MACROECONOMIC AND DEBT SUSTAINABILITY ASSESSMENT

1. This assessment provides a summary of developments in macroeconomic policy. It also presents a summary assessment of debt sustainability.

2. **Welcome recent economic stability.** In 2012, the economy stabilized, representing a turn of events in comparison to the volatile period of 2007-2011. In early 2011, the government implemented stabilization measures (Resolution 11) to address the country's chronic macroeconomic vulnerabilities, such as high and rising inflation, extreme volatility in the foreign exchange market, rapidly declining foreign reserves, high levels of fiscal and trade deficits, and weaknesses in the banking and corporate sectors. The result has been generally positive. In 2012, the country averted a macroeconomic crisis, eased inflationary pressures, stabilized the exchange rate, and improved fiscal and external accounts. The increased supply of US dollars in the market has enabled the State Bank of Vietnam (SBV) to replenish foreign exchange reserves, which are now reportedly just over two months of imports. While the government has made important strides in stabilizing the economy, progress in implementing structural reforms have been slower than expected. These structural problems are the root cause of high inflation.

3. **Improved policy coordination needed.** Moving forward, improvement in macroeconomic policies will also need to be met with reform in micro level policies. The government must address the uncontrolled increase in non-performing loans in the banking system and also the structural inefficiencies of state-owned enterprises.

A. Economic growth performance

4. In early 2011, the country was in a phase of heightened macroeconomic vulnerabilities. This was characterized by high and rising inflation, extreme volatility in the foreign exchange market, rapidly dwindling international reserves, a sharp rise in country risk following default by one of the biggest state-owned enterprises (SOEs), high levels of fiscal and trade deficits, and weaknesses in the banking and corporate sectors. These vulnerabilities, and the absence of a persuasive strategy to address them, led to weakening sentiments towards the country's economic prospects. Stabilization measures implemented in 2011 and 2012 helped Viet Nam avert a macroeconomic crisis, restored macroeconomic stability, reduced inflation, strengthened fiscal and external accounts, and stabilized the exchange rate. The increased supply of US dollars in the market has enabled the State Bank of Vietnam (SBV) to replenish foreign exchange reserves, which are now reportedly just over two months of imports.

5. **Slow economic growth in return for stability.** Stabilization policies and sluggish global growth have led to economic slowdown during 2012. GDP growth slowed to 4 % in Q1 year-on-year, the lowest it has been in three years. Growth picked up in Q2 2012 (4.6 %) and Q3 (5.4 %), reaching 5.03 % for the whole year. This is lower than the target of 6-6.5 % initially set for 2012. The slowdown has been felt most acutely in the construction sector as well as by SMEs. Nearly 42,000 SMEs are reported to have closed, liquidated or temporarily suspended their operations during the first ten months of 2012 – a 6.7 % increase compared to the same period in 2011. Government also committed to address the high non-performing loans in the banking sector.

6. **Decline in private investment.** A major source of the growth deceleration is slowing private investment. With the slowdown in credit growth and efforts to restructure public investment, total investment has fallen sharply — from 41.9 % of GDP in 2010 to 34.6 % in

2011. The decline has been uniformly shared across the state budget, state-owned enterprises and the private sector. The fiscal deficit in 2012 is however estimated to be somewhat wider due to off-budget expenditures funded through bond issuance. As noted above, foreign investments have declined in recent years. This is a source of concern as Viet Nam will require infusion of foreign capital to restructure its state-owned enterprises and banking sector.

B. External balance

7. **Surplus in trade.** The trade account recorded a rare surplus in 2012, the first one since 1992. The surplus largely reflected a sharp slowdown in import growth owing to weak domestic demand, in particular falling demand for construction material, but also reflected strong exports by the foreign direct investment sector. Import spending in the year to August is estimated at $114.3 billion, up 7.1%% year-on-year. Imports of machinery and equipment by foreign firms remained strong. However imports by domestic firms decreased, reflecting a strong consolidation of public as well as private investment. Imports of raw materials and intermediate goods (fertilizer, animal feed, cotton, fiber, fabrics) have also decreased, reflecting falling domestic demand and growing inventory. Imports of automobiles and motorbikes fell sharply partly because of a hike in taxes and fees to deal with chronic traffic congestion in large cities.

8. **Improved current account and reserves.** An improved trade account lead to an improved current account balance and higher foreign exchange reserves. In 2012, the current account balance improved to 5 % of GDP, which is a record figure. This is also a significant improvement from double-digit deficit the past five years. Moreover, the improvement in the current account balance was not accompanied by any sharp and sudden adjustments to the exchange rate. The improved trade account also enabled the SBV to shore up foreign exchange reserves. International reserves have built up from 7 weeks of import cover (end 2011) to about 10 weeks (December 2012), which is roughly $20 billion. This was also helped by a decline in domestic capital flight as exchange rate stability and falling inflation have helped to restore confidence in the VND. This is reflected in the fact that the reference rate for VND has been stable at 20,828 Dong to the US Dollar for nearly a year, and a narrowing differential between the parallel and official rates.

C. Inflation and Monetary Policy

9. **Improved inflation outlook.** Inflation has fallen steadily over the past twelve months. Headline and food inflation peaked at 23 and 34 % respectively in August 2011. By December 2012 headline inflation for the year had fallen to 6.8 %. While year-to-year inflation has been steadily declining, the month-on-month inflation, which suffers from seasonality bias and hence an imperfect measure of the general price movements, rises during the lunar new year months, and remained high in January-February 2013.

10. The decline in the inflation rate can be largely attributed to stabilization measures. There is a strong parallel with the last inflation episode when inflation peaked at 28.3 % in August 2008 and plummeted to 8.1 % in May 2009. But there is also a critical difference. In 2008/09, global commodity prices, especially the price of crude oil plunged from around US$150 per barrel to less than US$40 per barrel in the space of a few months. The current disinflation episode, however, has occurred despite high global prices, pointing to the effectiveness of Resolution 11 in bringing inflation down to single digits. Other important factors that assisted the decline in inflation included sharp drop in food prices (favorable weather conditions and improved supply), and strong trade flows.

11. **Reduction in SBV policy interest rates.** Falling inflation and a slowdown in growth enabled the SBV to aggressively cut policy interest rates by 600 basis points between March and December 2012. The cap for dong deposits has also been reduced from 14 % to 8% in 2012. The rules on lending to real estate and for private consumption have been relaxed. SBV is encouraging commercial banks to lower lending rates and is promoting credit for production, agriculture and rural development, exports, and small and medium enterprises. SBV has also lowered the foreign exchange position limit (ratio of total foreign exchange to the institutions' equity capital for the previous month) of credit institutions and branches of foreign banks by day-end to 20%, from the current level of 30%. The move, together lower caps in US deposits, is aimed at preventing commercial banks from hoarding foreign currencies and generating more VND liquidity in the banking system.

12. **Sufficient liquidity but lack of demand for credit.** In 2012, credit grew by 8.9%, while broad money supply (M2) increased by 22%, suggesting sufficient liquidity but lack of demand for credit. Total deposits, on the other hand, rose by more than 11 % during the first ten months of the year. The rate cuts may have helped alleviate the cost pressures in the private sector, but they are unlikely to influence the supply of consumer credit or consumer spending. This is partly because both individuals and firms are already highly leveraged, and there are uncertainties over future economic prospects, which has contributed to a more cautious attitude. The enterprises are unwilling to take out loans, or unable to due to lack of collateral. Most importantly, monetary transmission has been weakened by rising levels of non-performing loans, which limits the provision of new credit from banks.

13. **Improved policy coordination.** Macroeconomic coordination between SBV and Ministry of Finance (MOF) has also been improved. In February 2012, SBV and MOF signed a Memorandum of Understanding (MoU) to strengthen coordination of monetary and fiscal policy through a more regular exchange of information. However, effective implementation of the MoU will be key, given past experiences of lack of coordination between the two institutions.

D. Fiscal Policy

14. **Improved fiscal position in 2011.** The Government consolidated fiscal accounts by targeting more efficient public investment. The overall deficit fell from 5.2% % of GDP in 2010 to an estimated 3% %in 2011.[1] This was due in part to strong revenue performance and an initial conservative estimate of oil revenue. Corporate Income Tax (CIT) and Value Added Tax (VAT) (together around 55 %% of total revenue) grew at 29% and 19% respectively between 2010 and 2011, despite tax relief granted to over three hundred thousand enterprises. Total capital spending (including off-budget) declined slightly by 0.4 %% (and from 12% of GDP to 9.4%) over the same period.

15. **Revenue below target in 2012.** A drop in aggregate demand and tax relief for domestic enterprises contributed to below target revenues intake in the first nine months of 2012. Revenue collection in the first three quarters declined by 0.6% in nominal terms compared to the same period last year. The VAT, which makes up around a third of total revenue, declined from 5.4% of GDP in the first three quarters of 2011 to 4.8% in the first three quarters of 2012. This is in part due to tax relief measures introduced in May this year (Resolution 13). Lower VAT returns also reflect falling domestic consumption. VAT on imports and customs receipts have

[1] Although it widened again to 4.8% in 2012 despite modest fiscal stimulus.

declined due to a lower volume of imports and because of lower imports of high margin dutiable goods like cars. CIT payments by foreign invested enterprises have remained relatively strong (17% increase between Q3 2011 and Q3 2012), particularly compared to private domestic firms, thanks to buoyant exports.

16. **Effective expenditure utilization in 2012**. Expenditure utilization remained on track in the first nine months of 2012. Outturn across major spending categories has been around 75% of budgeted expenditure. There are also indications that the government has maintained discipline over capital expenditures, a major policy commitment in the 2012 State Budget amid growing concerns over inefficient public investments. By Q3 of 2012, the government had spent 71% of its VND 180 trillion capital budget. The ratio of capital to recurrent expenditure (on-budget only) was at around 27% in the first nine months of 2012 compared to an average of 29.5% over the same period in 2010-2011. MOF has reported that 67% of the VND 60 trillion in planned capital spending through off-budget bonds was also executed in the first nine months of 2012. These make up nearly a quarter of total capital spending. The government has capped off-budget capital expenditure to VND 225 trillion between 2011 and 2015, but this has been heavily frontloaded. Based on this, the government will need to limit off-budget capital spending to a total of VND 45 trillion in 2014 and 2015.

17. **Fiscal prudency is continued in 2013 state budget.** The National Assembly approved the 2013 State Budget estimates in November 2012. Government revenue is estimated to increase by 10% compared to the 2012 Budget to VND 816 trillion, and expenditure will also rise by 10% to VND 987 trillion. The overall budget deficit comes to 4.8% of GDP, based on government estimates. A priority for the government is salary adjustments for public servants. The 2012 State Budget raised the base salary from VND 830,000 per month to VND 1,050,000 per month. Starting in July 2013, the government plans to increase this by a further 9.5% to VND 1,150,000 per month, which may cost close to VND 50 trillion. On the other hand, the government has proposed a nominal cut to capital expenditure from VND 180 trillion in the 2012 Budget, to VND 170 trillion in the 2013 Budget. Notwithstanding higher off-budget spending as noted above, this would constitute the first nominal cut in the capital budget since at least 2006.

E. Structural Issues

18. **Continuing high levels of NPL's.** New information about the health of the banking sector indicated chronic NPL problems peaked in 2012. Even though problems in the banking system have been building up for some time, these were not reflected in the non-performing loan (NPL) ratios reported by banks to the SBV. The current regulatory regime discourages banks to report NPL's above 3%. Even as late as September 30, NPL's reported by banks stood at 4.93%. At the same time, SBV reported its own estimate of NPLs at 8.82%. Several independent analysts and academics, some of them using international standards to measure bad loans, estimate NPLs to be even higher.

19. **Limited options for NPL resolution.** The authorities have tried to seek viable solutions to the problem of rising NPL's, but without significant success. As a short-term response, SBV issued regulations in May 2012 allowing 14 banks to trade in bad debts. This was to enable banks with stronger capacity and capital base to acquire bad debts from weaker banks after paying a reasonable premium. Thus far, the solution has brought limited results. For the longer term, SBV has issued Circular 02/2013/TT-NHNN, replacing Decision 493 with stricter loan classification and provisioning requirements. This should allow more accurate reporting on NPL's and provide a better understanding of system-wide risks. The SBV has also submitted a plan to the Government for the establishment of a central Vietnam Asset Management

Company (VAMC) to address the bad debt problem. However, policymakers could not reach a decision on the VAMC. The SBV is working on a broader framework to resolve NPL's, of which the AMC may be a part. In addition, the authorities have proposed increasing caps on foreign ownership of financial institutions.

20. **Progress in restructuring SOE's.** The Prime Minister issued Decision 929/QD-TTg on the restructuring of State Owned Economic Groups and General Corporations. Reform priorities over the coming years include: (i) accelerating the equitization process including diversifying ownership, attracting strategic investors, and capital market development; (ii) strengthening corporate governance along with better monitoring of potential fiscal risks from SOE's; and (iii) improving the overall regulation and oversight of SOE's.

21. **Improvement's to public investments.** The Government has taken on a reform agenda to address inefficiency and fragmentation in public investments. The responsibility for screening, appraising, selecting, and executing infrastructure projects rests with Viet Nam's 63 provincial governments. Although this has helped to create strong competition among sub-national entities, the delegation of authority coupled with weak central oversight has led to inefficient spending and a lack of linkages between infrastructure and national priorities. Government reforms on public investment include: (i) the development of a Medium-Term Investment Framework (MTIF) to provide more predictability for planning and implementation of capital projects; (ii) mobilization of private resources for infrastructure development, especially through Public Private Partnerships (PPPs); and (iii) strengthening oversight, monitoring and evaluation of capital projects funded by public resources.

F. Macroeconomic Outlook and Debt Sustainability

22. **Positive economic outlook.** Viet Nam's economy is expected to grow at a moderate pace of around 5.4% during 2013 picking up to 5.6% in 2014. The base-case scenario assumed progress is made in strengthening the banking sector and recovery in major industrial economies gathers momentum in 2014.

23. **Easing inflation.** Inflation is seen easing to 7.5% on average in 2013 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

24. **Increasing trade surplus.** The trade surplus is expected to climb to a record $12.5 billion in 2013 and the current account surplus is expected to increase further this year before easing in 2014 as imports accelerate in tandem with GDP growth.

25. **Sustainable levels of public debt.** Total outstanding Government and Government-Guaranteed external debt increased by nearly 50% from 2008 ($21.8 billion or around 21% of GDP) to end of 2010 ($32.5 billion or 32.7% of GDP) due to the Government's fiscal stimulus package. Although debt to the private sector rose from around $3 billion in 2008 to $5.4 billion in 2010, more than 80% of Government and Government-Guaranteed external debt is long-term and concessional from official creditors. Domestic public debt has gone from around 18% of GDP between 2006 and 2008, to around 21.5% of GDP in 2010, also due to the fiscal stimulus.

26. **Low risk of debt related distress.** The present value of Government and Government-Guaranteed external debt is estimated at around 27% of GDP, considerably lower than the 50% of GDP threshold for external debt sustainability. The present value of public sector debt (i.e. including domestic debt) is closer to 50% of GDP. Maintaining the current course of fiscal

consolidation is essential for debt sustainability. It will help to shelter against potential exchange rate shocks, slowing exports due to falling global demand, and declining sources of concessional financing. Some of the recent developments imply a different set of assumptions than what was considered in the last Debt Sustainability Analysis (DSA). Weaker economic growth and higher recapitalization needs due to high levels of NPL's would adversely impact debt sustainability. This will be looked at in more detail in the next DSA planned for Q2 of 2013.

27. **Heightened risk form contingent liabilities.** There is growing recognition that contingent liabilities from SOE's and the financial sector pose significant risks to debt sustainability. Explicit obligations in the form of government guarantees are less than 5% of GDP. However, implicit obligations are not captured under government and government guaranteed debt statistics. A large proportion of NPL's is attributed to state enterprises. SOE's are in turn highly leveraged. Between 2007 and 2009, the aggregate debt-to-equity ratio of SOE's averaged 307% relative to 183% for non-state firms and 145% for foreign firms. SOE's also had the highest debt-to-asset ratio among the three groups. Therefore an economic slowdown would have an outsized impact on SOE's and would likely lead to an increase in NPL's followed by a crisis in the banking sector. However, even in the absence of a shock, Viet Nam's debt dynamics can change quickly depending on the costs of the government's economic restructuring agenda. The latter includes a plan to deal with NPL's and to restructure the largest state enterprises in the country (i.e., Economic Groups and General Corporations). The preliminary 2013 Budget estimates however do not seem to have provisions for restructuring costs.