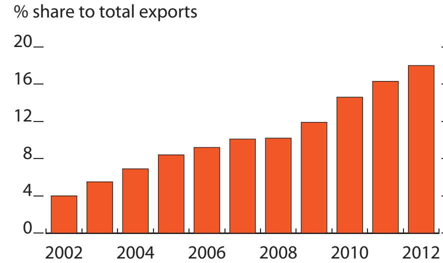
Government statements indicate that macroeconomic stability remains the main priority. The discussion below assumes policy stimulation to support growth during the forecast period will be moderate.

The central bank is targeting credit growth of 12%, stronger than the 2012 outcome of 8.9%, and M2 growth of 14%–16%, down from last year's actual growth of 22.4%. The central bank has removed restrictions on lending for consumption, real estate, and marketable securities. After inflation eased to 6.6% year on year in March 2013, the central bank lowered a number of interest rates, including its refinance and discount rates by 100 basis points to 8% and 6%, respectively. The impact of these lower rates on credit growth may be muted until the banking sector problems are addressed more decisively.

On the fiscal front the government has maintained the budget deficit target at 4.8% of GDP for 2013. In January it allowed small and medium-sized enterprises and labor-intensive manufacturers to defer corporate income tax and value-added tax payments, and it offered subsidies and tax breaks to revive the property market. Capacity to provide greater fiscal stimulation is constrained by public debt, which has increased to 55% of GDP, and contingent liabilities in SOEs and banks.

Private consumption will get support from the downtrend in inflation, though labor market weakness remains a dampener. The outlook for investment has improved with a surge in FDI commitments from Japan

**3.31.6 High-technology exports**




*Note:* Merchandise exports.

*Sources:* United Nations. Comtrade database. http://comtrade.un.org (accessed 1 April 2013) ; General Statistical Office; ADB estimates.

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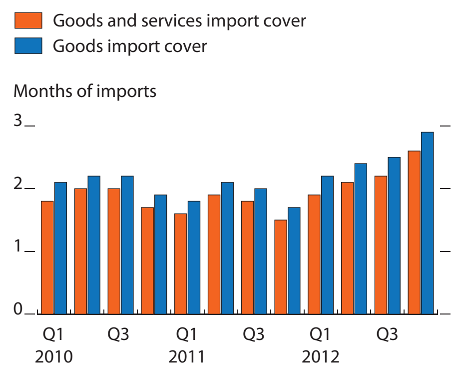
**3.31.7 Gross international reserves**




*Note:* 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; International Monetary Fund; ADB estimates.

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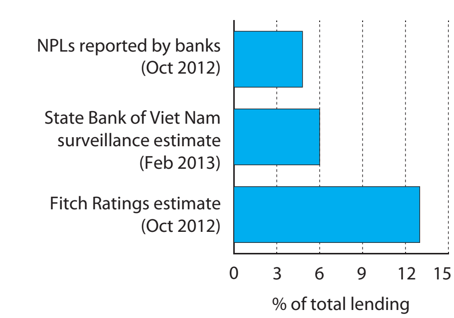
**3.31.8 Nonperforming loans**




NPL = nonperforming loan.

*Sources:* State Bank of Viet Nam; Fitch Ratings.

*Click here for figure data*

last year and the policy decisions mentioned above. However, questions over the soundness of the banking system will continue to weigh on domestic private investment.

Exports are projected to maintain solid expansion, given higher economic growth in the PRC and some other markets this year, and the anticipated pickup in major industrial economies in 2014. Manufactured exports will continue to trend up as FDI-funded factories come into production. Imports also will increase, though, to meet domestic demand as it gradually recovers and to supply inputs for the export-oriented manufacturers.

GDP grew by 4.9% in the first quarter of 2013, marginally higher than the year-earlier period, and the purchasing managers' index trended up slightly as orders increased. On the down side, growth in industrial production at 4.9% and in real retail sales at 4.5% showed slight decelerations from a year earlier.

Taking these factors into consideration, GDP growth is forecast at 5.2% in 2013, picking up to 5.6% in 2014 (Figure 3.31.9) if progress is made in strengthening the banking sector and recovery in major industrial economies gathers momentum in 2014.

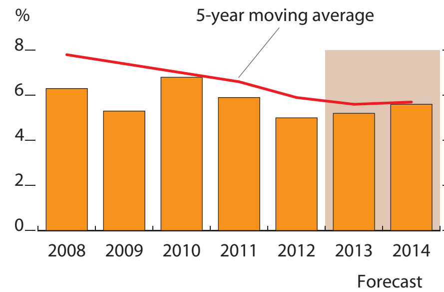
Inflation is seen easing to 7.5% on average this year before quickening to 8.2% in 2014. This view assumes reasonable weather for food production, a broadly stable dong exchange rate, and restrained policy stimulation. The trade surplus is expected to climb to a record $12.5 billion in 2013 and the current account surplus to increase further this year before easing in 2014 as imports accelerate in tandem with GDP growth (Figure 3.31.10).

Risks to the outlook center on the soundness of the banking system and the scale of NPLs. The NPL problem started spreading to the interbank money market from late 2011, when some banks were unable to recover funds provided to smaller banks with high NPLs. The central bank responded last year by, among other measures, restricting banks with interbank debts overdue by more than 10 days from borrowing through the interbank market. Those measures reduced interbank transaction risks but also restricted the functioning of the market (Figure 3.31.11). The central bank eased some restrictions at the start of this year.

A financial sector assessment, conducted by the International Monetary Fund and the World Bank with the agreement of the government, will be completed this year. Meanwhile, the authorities have introduced regulation that requires commercial banks to increase risk provisioning against NPLs and report on loan classification by June 2013. Compliance might take longer because banks need to upgrade their accounting systems. The central bank's supervisory and regulatory functions need to be strengthened to ensure compliance with the new regulations.

Cleaning up bank balance sheets would pave the way for a more robust expansion of lending. With this in mind the central bank intends to establish an asset-management company to acquire bad loans from banks. Adequate funding will be critical to the success of this plan, as will a transparent process by which assets are priced and an insolvency system with improved capacity to manage the resolution of distressed assets.

**3.31.9 GDP growth**




*Source: Asian Development Outlook* database.
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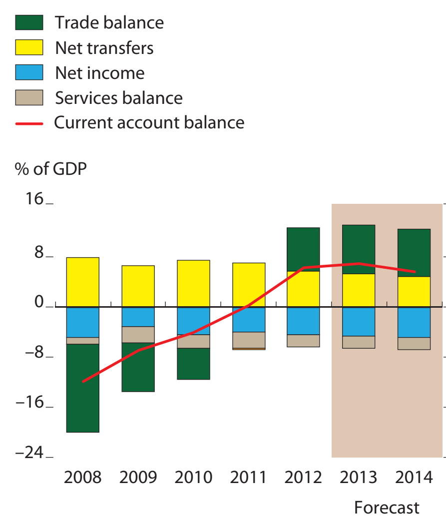
**3.31.10 Current account components**




*Sources:* State Bank of Viet Nam; ADB estimates.
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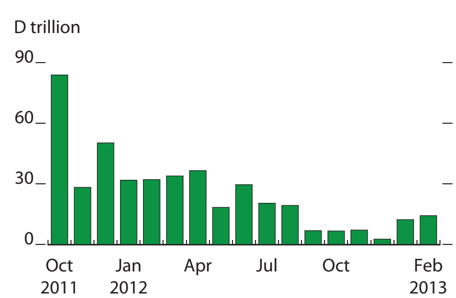
**3.31.11 Interbank volume**




*Source:* Reuters.
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A revival of the property market could ease pressure on the banks, at least temporarily. In this regard the government unveiled in January 2013 a package of measures that targets social housing projects with subsidized mortgage rates for low-income earners and public servants, reductions in state land rents, deferment of land use fees, and cuts in corporate income and value-added tax. The measures also involve a streamlining in the building permit process.

As a way to draw in foreign capital and expertise, the government is expected to increase the cap on foreign ownership in domestic banks by an institutional investor from 10% to 15%, and up to 20% for strategic investors, as well as allow more than 30% total foreign ownership in weak banks undergoing restructuring.

Plans for broader financial sector reform include the development of the bond market over the medium term as outlined in a government blueprint in February 2013. Policy actions will involve establishing credit rating agencies, a benchmark yield curve, a primary dealer system, and a legal framework to encourage investment in government bonds by voluntary pension funds and insurance companies. The government aims to increase the value of bonds outstanding from 18% of GDP in 2011 to 38% in 2020 and to raise the percentage of bonds held outside banks from 12% to 20% in that period.

As for the SOE sector, the government has committed to issuing a road map for reform by mid-2013. Implementation will require interagency coordination as SOE reform cuts across the mandates of several ministries. Restructuring plans have been approved for 24 large SOEs, and more such plans are expected, including equitization or partial privatizations through share offerings if market conditions allow. Equitization has slowed in recent years (Figure 3.31.12). One goal is to divest SOEs' noncore businesses by 2015, as many SOEs have accrued debts by investing in areas unrelated to their core businesses. The absence of an overarching regulatory framework for SOE reform could put at risk the implementation of restructuring plans developed through an ad hoc approach. For example, support for SOE restructuring will be difficult to muster until programs are put in place to support and retrain workers displaced during the shakeup of state firms.

Despite these concerns, Viet Nam has remained an attractive investment destination in light of its growing working-age population and low labor costs. This is illustrated by an increase in FDI from Japan. Nevertheless, the country faces increased competition for FDI in Southeast Asia, particularly from Indonesia (Figure 3.31.13). Viet Nam's ability to remain competitive and drive economic growth back up to 7%–8% will depend in large part on the timely and decisive implementation of structural reforms to the banking and SOE sectors and the improvement of other aspects of the business environment.

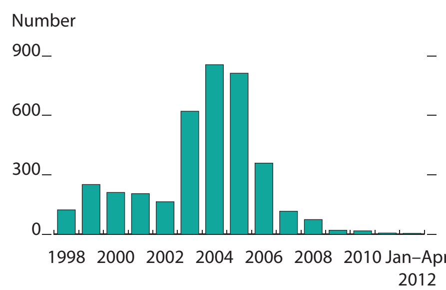
Indicating the extent of this challenge, Viet Nam's ranking in the World Economic Forum's *Global Competitiveness Report 2012–2013* fell by 16 places in the past 2 years to 75th of 144 countries (Table 3.31.2). That puts it below other larger Southeast Asian economies. Viet Nam scored poorly on several index components, including infrastructure (95), business sophistication (100), respect for property rights (113), irregular payments and bribes (118), and soundness of banks (125). The World

**3.31.1 Selected economic indicators (%)**

| | 2013 | 2014 |
|---|---|---|
| GDP growth | 5.2 | 5.6 |
| Inflation | 7.5 | 8.2 |
| Current account balance (share of GDP) | 6.9 | 5.6 |

*Source:* ADB estimates.

**3.31.12 Number of equitized state-owned enterprises**




*Sources:* Ministry of Finance; ADB estimates.

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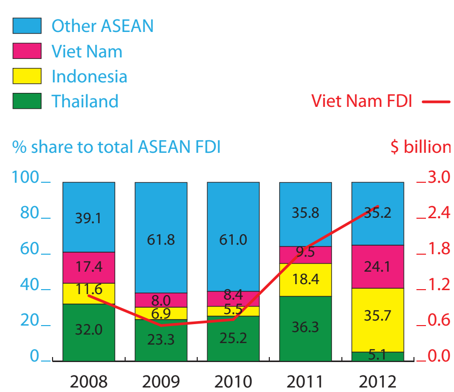
**3.31.13 Foreign direct investment from Japan**




ASEAN = Association of Southeast Asian Nations, FDI = foreign direct investment.

*Sources:* Japan External Trade Organization; ADB estimates.

*Click here for figure data*

Economic Forum report noted that the country's relative strengths are its labor market (ranking 51) and large domestic market (32).

**3.31.2 *Global Competitiveness Report, 2012–2013* rankings**

| | Rank |
|---|---|
| Singapore | 1 |
| Malaysia | 25 |
| Brunei Darussalam | 28 |
| China, People's Rep. of | 29 |
| Thailand | 38 |
| Indonesia | 50 |
| India | 59 |
| Philippines | 65 |
| Viet Nam | 75 |
| Cambodia | 85 |

*Source:* World Economic Forum. http://www.weforum.org

## Policy challenge—wastewater threat to water resources

Less than 10% of urban wastewater in Viet Nam is treated adequately. Most urban households use poorly maintained septic tanks or similar on-site systems that only partly treat sewage and can pollute freshwater resources. A study of water resources in 2009 found that the safety of water supplies in several river basins was at risk from the discharge of untreated and partly treated wastewater, including domestic sewage and industrial wastewater.

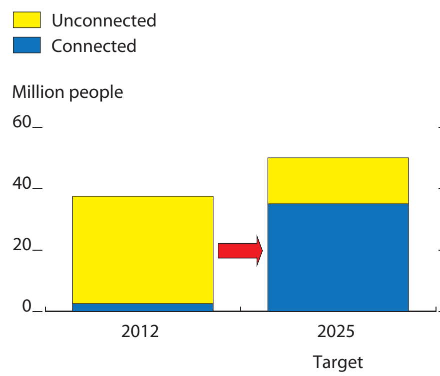
A rapidly growing urban population means the government will need to invest substantial amounts in wastewater collection and treatment to protect public health and guard against the pollution of freshwater resources. The government aims to connect 70% of the urban population, or about 35 million people, to central wastewater collection and treatment systems by 2025. Currently, only about 2.5 million people are centrally connected. The average per capita cost to connect to a new wastewater system with adequate treatment is \$200–\$600, suggesting the government will need to invest \$6.4 billion–\$20.0 billion over 12 years to meet its target (Figure 3.31.14).

Responsibility for urban infrastructure rests with local governments, but most do not have the financial or technical capacity to manage the scale, complexity, and cost of urban environment programs. Many wastewater utilities are not fully prepared to operate on commercial principles and attract private sector financing and expertise. Neither do they have access to capital markets. A sustained capacity-building effort is therefore required to implement urban wastewater management systems on a large scale.

While new wastewater treatment facilities have been constructed, a recent performance review found that legislation and regulations governing these projects need to be amended to ensure limited financial resources are directed to high-priority areas. Some investments were misdirected to unnecessarily costly treatment options or systems with high energy requirements. Local implementation of new sewer systems has on occasion resulted in poor coverage and failure to improve public health or the environment.

Looking further ahead, the government could supplement public funds by attracting private investment into wastewater management. This would require clarity on asset ownership, reliable information on existing infrastructure, clear assignment of responsibility for operation and maintenance, accounts and procedures that are consistent with international standards, and the timely imposition and enforcement of water and wastewater tariff increases to ensure at least cost recovery.

**3.31.14 Urban population connected to wastewater system**




*Source:* ADB estimates.
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