



Introduction

Following turbulence in 2012–2013, the Vietnamese economy seems to have recovered its momentum. Its growth rate was 6.7% in 2015 and is expected to stabilize at over 6% in 2016 despite the negative impacts of climate events on agricultural production. Further, against a backdrop of international economic stagnation, Vietnam has capitalized on China's loss of competitiveness and become even more intensely integrated into international value chains, especially in new segments such as telephones.

But while Vietnam's development process over the last two decades has been impressive, it cannot be fundamentally differentiated from the overall dynamism of development in Asia. The process of convergence in particular seems to have slowed down very recently. This raises questions about the overall efficiency of the Vietnamese economic system (weakness of contribution from overall productivity of growth factors) and about the reforms needed to anticipate the limits of the current development model. This change will involve renewed interactions among the three major segments of actors—public, foreign private, and local private enterprises—as well as a rebalancing of rights in access to markets and to financing, etc.

The last five years have witnessed a structural change in the major budget balances in Vietnam: a marked drop in revenues; a change in the composition of public expenditures, to the detriment of investment; and a rise in budget deficit. These budget trends go hand in hand with an active policy of remobilization that benefits the Communist Party of Vietnam (CPV) and affects all the social as well as economic sectors (admini-

Vietnam: New “Workshop of the World”?

Opportunities and Challenges

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nistration; public enterprises, Vietnamese and foreign private enterprises) of the country. Its outcome has been a significant increase in the public debt, which is approaching the domestic ceiling of 65% of gross domestic product (GDP).

This additional debt, which is mostly in local currency Vietnamese dong (VND), has of course helped the process of consolidating the banking sector. However, the process by which it has occurred raises several questions, all the more so because the resulting administrative organization and budget composition continue to be characterized by a notable lack of transparency. To this “formal” debt must be added the importance of contingent liabilities linked to the poor performances of public enterprises and the deteriorated condition of the banking sector. The process of restructuring the public enterprises, through equitization, is complex and

slow. But thanks to impetus from the central bank, the process of restructuring the banking sector seems to be progressing more swiftly, through consolidation (mergers) of banks and the strengthening of prudential supervision systems. The recent robust growth in credit, which is markedly higher than nominal GDP growth, nevertheless brings up the question of the regulator's capacity to supervise the risk policy of banks.

At the external level, there has been massive rebalancing of the current account, thanks to healthy exports in recent years.

But foreign financing is still unstable, with economic actors maintaining strong mistrust vis-à-vis the VND. In this context, it would be worth introducing more flexibility into the exchange policy, which seeks to maintain fixed parity with the USD by conducting a limited number of symbolic devaluations. This is all the more true given that the level of foreign reserves was not adapted to the policy put into effect, and that China—Vietnam's main trade partner—recently made its exchange policy flexible. Measures taken after the last CPV Congress seem to confirm a trend toward more flexibility in Vietnam's exchange policy.

Table of Contents

| | | | |
|--|----|---|----|
| 1 / MAJOR LONG-TERM SOCIOECONOMIC CHANGES | 3 | 3 / PUBLIC FINANCES AND DEBT | 23 |
| 1.1. Significant decrease in income poverty | 3 | 3.1. Persistence of budget deficit, linked to low level of government revenue | 23 |
| 1.2. Improvement in other aspects of living conditions | 4 | 3.2. Rising public debt approaches domestic ceilings | 24 |
| 1.3. Weak incentives to deal with residual pockets of poverty | 5 | 3.3. Uncertainty regarding the size of contingent liabilities | 25 |
| 1.4. Strong vulnerability to climate change, with significant social impact | 6 | | |
| 2 / SUSTAINED GROWTH, BUT IN A MODEL REQUIRING REFORM | 8 | 4 / EXTERNAL FINANCING AND CREDITWORTHINESS | 26 |
| 2.1. Overall performances and regional comparisons: Vietnam is no exception | 8 | 4.1. Remarkable rebalancing of the current account | 26 |
| 2.2. Contrasts among the three sectors of the Vietnamese economy | 11 | 4.2. EFR: structurally high and dependent on short-term flows | 26 |
| 2.3. Effects on the job market | 15 | 4.3. Pressure on foreign reserves and the exchange rate | 28 |
| 2.4. Foreign trade: its importance in Vietnam's development process and the associated risks | 18 | 5 / MONETARY POLICY AND FINANCIAL SECTOR | 29 |
| | | 5.1. Success in limiting inflation | 29 |
| | | 5.2. Bank sector reform: progress despite lack of transparency | 30 |
| | | ACRONYMS AND ABBREVIATIONS | 31 |
| | | BIBLIOGRAPHIC REFERENCES | 32 |

1 / Major long-term socioeconomic changes

Vietnam has gone through in-depth transformation since the end of the 1980s, when it began its economic reform policy (*Đôì mới*, or “renovation”). The process has been a gradual one, following decades of war and an economic policy based on the Soviet model. It began to truly bear fruit from the second half of the 1990s.

Some milestones:

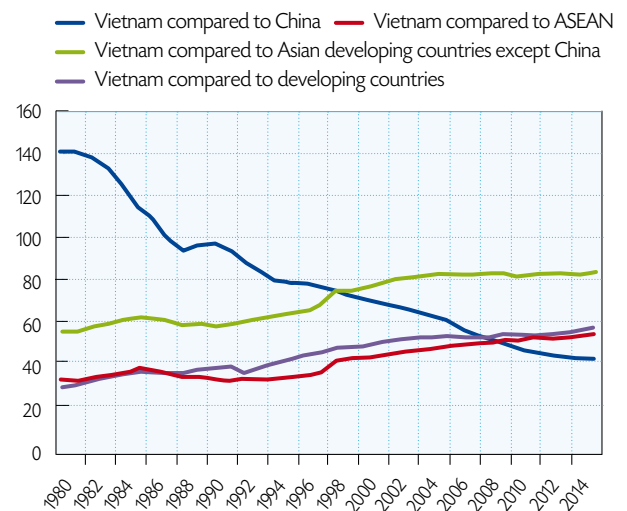
| | |
|------|---|
| 1986 | 6 th Congress of the Communist Party, declaring the start of <i>Đôì mới</i> |
| 1987 | Law on foreign investments |
| 1988 | Elimination of the price-control and two-price systems |
| 1992 | New constitution of the Socialist Republic of Vietnam, authorizing private property |
| 1993 | Transferability of land-use rights |
| 1995 | Accession to the Association of Southeast Asian Nations (ASEAN) |
| 2007 | Accession to the World Trade Organization (WTO) |
| 2015 | Trans-Pacific Partnership (TPP) agreement, finalization of the free-trade agreement with the European Union |

The process of economic liberalization in Vietnam has noteworthy similarities with that of China, which began a decade earlier.

1.1. Significant decrease in income poverty

Graph 1

Trends in Vietnam’s GDP per capita in PPP*, compared to other geographic areas



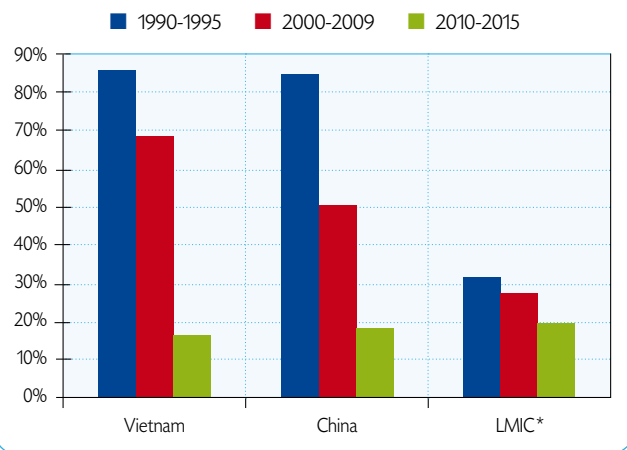
* PPP: Purchasing power parity.

Source: International Monetary Fund (IMF);

World Economic Outlook (WEO); AMR (AFD) calculation.

Graph 2

Comparative trends in poverty rates (at USD 2 per capita in PPP)



* LMIC: Lower middle-income countries

Source: World Development Indicators (WDI).

The economic performances of Vietnam since the 1990s (cf. Section 2) have led to undeniable results in terms of economic convergence and income-poverty reduction. Vietnam is engaged in a process of convergence with all the other economies—with the exception of China, whose performances are unmatched worldwide (cf. Graph 1). Convergence has occurred over different time periods depending on the geographic areas considered, as described below.

- Compared to all the developing countries as a whole, convergence has remained stable overall, despite a bit of a slowdown in the 2000s. Nonetheless, the income gap is still significant, insofar as the per-capita income in PPP in Vietnam remains 60% lower than the average among developing countries.
- Compared to the other ASEAN member states, convergence only truly began with the Asian economic crisis in 1998, and the trend remains stable. Vietnam's income gap remains significant (more than 40%), as in the case of LMICs.
- Compared to all the Asian developing countries besides China, the convergence process was most robust between 1992 and 2002 and then slowed down notably. The China

effect aside, it is possible that this deceleration is related to the performances of India, the other big player of continental Asia. The slightest time gap Vietnam may have compared to Asian developing countries other than China (less than 20%) can also act as another factor slowing down convergence.

This convergence is more or less strong depending on the sample with which it is compared. Above and beyond this convergence, the growth process has led to a steep decline in the rate of income poverty no matter which indicators are used. For example, the percentage of the population living under the threshold of USD 2 PPP/per capita/day dropped from 85% at the beginning of the 1990s to less than 20% at the beginning of the 2010s (cf. Graph 2). Progress in Vietnam has been comparable with that of China, but with a time gap of one decade. The pattern is different, though, from that of the LMICs: Vietnam entered this category relatively recently and has a per-capita income lower than the LMIC average; on the other hand, Vietnam's more balanced income distribution translates into a poverty rate lower than the LMIC average.

1.2. Improvement in other aspects of living conditions

Table 1 Social indicators in Vietnam, compared to developing countries of East Asia and to LMICs

| | Vietnam | Developing countries of East Asia and the Pacific | LMICs |
|---|----------------|---|----------------|
| Education | | | |
| Primary school completion rate | 97% (2013) | 104% (2013) | 91% (2013) |
| Lower secondary school completion rate | 79.5% (2013) | 91% (2013) | 69% (2013) |
| Illiteracy rate (population > 15 yrs.) | 6.5% (2010) | 5.5% (2010) | 29% (2010) |
| Health | | | |
| Direct expenditures on health care by households (% of total health expenditures) | 49% (2013) | 35% (2013) | 55% (2013) |
| Child mortality rate | 17‰ (2015) | 15‰ (2015) | 40‰ (2015) |
| Under-5 mortality rate | 22‰ (2015) | 18‰ (2015) | 53‰ (2015) |
| Prevalence of anemia among children | 31% (2011) | 25% (2011) | 55% (2011) |
| Maternal mortality ratio | 54‰ (2015) | 63‰ (2015) | 253‰ (2015) |
| Percentage of women receiving prenatal care | 94% (2011) | 95% (2011) | 77% (2011) |
| Tritherapy coverage rate | 37% (2014) | NA | NA |
| Life expectancy at birth | 76 yrs. (2013) | 74 yrs. (2013) | 66 yrs. (2013) |

...



| ... | Vietnam | Developing countries of East Asia and the Pacific | LMICs |
|--|------------|---|------------|
| Other services | | | |
| Child labor rate (7–14 yrs) | 11% (2012) | NA | NA |
| Rate of access to improved sanitation facilities | 78% (2015) | 75% (2015) | 52% (2015) |
| Rural | 70% | 64% | 42% |
| Urban | 94% | 85% | 67% |
| Rate of access to improved water source | 98% (2015) | 94% (2015) | 90% (2015) |
| Rural | 97% | 90% | 87% |
| Urban | 99% | 97% | 94% |

Source: WDI.

The decrease in income poverty has been accompanied by clear improvement in most of the social indicators. In an international comparison (cf. Table 1), Vietnam is positioned significantly higher than the average LMIC score (even though it is ranked lowest in LMIC income) and close to the average of the developing countries of East Asia and the Pacific (even though its per-capita income is clearly lower than the sample average). The Vietnamese statistics are especially positive for access to water and sanitation, as well as for certain health-related indicators (life expectancy at birth and maternal mortality rate in particular).

Nonetheless, these positive international comparisons should not make us forget the inequitable access to social services of an acceptable quality, in both education and health care. Indeed, while access to basic services is widespread, their quality strongly depends on the financial means or the social position of the beneficiaries (cf. Sections 3 and 5 of the book *Vivre avec les Vietnamiens* by Philippe Papin and Laurent Passicouset (2010) for a detailed description of the forms of access to education and healthcare services).^[1] The World Health Organization (WHO) estimates that out-of-pocket household spending represents half of healthcare expenditures, despite the fact that access to health care is supposed to be a public service. Unequal access in terms of quality of services has its roots in this practice, which occurs on a large scale in the health sector as well as in the education sector.

1.3. Weak incentives to deal with residual pockets of poverty

The Gini index is used to measure income inequalities by country (the higher the index value, the stronger the inequalities are). Within the region, only Cambodia has a lower index value than Vietnam. In 2012, the *Vietnam Household Living Standard Survey* estimated Vietnam's index value at 35.6, a figure that had remained stable over a ten-year period. This suggests that growth in Vietnam has remained inclusive overall, without notable development of inequalities during the 2000s.

However, this impression stems from quantitative data and is at variance with the perception of growing inequality expressed by the majority of stakeholders (citizens, press, academics, etc.). These latter perceive a more qualitative inequality, in access to health or education services (see section 1.2.), in job opportunities of an acceptable quality, and in access to property, etc. (World Bank, 2014b). This contributes to a feeling of permanent stratification in society, in which—while there is admittedly guaranteed access to minimum service—there are few opportunities for social mobility.

The gap between urban poverty (5%) and rural poverty (22%) remains significant. In rural areas, the size of this gap depends on the inhabitants' ability to take up informal income-generating activities in addition to their agricultural activity. Against a backdrop of low "primary" income, resorting to an extra activity to increase one's income seems to be a permanent feature of the Vietnamese economy, in both urban and rural areas.

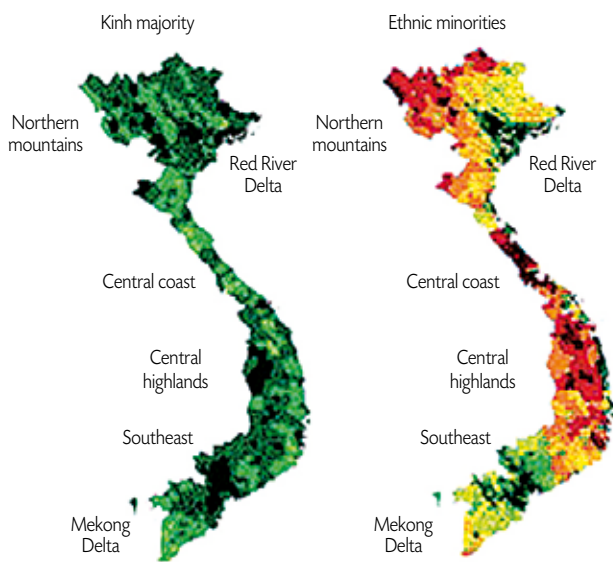
[1] The low level of nominal salaries for teachers and health workers makes their search for supplementary income inevitable, thus helping to blur the line between public sector and private sector: "4 – Public, privé : les figures d'un vieux tour de gobelet" (Papin and Passicouset, 2010).

Poverty, both in income or human terms, is concentrated in areas where minorities live (cf. Graph 3). These latter represent less than 15% of the population (this according to the 2009 census, while the majority Kinh ethnic group make up 85.7% of the population). Moreover, these pockets of poverty show clearly higher levels of inequality (Gini index).

Graph 3

Poverty rate according to ethnic origin

- 0-10%
- 10-20%
- 20-30%
- 30-40%
- 40-50%
- 50-60%
- 60-70%
- 70-80%
- 80-90%
- 90-100%



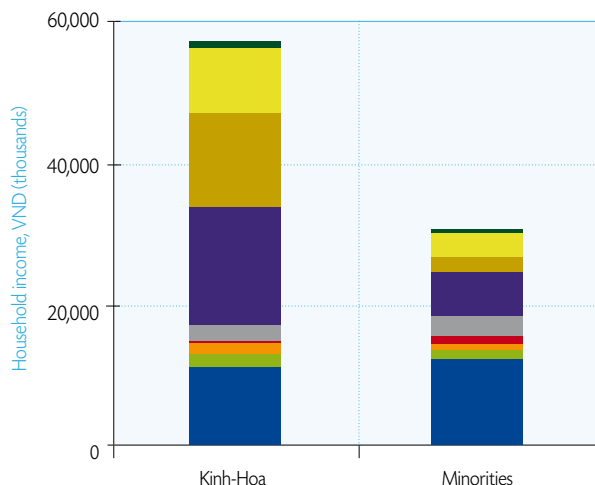
Source: World Bank (2014b).

Against a backdrop of large-scale acceptability of poverty among the Vietnamese people, the authorities pay limited attention to poverty and minorities issues. "Program 135" is the main anti-poverty program; it targets minorities and was launched in 1998. It has been funded by the state as well as by donors, especially by the World Bank through a series of Development Policy Operations (DPO). The third phase of this program covers the 2011–2016 period. In 2009, the authorities

Graph 4

Sources of income by ethnic origin

- Crops
- Livestock
- Aquaculture
- Forestry
- Agriculture wages
- Nonagriculture wages
- Nonfarm enterprises
- Transfers
- Other



Source: World Bank (2014b).

also launched a program targeting the 63 poorest districts of the country. A World Bank study carried out in late 2010 on social safety nets indicates that coverage for poor households is still limited, even though it is making progress. The share of transfers to incomes of minorities is not higher than that to income of the Kinh population (cf. Graph 4). This absence of redistributive effect can also be found in the various quintiles of income, regardless of ethnic origin.

1.4. Strong vulnerability to climate change, with significant social impact

Given its very special geography (long coastal band and two large densely populated deltas), climate change incidents are likely to have socioeconomic impacts in Vietnam that will become especially serious and that will grow in intensity.

Table 2 Index of physical vulnerability to climate change — Vietnam's ranking

| Rise in sea level | Rainfall | Desertification | Arithmetic average index | Quadratic average index |
|-------------------|----------|-----------------|--------------------------|-------------------------|
| 13/156 | 25/201 | 177/188 | 55/147 | 80/147 |

Source: FERDI.

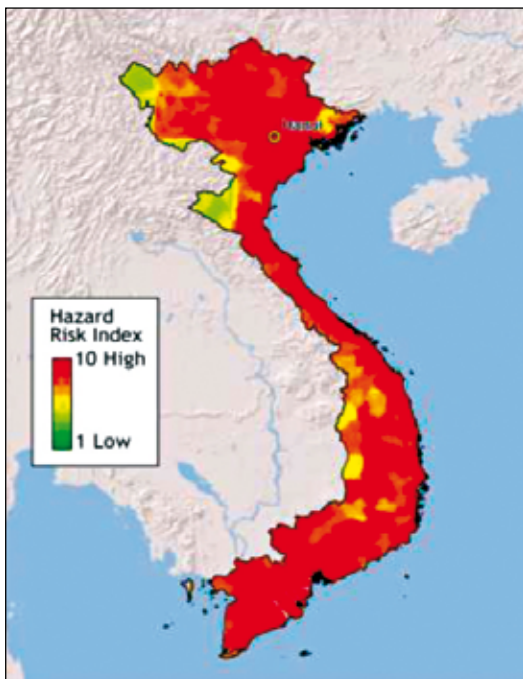
Comparative assessment findings conducted by Fondation Pour les Études et Recherches sur le Développement International (FERDI) (cf. Table 2) place Vietnam among the countries most vulnerable to rise in sea level and to increased extreme natural phenomena such as typhoons. According to the Global Facility for Disaster Reduction and Recovery report (GFDRR,

2011), a one-meter rise in sea level would affect nearly 5% of land in Vietnam, 11% of its population, 7% of its agricultural land, and would have a negative impact of approximately 10% on GDP. More locally, there are significant drought-related risks in the Mekong Delta.

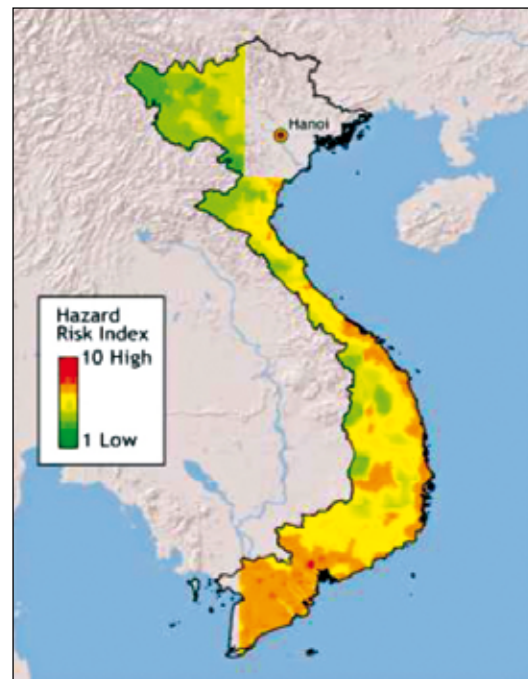
Graph 5

Flood and drought mortality risks

Risk of Flood Mortality



Risk of Drought Mortality



Source: GFDRR, 2011.

Faced with these major risks, authorities' response capacities are limited by the triple effect of:

- the absence of a culture of transparency regarding the impacts of such events,
- a lack of material resources to deal with them, and
- relative inefficiency in operational processes (anticipation, chain of decision-making, implementation).

Because there is no safety net coverage and no insurance system, the people who are affected—and who often happen to be the poorest—are alone to face the consequences. They find themselves in a perpetual cycle of indebtedness, insofar as the more frequent reoccurrence of such “exceptional” events systematically puts into question any accumulation of wealth.

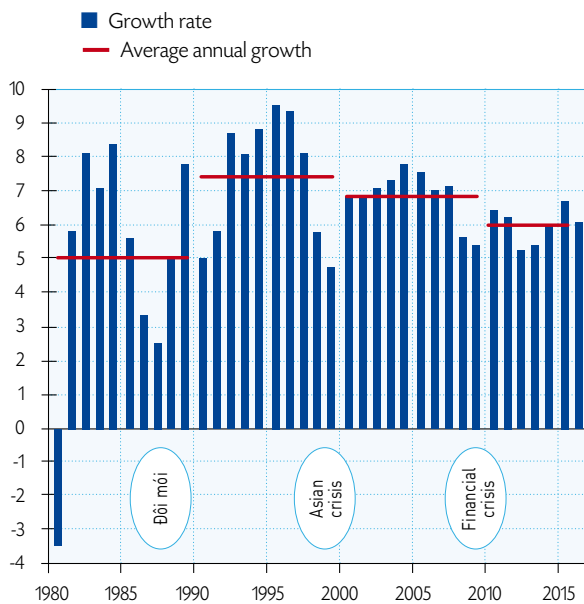
2 / Sustained growth, but in a model requiring reform

This section analyzes the growth process over the long term, the main factors behind this growth, and how they have evolved over time.

2.1. Overall performances and regional comparisons: Vietnam is no exception

Graph 6

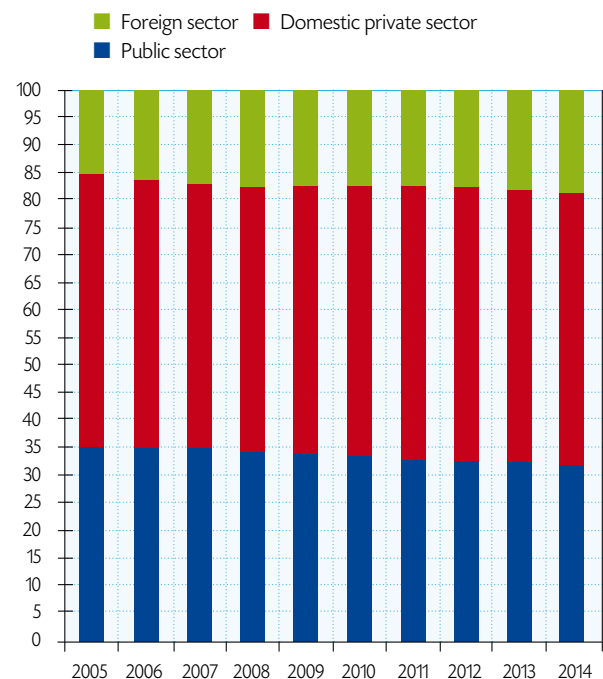
Real annual growth of GDP (%)



Sources: IMF (WEO); General Statistics Office (GSO).

Graph 7

Distribution of GDP in constant prices (%)



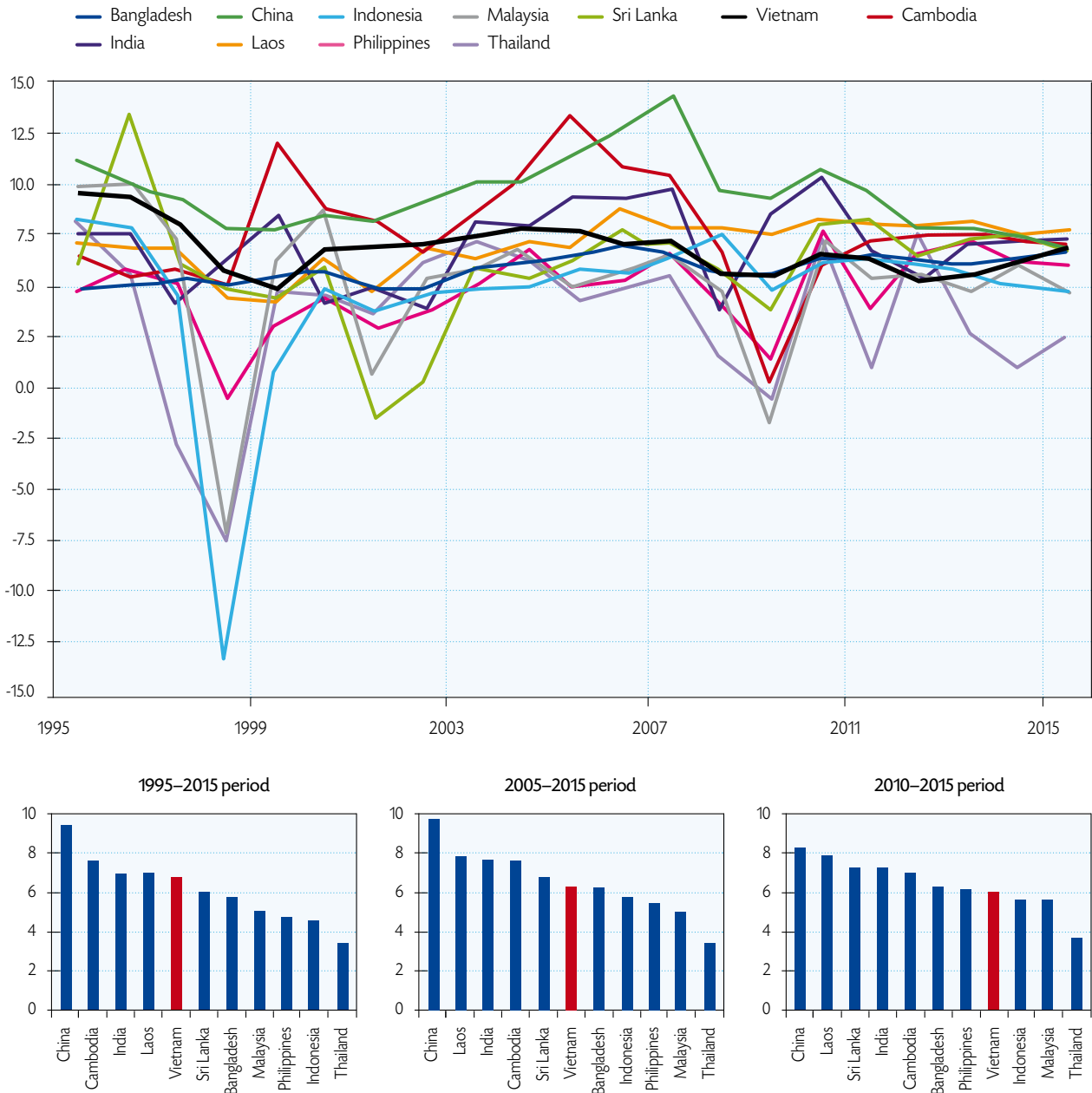
Source: GSO.

As previously mentioned, the economic reform that started with *Đổi mới* led to long-term acceleration of growth. In particular, there was a 50% rise in average annual growth between the 1980s and the 1990s, with an average of 5 to 7.5% per year on average (cf. Graph 6). The performance in the 1990s probably includes a catch-up effect, which would explain the trend for lower growth levels during the following decades (7% on average in the 2000s and 6% on average from 2010 to 2015).



Graph 8

Real growth rate of GDP (%) — annual (left graph) and annual average (right graphs)



Source: IMF (WEO); AMR (AFD) calculations.

Comparative analysis between the growth rates of Vietnam and those of other countries of the region suggests a moderate performance close to average scores but that deteriorates

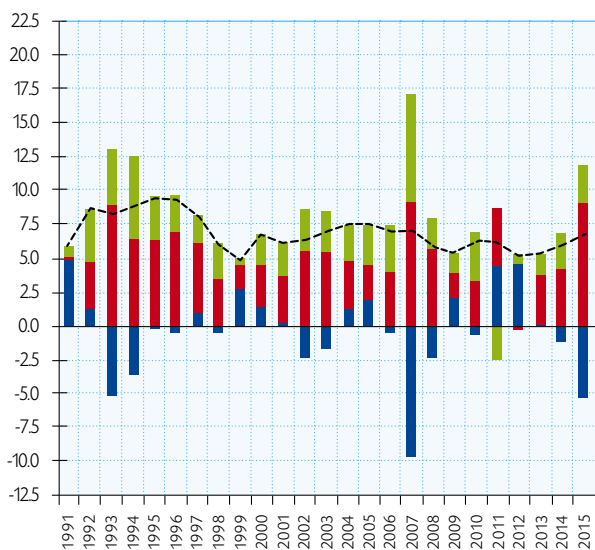
over time (cf. Graph 8). The combination of growth dynamics with the initial per-capita income levels has led to overall convergence, but this convergence is slowing down.

On the other hand, the stability of Vietnamese growth is a positive point. Its volatility is one of the lowest among the sample of Asian developing countries, and this despite the extreme outward orientation of the Vietnamese economy (cf. Section 2.4). The 1998 Asian economic crisis and the 2008 international financial crisis led to lower growth rates of around 5%, whereas other countries fell into recession or suffered growth close to 0% (cf. Graph 8). Likewise, the slowdown in growth brought about by the macroeconomic stabilization policy launched in 2011 (Resolution 11) remained limited, with low points above the 5% mark in 2012 and 2013.

Graph 9

Breakdown of GDP growth (%)

- Contribution of investment to GDP growth
- Contribution of domestic consumption to GDP growth
- Contribution of external demand to GDP growth



Source: World Bank (WDI); AMR (AFD) calculations.

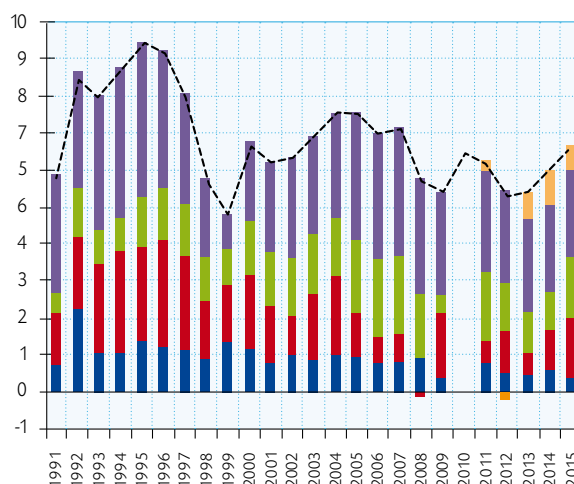
The relative stability of economic growth over the long term hides variations that may be significant when this growth is broken down according to factors of supply (GDP distribution by sector) or demand (GDP distribution among domestic consumption, investment, and external net demand).

By sector (cf. Graph 10), agriculture's contribution to growth deteriorated in the 2000s, especially from 2009. This trend can be especially seen in the drop in share of agricultural products among Vietnamese exports. While the non-manufacturing industry, commonly associated with

Graph 10

Sectoral breakdown of GDP growth (%)

- Contribution of net taxes on grants
- Contribution of services
- Contribution of manufacturing industry
- Contribution of non-manufacturing ind.
- Contribution of agriculture



Source: World Bank (WDI); AMR (AFD) calculations.

heavy industry, was a significant driver of growth from 1995 to 2004 (27% of growth), its share fell sharply between 2005 and 2014 (15%). On the contrary, the manufacturing industry took on a greater role as a driver of growth (from 19 to 27%), as did services (from 39 to 46%). From this point of view, the development in Vietnam over the last two decades seems rather conventional, with the economy becoming increasingly high-end and sophisticated.

Analysis of growth by demand shows a clearly more significant variability, especially since the international financial crisis (cf. Graph 9). Domestic consumption represented two-thirds of growth from 1995 to the international financial crisis, after which it dropped sharply and made no contribution in 2011 and 2012 due to the macroeconomic stabilization policy. Its contribution to growth went up from 2013 to 2015, along with the economic recovery. The contributions to growth by investment and net external demand have experienced a "mirror" effect. For example, as the imported goods component of investment was significant overall, the periods with especially high investments led to a weak or negative contribution by net external demand, and vice versa.



This relationship is especially visible during two recent periods:

- In 2007/2008, Vietnam's accession to the WTO led to a massive flow of foreign investments (especially in 2007) and to a "mirror effect" negative contribution by external demand. The international financial crisis then reversed this situation.
- Between 2013 and 2015, investment started up again (2.4 points in average annual GDP) following the macroeconomic stabilization phase. This led to a negative contribution by external demand (-2 points in GDP) despite healthy exports.

This relationship is moreover strengthened by the fact that, especially in the case of Vietnam, the foreign direct investment (FDI) of today lays the groundwork for the exports of tomorrow.

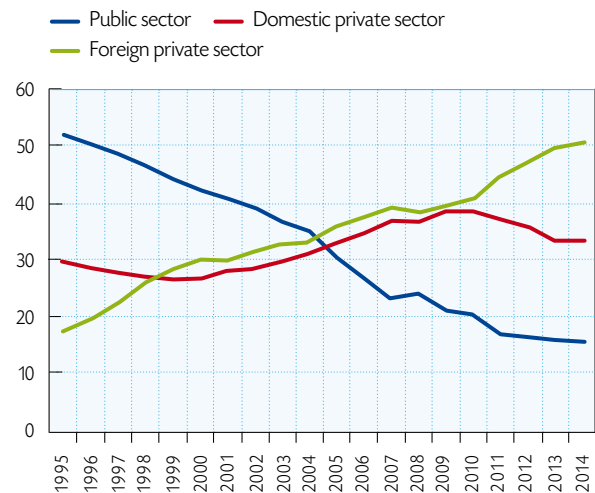
2.2. Contrasts among the three sectors of the Vietnamese economy

The Vietnamese economy is often broken down into three major sectors: 1) the public sector including government administration and public enterprises ("SOEs", for state-owned enterprises); 2) the foreign-investor sector, which is mainly but not exclusively export-oriented; and 3) the domestic private sector, which is made up of a much less homogenous group, ranging from farming households to large-scale private enterprises that are listed on the stock exchange and fully globalized.^[2] While this oversimplified breakdown does not show the many overlaps among these categories, it is nonetheless a useful macroeconomic approach for trying to understand the overall development of the Vietnamese economy. It also backs up, with figures, the general impression that the share of the public sector is dropping, to the advantage of both Vietnamese and foreign private entrepreneurs.

The first aspect we can notice is that there is no disruption in trend among the major sectors in terms of added value (cf. Graph 7). Decline in the public sector's share remains limited (less than 5 percentage points in 10 years). The corollary of this is an equally limited rise for the foreign-investment sector and a stable share, of around 50%, for the GDP generated by the domestic private sector.

Graph 11

Breakdown of manufacturing production (%)



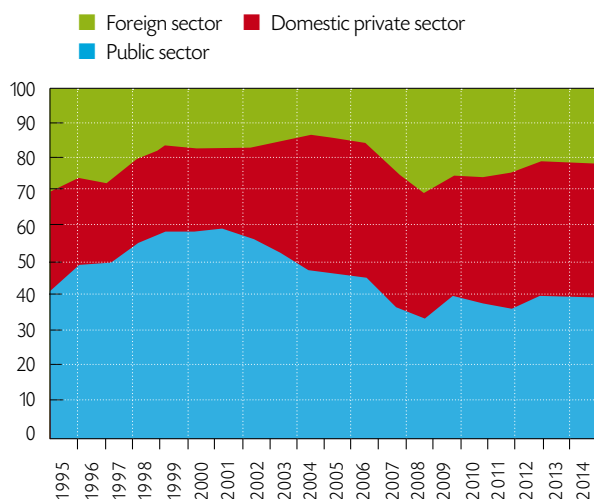
Source: Hung X.T., 2014.

While these results suggest no significant changes, there is an exception for the manufacturing sector (cf. Graph 11), where we can see that, over the last two decades, the trends of the public sector and foreign private sector have clearly switched. Meanwhile, the share of the domestic private sector has remained stable overall.

[2] FPT Corporation is a typical example of these enterprises, with USD 1.7 bn in turnover (2014) and 25,000 employees. The company is listed on the Ho Chi Minh City Stock Exchange, and foreign shareholders make up 49%.

Graph 12

Distribution of investment at current price (%)



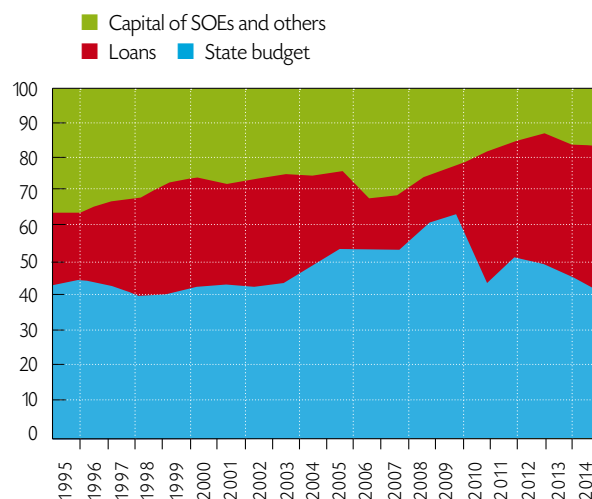
Source: GSO.

The distribution of investment among these three major economic sectors has evolved in a cyclical fashion (cf. Graph 12):

- Public investment increased until the beginning of the 2000s, when it made up 60% of total investment. It then steeply declined until the international financial crisis of 2008, after which it stabilized at around 40%. Public investment continues to play a crucial role in maintaining economic momentum, despite the financial fragility of the public enterprises and their lack of efficiency. This raises questions about the sustainability of this policy and its cost for public finances.

Graph 13

Mode of public investment financing (%)



Source: GSO.

- There was a significant increase in foreign investment in 2007–2008, when Vietnam acceded to the WTO. Its share then shrank due to the international financial crisis and represented only a bit more than 20% of total investment in 2014.



Table 3 GDP distribution by sector

| Constant price 2010 | 2010 | | | 2014 | | |
|----------------------------------|-------|--------|--------|-------|--------|--------|
| | % GDP | li/GDP | IGi/li | % GDP | li/GDP | IGi/li |
| Primary sector | 18.4 | 2.4 | 36.3 | 16.8 | 2.2 | 45.0 |
| Secondary sector | 32.1 | 16.4 | 35.8 | 33.2 | 15.7 | 35.9 |
| Manufacturing | 12.9 | 7.5 | 18.6 | 14.8 | 8.5 | 15.5 |
| Mining and quarrying | 9.5 | 2.9 | 32.9 | 8.4 | 2.2 | 42.8 |
| Other branches | 9.7 | 6.0 | 58.7 | 10.0 | 5.1 | 67.1 |
| Tertiary sector | 36.9 | 19.7 | 40.2 | 38.4 | 17.6 | 42.3 |
| General trade | 8.0 | 1.9 | 18.6 | 9.1 | 2.7 | 13.9 |
| Financial services and insurance | 5.4 | 0.7 | 30.0 | 5.5 | 0.7 | 33.3 |
| Real estate | 6.1 | 1.8 | 17.6 | 5.4 | 2.5 | 15.7 |
| Hotels and restaurants | 3.6 | 0.8 | 22.1 | 3.8 | 1.0 | 21.2 |
| Other branches | 13.8 | 14.5 | 47.4 | 14.6 | 10.8 | 58.0 |
| Net taxes on production | 12.5 | NA | NA | 11.6 | NA | NA |
| GDP at market price | 100 | 38.5 | 38.1 | 100 | 35.5 | 39.7 |

Source: GSO; AMR (AFD) calculations.

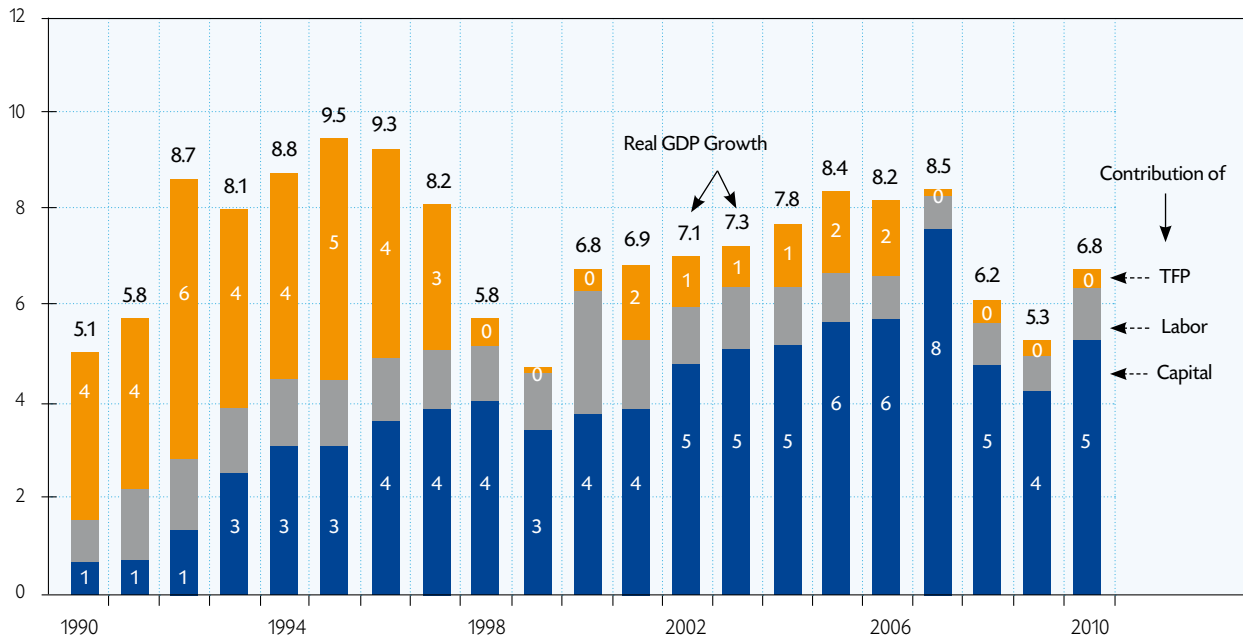
l = investment; IG = public investment; i = branch considered.

Assuming that the share of public investment within total investment is a satisfactory reflection of the degree of state involvement in a branch or sector, it appears rather clear that, with the exception of the branches of manufacturing (15% of GDP in 2014) and general trade (9% of GDP in 2014), the role of the state remains significant and is even tending to increase. Even if this is not visible in the direct production of goods and services, it can at least be found in terms of the availability of investments for the production of these goods and services. Between 2010 and 2014, the share of public investment thus climbed from 36 to 45% in the primary sector, from 33 to 43% in the mining and quarrying branch, and from 59 to 67% in the other industrial branches.

This trend raises the structural question of the “economic cost” of maintaining a high level of growth. This issue has been analyzed in recent years via the trend in total productivity of the factors. The 1990s saw considerable gains in productivity, but these dropped significantly during the 2000s (cf. Graph 14), as the continuity of the growth level was more the result of the accumulation of production factors (especially capital via investment) than the effect of economic efficiency.

Graph 14

Breakdown of growth among labor, capital, and total factor productivity (%)



Source: World Bank (2013).

With Vietnam having entered the middle-income country (MIC) category in 2009, the structural weakness of the overall productivity of factors leads some economists and institutions^[3] to bring up the issue of the MIC trap^[4] for Vietnam. However, the question of whether Vietnam is headed toward the MIC trap seems premature in view of its limited per-capita income and low wage costs.

Nevertheless, it is worth asking whether the economy's overall efficiency and the downward trend in productivity gains are cause for concern. The recurrent argument is the supposed absence of interactions among the three major segments of the economy. The **foreign-investment sector** is very competitive but generates little local spillover other than foreign reserves and fiscal revenue (but with limited contribution to employment, cf. Graph 17). The **public sector** is inefficient and benefits from privileged access both to financing and to

local and national authorities for public procurement. As for the poorly structured **domestic private sector**, it has difficulty obtaining subcontract work from foreign companies and suffers from unfair competition from SOEs. There is definitely some element of truth in these generalizations, especially when it comes to explaining the constraints of efficiency in the Vietnamese economy. What they do not show us is that there are non-formalized interactions that external actors are not aware of and that are difficult to model within a traditional economic framework.

Questions regarding SOEs concern not only economic efficiency, but also the issues relative to public finances (cf. Section 3) and the banking sector (cf. Section 5). Public investment continues to play an essential role, but the development of its financing over the last decade (cf. Graph 13) raises questions about the sustainability of the system. Indeed, we can see a significant

[3] Harvard Kennedy School, 2015; Berliner T. *et al.*, 2013.

[4] MIC trap: loss of competitive advantage in the export of manufactured goods, linked to an upward trend in wages, without the country having succeeded in changing its economic structures so as to break through into higher added-value markets. This notion applies generally to countries whose per-capita income stagnates at around USD 10,000 to 12,000 (2011 constant price) and whose characteristics are weak investment, low growth in the industrial sector, low level of diversification, and poor job market conditions (typical examples: South Africa and Brazil).



increase in borrowing by SOEs to compensate for the erosion of their equity as well as for the moderate decline in public budgetary resources. As SOEs do not publish their financial reports, it is difficult to pass final judgment on the state and evolution of their financial situation. However, the results of several interviews indicate that the dominant position that SOEs have enjoyed in negotiating major contracts is tending to weaken due to the deterioration of their situation. They are able to maintain some leeway only thanks to their capacity for access to state guarantees.

SOE reform: a complex and slow process ^[5]

The economic reform has led to a big decline in the number of SOEs, from 12,000 in 1990 to 800 in recent years. Yet, the size of this decrease must not blur reality: SOEs continue to play a decisive role in the public sector, which still accounts for 35% of GDP. Actually, most of the SOEs that have been sold off, merged, or privatized over the last 20 years were small-scale or unprofitable. The remaining 800 SOEs, which are 100% owned by the state, are markedly more strategic in terms of their size, specific sector, and the jobs they represent (cf. Section 2.3.).

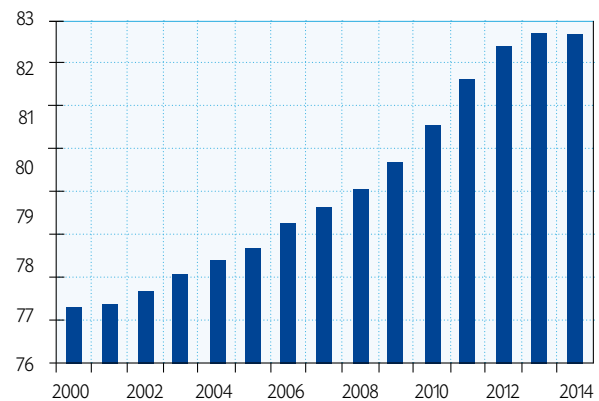
The final aim of the authorities is, by 2020, to keep 200 strategic SOEs in the hands of the state.^[6] Meanwhile, the other SOEs will have to undergo a process of equitization. The size of capital transfer to private domestic or foreign investors will depend on the nature of the enterprises and their situation in the competitive market. The equitizations must enable greater transparency in the management of SOEs, whatever their later degree of privatization (due in particular to their being listed on the Ho Chi Minh City or Hanoi stock exchanges).

The equitization process began in the 1990s. The greatest number of SOEs concerned (2,000) were equitized between 2003 and 2005, after which the process slowed down considerably. The authorities have sought to renew the process in recent years (99 were equitized between 2011 and 2013, and 144 in 2014). However, despite official declarations, the process has been slowed down, being faced with many types of resistance (of the 289 SOEs to be equitized in 2015, the program was only very partially completed). The equitization operations can sometimes consist of simple mergers between SOEs and of share-grabbing by privileged individuals (employees, authorities, etc.), with liquidation procedures not functioning. The process lacks appeal for the private sector, given the limited share of capital available for purchase and the absence of protection for minority shareholders. Furthermore, the rules of purchase for foreign investors remain restrictive, preventing them from establishing themselves in certain segments.

2.3 Effects on the job market

Graph 15

Employment rate (%)



Source: WDI; GSO; AMR (AFD) calculations.

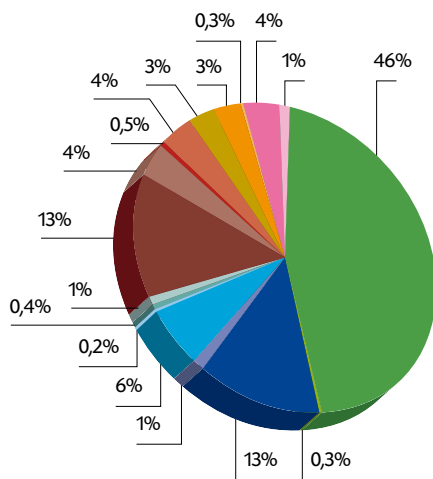
[5] With 10% of the employed population still working in the public sector in 2014, the SOE reform takes on an obvious social dimension in terms of jobs. This admittedly real dimension also acts as an immediate pretext for maintaining the *status quo*.

[6] Enterprises for which the Council for National Defense and Security has a natural monopoly, as well as specific sectors where the need for investment is too large for the private sector.

Graph 16

Employment distribution by branch and type — 2014

- Primary sector – private
- Primary sector – public
- Manufacturing industry – private
- Manufacturing industry – public
- Construction industry – private
- Construction industry – public
- Other industries – private
- Other industries – public
- General trade – private
- Hotels and restaurants – private
- Education, training, healthcare – private
- Education, training, healthcare – public
- Party-related activities – public
- Transportation and storage – private
- Transportation and storage – public
- Other service activities – private
- Other service activities – public



Source: GSO; AMR (AFD) calculations.

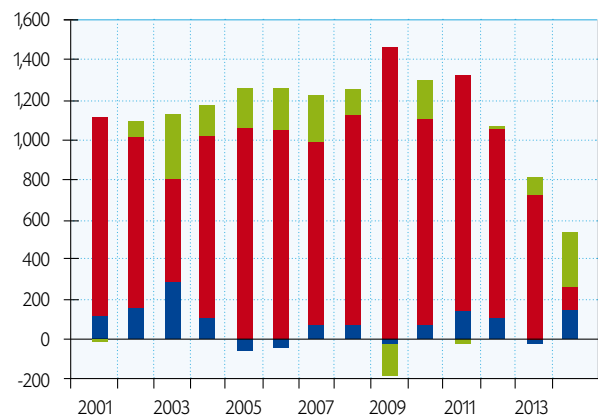
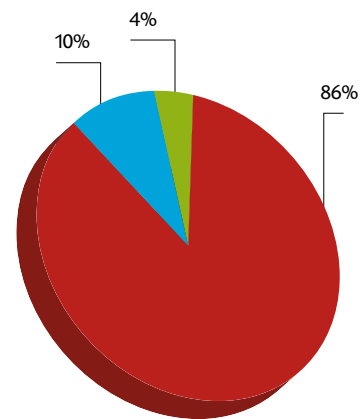
The total occupied labor force was 52.6 million persons in 2014. The overwhelming majority (86%) were working in the domestic private sector; 10% in the public sector, and 4% in the foreign-invested sector (cf. Graph 17). The employment rate (employed labor force out of a working-age population 15–64 years old) increased steeply from the beginning of the 2000s but has slowed down since 2013 (cf. Graph 15).

In view of the pace of increase in employment rate between 2002 and 2012, it is surprising that the contribution by the labor factor to economic growth during this period was limited (cf. Graph 14). The nature of the jobs created may explain this. Between 2001 and 2012, the annual creation of jobs fluctuated between 1 and 1.2 million, and the vast majority of these were in the domestic private sector (cf. Graph 17). Nonetheless, the apparent productivity of the domestic private sector remains limited (annual added value per employee less than USD 2,000) and clearly inferior to the apparent productivity of the foreign-investment sector (USD 16,000) and the public sector (USD 10,000) (cf. Graph 18).

Graph 17

Employment distribution by type of activity (% , 2014) and annual net creation of jobs by type of activity (thousands)

- Domestic private sector
- Foreign private sector
- Public sector

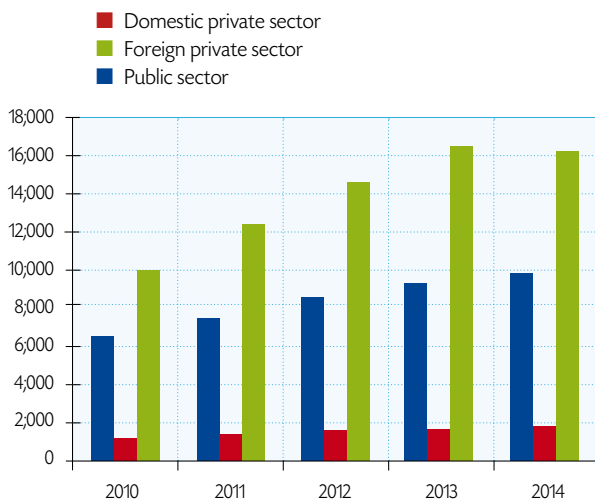


Source: GSO; AMR (AFD) calculations.



Graph 18

Added value per employee, by type of activity (USD)



Source: GSO; AMR (AFD) calculations.

These differences in productivity are logical, considering the strongly capitalistic component of the foreign-investment sector. Moreover, they do not reveal the extreme disparities within the domestic private segment, between the several large-scale private Vietnamese groups (such as FPT) and the huge number of farming households (22.5 million jobs, 43% of the occupied labor force, undergoing structural decline), and the non-agricultural self-employed (11 million jobs, 21% of the labor force, undergoing structural increase).

With only 22% of jobs being salaried (World Bank, 2014a, GSO, based on the *Labor Force Survey*), the quality of jobs is a big issue, from both the social and economic angles. The levels of remuneration and protection among the different categories of jobs are very variable. A unified minimum wage has been in place since 2012 and applies to all salaried employees (with or without contract) outside the civil service, with differentiated levels according to province. The minimum wage in the civil service is specific and less high. The degree to which the minimum wage is applied strongly depends on the nature of the employer, with non-contractual employees having the greatest risk of falling below the minimum wage: 11% in domestic private enterprises and 17% in family enterprises. This can be explained by the process of job formalization having experienced distortion that was linked to growth in formal protection of salaried employees following implementation of the 2012 labor code.

In a context in which unemployment must be put into perspective, the job market regulates itself almost automatically via informal activities, with demographic pressure being an essential factor of balance on the job market. With an employment rate now over 80%, and having significantly increased in the 2000s, can a decrease in labor supply pressure (job demand) be anticipated? Is the regular and noticeable decrease in net job creation since 2012 a structural sign that the employment rate ceiling has been reached, or is it merely linked to the present economic climate?

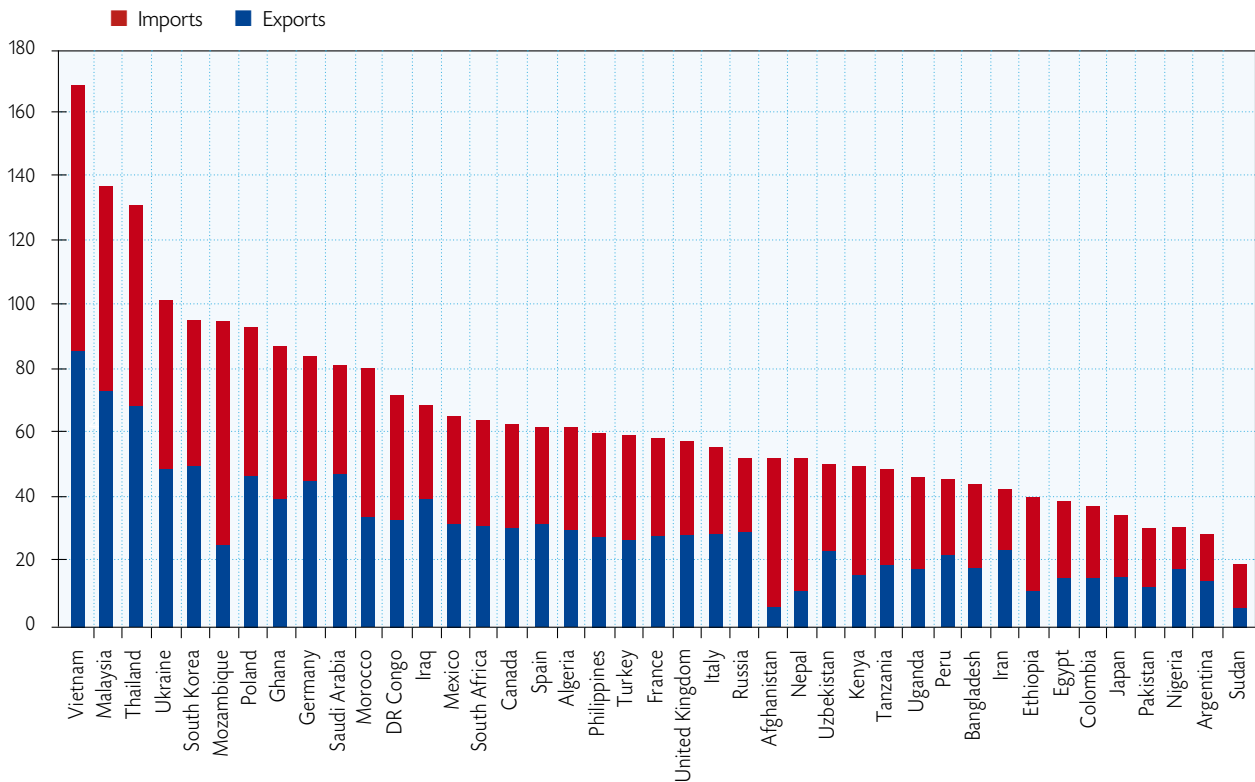
In order to take advantage of this demographic momentum to increase the quality of jobs and thereby renew the rising productivity, a system of higher education and vocational training making it possible to meet the requirements of economic operators will be required. However, the education and vocational training system is faced with many challenges; its offer, which is anachronistic and too theoretical, does not correspond to the skill needs of the economic world. From as early as 2005, the government admitted that education was not in line with economic needs (governmental resolution No. 14/2005/NQ/CP). The 2011–2020 education plan also stated that the biggest problem of higher education in Vietnam was its inability to meet the human resources demand ensuing from the modernization and industrialization process in the sectors where the needs for technical training are not met. Indeed, a recent survey indicates that 50% of university graduates do not find jobs in fields corresponding to their diplomas. Without improvement in training, it is possible that wage pressure stemming from lack of productivity growth will lead to a loss of competitiveness that could jeopardize the country's economic momentum.

In addition to training, there is the question of whether the domestic private sector, which is the main source of jobs, can upgrade itself. This will also depend on the rebalancing of the economic environment (access to funding and to markets, competition rules, etc.) and on domestic private enterprises' ability to work in complementarity with the foreign enterprises and the SOEs.

2.4 Foreign trade: its importance in Vietnam's development process and the associated risks

Graph 19

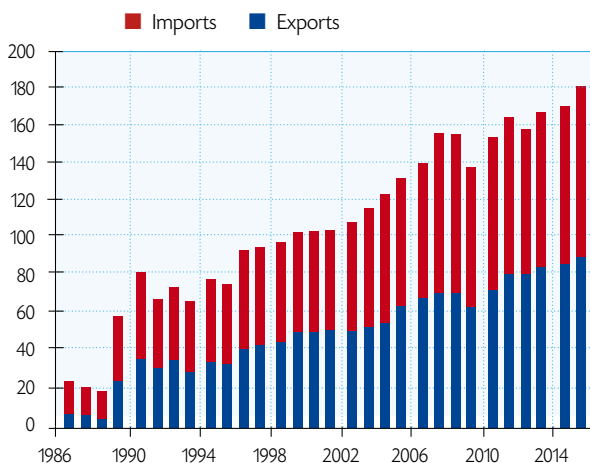
External trade rate in 2014, among countries with populations between 25 and 200 million (% of GDP)



Source: WDI.

Graph 20

External trade rate in Vietnam (% of GDP)



Source: WDI.

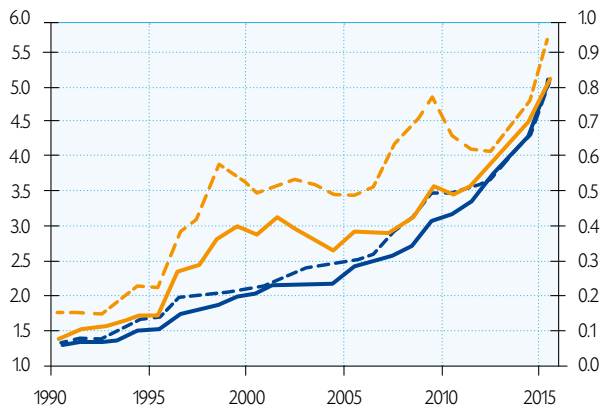
Among the countries with a big domestic market (in terms of population), Vietnam is an exception with its much higher degree of external trade rate (relationship between the sum of exports and imports relative to GDP) (cf. Graph 19). This outward-looking nature of the Vietnamese economy has been built up gradually over the last two decades. The pace has continued since 2010, with 2009 having seen a temporary disruption—common to all countries—in Vietnam's trade dynamics (cf. Graph 20).



Graph 21

Indicators of integration into global trade (%)

- % of Vietnam's G&S X° among global X° – right scale
- - - % of Vietnam's G&S M° among global M° – right scale
- % of Vietnam's G&S X° (exports) among X° of Asian developing countries – left scale
- - - % of Vietnam's G&S M° (imports) among M° of Asian developing countries – left scale



Source: WDI; AMR (AFD) calculations.

Vietnam's market shares in international trade have been rising constantly since the beginning of the 1990s. These tended to accelerate in 2005, just before Vietnam's accession to the WTO. Between 1990 and 2015, the share of Vietnam's share of global exports rose constantly each year, from 0.05 to 0.8%. From this point of view, Vietnam's performance recalls that of China, but on a lesser scale given the difference in size between the two economies.

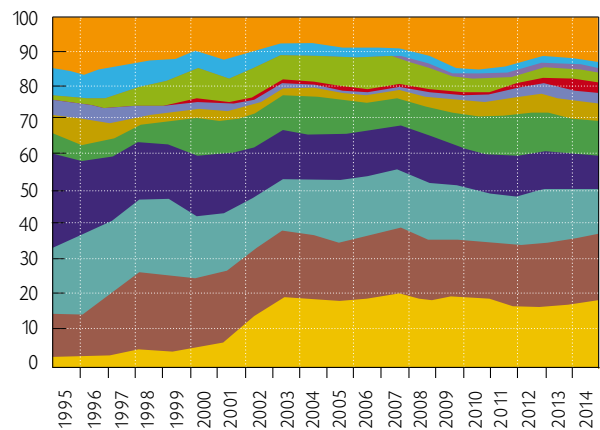
Vietnam's foreign-trade position shows growing integration into the value chains, both geographically and in Asian countries terms of products (in 2014, 60% of foreign trade was generated by the foreign-investment sector). We can see remarkable development in the nature of products exported and of bilateral exchanges, especially with Asian countries.

The Vietnamese export and import curves, expressed in USD, are exponential. They intensified from 2005, with only a single year of decline, in 2009 (cf. Graph 24 for the exports). Exports have increased nearly thirty-fold, from USD 5.4 bn in 1995 to USD 150 bn in 2014. Vietnamese exports remain relatively concentrated on a limited number of types of products, broken down into five homogenous groups representing half of its exports. These were, in order of importance in 2014, telephones 16%, textiles 14%, oil 8%, electronics 8%, and footwear 7%. However, the relative share of each of these groups has changed in recent years, showing the changes in specializations in Vietnam. While exports of telephones and electronics have increased, exports of textiles remain stable, and those of footwear and especially oil have seen a moderate decline. The share of imports used as means of production (equipment, raw materials, inputs) was overwhelming and stable from 1995 to 2014, when it settled at around 90%. This is proof that Vietnam's foreign-trade operations are fundamentally oriented toward value chains.

Graph 22

Distribution of Vietnamese exports

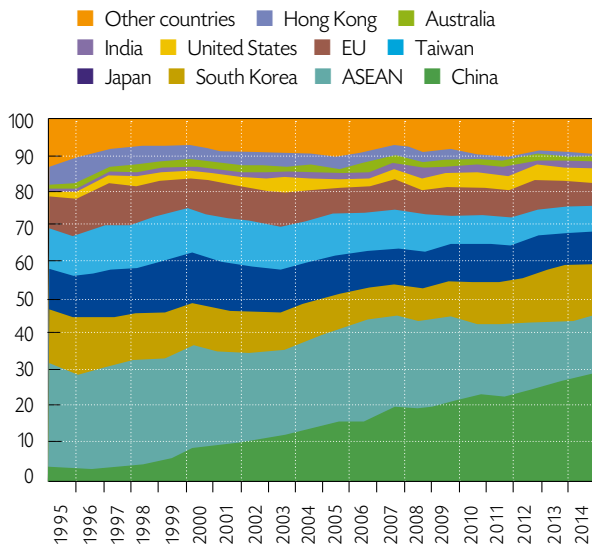
- Other countries ■ Taiwan ■ India ■ Australia
- UAE ■ Hong Kong ■ South Korea ■ China
- Japan ■ ASEAN ■ EU ■ United States



Source: GSO.

Graph 23

Distribution of Vietnamese imports



Source: GSO.

Geographically (cf. Graphs 22 and 23), the United States has been the main outlet for Vietnamese exports since 2003 (stable, at 15% of exports); 60% of these exports are textile products and footwear. Vietnam has a very big trade surplus with the US (USD 24 bn in 2014). The European Union (EU) is the second-largest market for exports from Vietnam (also receiving approximately 15% of its exports), but notable change in the types of products exported there can be seen (e.g., rise in telephone products from 2011, representing 30% of exports in 2014). There is also a very large trade surplus with the EU (USD 21 bn in 2014), with the latter exporting mainly aircraft, pharmaceutical products, agri-food products, and other capital goods.

ASEAN is Vietnam’s third-largest partner for exports and second-largest for imports, with Vietnam having a slight trade deficit (USD -1.4 bn in 2014). The top item traded between Vietnam and ASEAN is oil products: Vietnam exports crude and refined oil and imports refined products^[7] Other significant reciprocal trade also includes electronic products (with Vietnam having an overall deficit), while Vietnam exports mainly telephones and rice (USD 2 b and 1.2 bn respectively in 2014).

If we ignore unofficial trade, which is said to be significant, the trade relation with China is increasingly asymmetrical. While it was balanced in the middle of the 1990s, Vietnam’s trade balance with China has been constantly steadily worsening. The deficit has been growing strongly since 2012, reportedly reaching nearly USD 30 bn in 2014. China’s share of Vietnamese imports is constantly increasing, reaching 30% of the total in 2014. At the same time, Vietnamese exports to China have been growing less rapidly: China is Vietnam’s fifth-largest partner. The main import item seeing increase is telephones (USD 7.7 bn in 2014). The reciprocal trade with China also involves electronic products and inputs related to textiles. This reflects the progress of how each of the two countries is positioned in value chains and is in line with Vietnam’s increasing role as a replacement for China.

Japan and South Korea are the other major trade partners of Vietnam. They are moreover the foremost foreign direct investors there (each possessing 15% of FDI stocks at the end of 2014). While Vietnam has a slight trade surplus with Japan (USD 1.7 bn in 2014), its trade balance with South Korea is markedly negative (USD -15 bn in 2014), due in particular to the large-scale imports of inputs for electronic products and telephones.

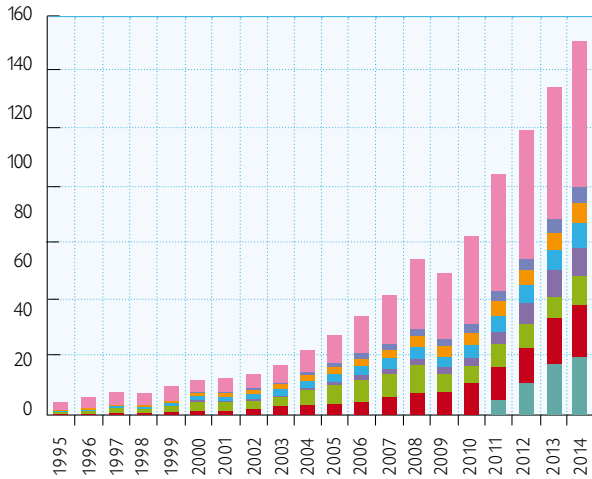
[7] In annual average over 2012–2014: USD 2.9 bn in exports and nearly USD 5 bn in imports.



Graph 24

Exports of main products (USD bn)

- Other products
- Marine products
- Electronics
- Textiles
- Wood products
- Footwear
- Oil
- Telephones

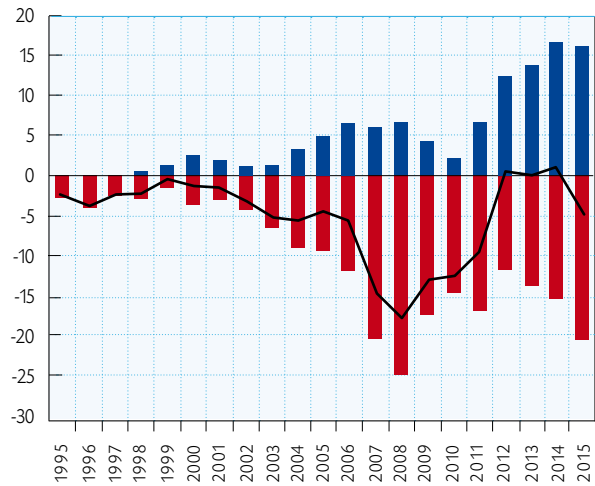


Sources: GSO; UNCTAD.

Graph 25

Trade balance (USD bn)

- Trade balance generated by the domestic economy
- Trade balance generated by the foreign investment sector
- Trade balance



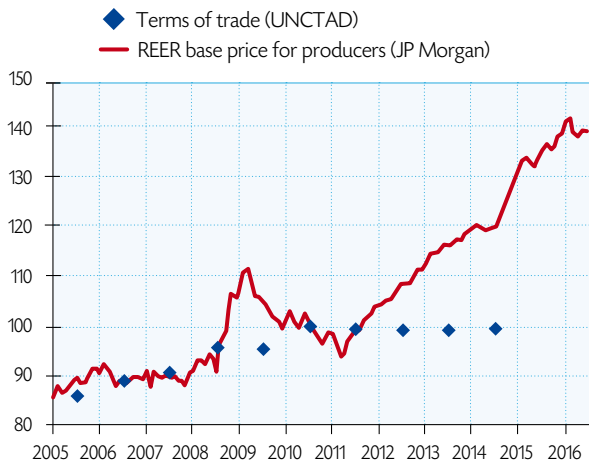
Source: GSO.

Vietnam’s foreign-trade trends are symptomatic of the country’s growing integration into value chains and of the evolutions of the latter. These are characterized by significant reciprocal exchanges at the Asian level and massive surpluses with the American and European trade blocs. Vietnam’s trade deficit grew suddenly when it acceded to the WTO, due to massive investments linked to the expected benefits from this new stage of market reform. The international financial crisis and the macroeconomic stabilization policies, which had impact on domestic demand, made it possible to reduce the trade deficit between 2009 and 2011 (cf. Graph 25). Between 2012 and 2014, the continued trade rebalancing and the reaching of a slight surplus were rather due to good export performances in the foreign-investment segment. In 2015, the recovery of domestic demand, which occurred at the same time that the trade surplus generated by the foreign-investment sector ceilinged, led to a return to a trade deficit, but in perfectly sustainable proportions (less than 2.5% of GDP).

With production costs rising in China, Vietnam has been able to seize the occasion and partially replace China within value chains. These new opportunities have strongly helped support the momentum of growth and have more than made up for the recessionary effects linked to the slump in global demand. However, the question remains as to whether Vietnam will be able to maintain this status over the long term, as it is linked to its very low relative cost of labor (cf. Section 2.3).

Graph 26

Vietnam — Terms of trade and real effective exchange rate (REER) (base of 100 in 2010)



Sources: UNCTAD; JP Morgan.

Competitiveness is very much required if Vietnam is to maintain its position in segments for which globalization is experiencing full development. Within a context of stable terms of exchange, Vietnam has up to now benefited from very significant price competitiveness, linked to very low wage costs (30% of those in China), for which it has some room for maneuver. However, the real appreciation of the currency—40% in five years—denotes a decrease in price competitiveness. If the decline in demographic pressure on the labor market is confirmed, the pressure on wages that this could generate would likely accelerate this process of real appreciation (as is currently happening in China).

In this case, it is important to compensate this loss in competitiveness by a rise in labor productivity. This implies structural reforms as well as stronger and more transparent interactions among the various segments of the economy. The challenge is of course not an immediate one, but it planning must start now. Real appreciation of currency is generally an outcome of the development process, leading to modification of relative prices (the prices of non-tradable goods increase faster than exchangeable ones). This has been accentuated in Vietnam by the inappropriateness of the exchange policy, which for the authorities consists in maintaining a high level of parity with the US dollar and of adjusting it only as little as possible when there is no alternative (low level of foreign reserves).

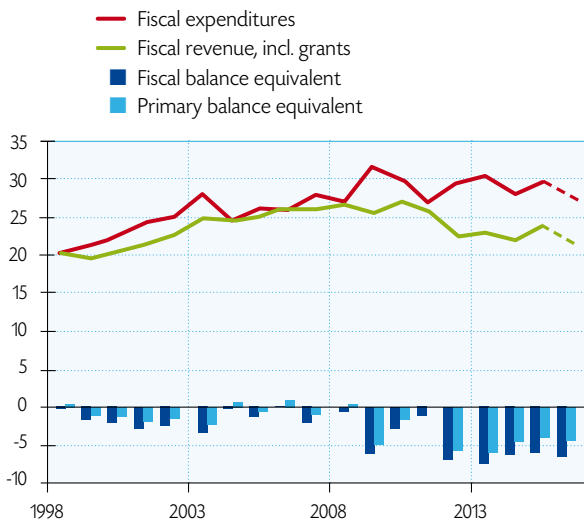
3 / Public finances and debt

NB: Data on the Vietnamese budget are relatively limited (e.g., no data on the wage bill), and the methodologies used are quite different from international practices. Such data must thus be dealt with carefully—all the more so because the administrative structure of the country is complex and the interactions among segments of the economy are not obvious.

3.1. Persistence of budget deficit, linked to low level of government revenue

Graph 27

Revenue, expenditures, and equivalent fiscal balances — GFSM* 2001 (% of GDP)

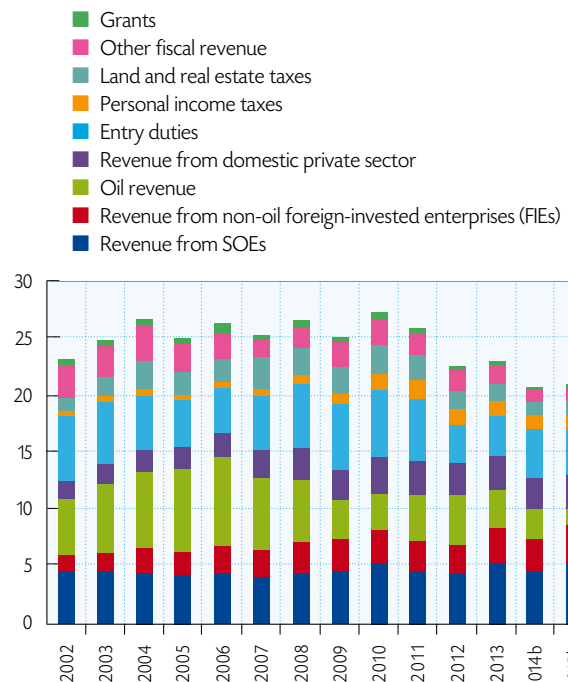


* GFSM: Government Finance Statistics Manual.
Source: IMF (WEO).

The budget balances were generally under control throughout the 2000s, with the exception of 2009, when the Vietnamese government increased budget expenditures to support activity. But, since 2012, we can observe a structurally high level of budget deficit that the government is not able to curb (cf. Graph 27). Whereas the relative level of public expenditures remains stable, the deficit growth results from an underlying decline in fiscal revenue, whose share in GDP has plunged five percentage points in five years.

Graph 28

Structure of fiscal revenue (% of GDP)



Sources: GSO; MoF; AMR (AFD) calculations.

The main factor behind decline in fiscal revenue involves the oil sector. Fiscal revenue from this sector was initially affected by declines in volume (50% drop in export volume between 2004 and 2014). More recently, it was affected by prices: in 2015, oil revenue represented only 1.5% of GDP and is expected to fall to 1.2% of GDP in 2016.

This decrease was offset only very partially by the other revenue items: there was a limited increase in fiscal contribution from foreign enterprises and a rise in entry duties linked to the new foreign trade dynamics since 2013. The good performance of fiscal revenue generated from the public enterprises should also be mentioned. These represented around 5% of GDP (nearly one-quarter of fiscal revenue), in particular along with the introduction in 2014 of dividend payments to the government by beneficiary SOEs. This underlying revenue trend in is nonetheless an argument for in-depth reform of fiscal policy.

While expenditures in relation to GDP tend to be stable (with, however, significant variability), the structural decline of the relative share of investment expenditures (32% in 2009, 17.5% in 2015) raises questions regarding government budget orientations. This is all the more true given that the most strongly expanding item is that of recurrent expenditure by the general public administration (which is consistent with the policy to remobilize the CPV apparatus). However, by having budgeted a 28% increase in infrastructure expenditure for 2016, it seems the authorities want to put an end to the underlying decline in investment expenditures for that year.

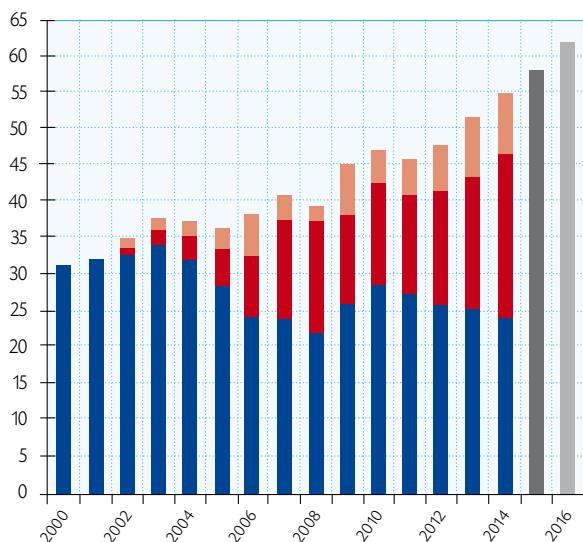
Given the lack of information, it is difficult to go any further in budget policy analysis. The absence of wage bill data is an especially strong factor limiting such analysis.

3.2. Rising public debt approaches domestic ceilings

Graph 29

Public debt (% of GDP)

- Other public debt in VND
- Bond debt in VND
- Foreign currency debt



Sources: IMF (art4); World Bank (WDI); AFD calculations.

With the budget deficit at around 6 to 7% of GDP (according to IMF methodology) since 2012, Vietnam's public debt has been constantly and steadily growing, despite the country's good growth performance. While it represented only 46% of GDP in 2011, it is expected to exceed 60% in 2016 (cf. Graph 29) and to approach the domestic ceiling of 65% set by national regulations.

The foreign currency debt has been on a slightly downward curve since 2011 (25% of GDP in 2014). In fact, the overall increase is to be found in the local market, although we do not know the proportion of non-resident entities holding government bonds.

At the end of 2014, outstanding government bond debt in local currency represented 22% of GDP, essentially with short maturities. Among public bonds (central government, central bank, local authorities, or SOEs) with maturities superior to one year, 60% have an effective maturity date of less than three years. Furthermore, the outstanding treasury bills (of less than one year) issued by the central government and the central bank represented 4.1% of GDP at the end of 2014.

Demand for government bonds was high until 2014, as they allowed banks to improve the quality of their assets. However, several indices suggest that 2015 led to a tightening of the market liquidity of domestic public debt. This included a hike in interest rates on short-term treasury bills between the fourth quarter of 2014 and the third quarter of 2015 and increase in 2015 in the spread between the rates offered and proposed, thereby marking a change after three years of decline. The economic recovery spurred on by the domestic private sector stimulated financing opportunities for the banking sector (20% growth in bank credit year-on-year at the end of 2015). This simultaneously reduced the appeal of government bonds (more than three-quarters of treasury bonds are held by banks).^[8]

[8] Vietnam International Bank estimate.



While the market for domestic public debt is experiencing some tension, the external public debt continues to develop favorably. The level of public foreign currency debt is moderate (25% of GNP in 2014), and its composition is low-risk (80% public creditors, 70% of a concessional nature). However, we can note that the heading with strongest growth since 2010 is the debt in foreign currency to commercial banks (+260% in five years), representing nearly 4% of GDP in 2014. Some of this state debt is borne by Vietnamese public banks^[9] or ensues from currency swap operations between Chinese and Vietnamese banks^[10] carried out “on behalf of” the governments.

Along with increase in its per-capita income, access to concessional financing should gradually tighten. Vietnam was awarded “blend” country status in 2010, making it eligible to borrow from the World Bank’s International Development Association (IDA) and International Bank for Reconstruction and Development (IBRD). It may “graduate” to IBRD from 2017, making it eligible for loans only at market rates. For now, this process remains very gradual, and the low international rates of interest have made it possible to maintain the overall level of concessional foreign debt. Thus the average grant element of total long-term foreign debt (public, guaranteed, and “private non-guaranteed”) stayed at 34% in 2014, slightly higher than in 2013. Vietnam’s capacity to assimilate the evolution of its financing conditions inspires confidence.

3.3. Uncertainty regarding the size of contingent liabilities

Besides the direct and guaranteed public debt, there is major uncertainty, given Vietnam’s economic structure, concerning the size of the state’s implicit contingent liabilities. These contingent liabilities are of different natures and linked to public enterprises and the bank sector.

The non-guaranteed debt of SOEs that are strategic for the state appears to represent more than 30% of GDP.^[11] In addition to this debt, it is important to add the fiscal risk inherent in the restructuring and possible liquidation processes.

In the banking sector, the most recent consultation on IMF Article IV (“art. 4”) of June 2016 indicates that recapitalization of public banks, which is needed to resolve their non-performing loan portfolio, will cost 2.5% of GNP, based on official data. This is markedly less than the previous estimation of September 2014. However, the absence of transparency means that this figure is uncertain, especially given the considerable overlapping economic and financial relations among the various operators (cross debts and shareholding, etc.). For example, the most recent IMF analysis of debt sustainability, conducted according to the methodology applied to market access countries, chooses to overlook analysis of the impact of a contingent liability shock on the level of debt and the needs for public financing.

[9] Loan of USD 1 bn by Vietcombank to the state.

[10] Swap line between Agribank (Vietnam) and Industrial and Commercial Bank of China.

[11] Estimation by the Vietnam Academy of Social Sciences / Center for Analysis and Forecast.

4 / External financing and creditworthiness

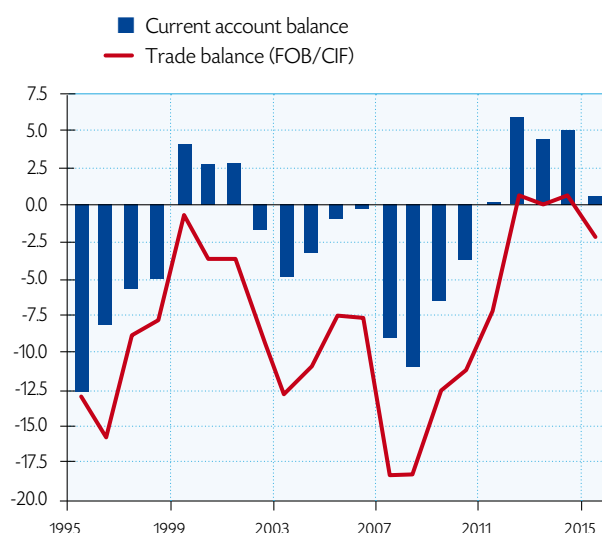
Thanks to foreign investments, Vietnam experienced remarkable rebalancing of its commercial and current account balance in the first half of the 2010s. External liquidity nevertheless remains strained and contributes to repeated pressure on the VND (structural absence of confidence) against a backdrop of exchange policy lacking in flexibility.

According to the IMF, there are significant deficiencies in external statistics at many levels of the balance of payments: migrants' remittances, FDI, gold transactions, etc. These statistical deficiencies, which hinder calculation of Vietnam's net external position and are responsible for a high level of errors and omissions, limit the ability to analyze external balances.

4.1. Remarkable rebalancing of the current account

Graph 30

Trade and current account balances (% of GDP)



Source: IMF (WEO); SBV; GSO; AMR (AFD) calculations.

Accession to the WTO, with its resulting opportunities for foreign investors, deeply modified Vietnam's foreign-trade balances.

The FOB/CIF trade balance (including imports of services linked to imports of goods) had been structurally negative until then. But it became positive from 2012 to 2014 (cf. Graph 30), thanks to robust exports by foreign investors. In 2015, the trade balance became slightly negative again, due to recovery of domestic demand.

Insofar as the other headings of the current account balance (tourism revenue and migrants' remittances as positive, profit transfers as negative) are structurally positive, the current account balance is systematically higher than the trade balance. As the current account balance had a significant surplus from 2012 to 2014 (around 5% of GDP), it was close to being balanced in 2015 from the effect of snapback in imports.

4.2. EFR: structurally high and dependent on short-term flows

Despite improvement of the current account balance, the external financing requirement (EFR) remains strong and is expected to increase in 2015.

An essential characteristic of external financing is its short-term nature: 37% of disbursements and 80% of amortization of the external debt were short-term on average from 2010 to 2014. This mostly covers commercial operations paid through debit and credit (letters of credit, etc.), but some of this short-term financing should be categorized in the portfolio of investment flows, which appear very limited.

Another important characteristic concerns the size of the "currency and deposits" heading, which is systematically negative. This latter is indicative of structural mistrust of the VND among economic actors, who thereby invest some of their assets in foreign currency and gold (meaning capital outflow). The high level of the heading "errors and omissions" (E&O), which is systematically negative, can also be interpreted as capital flight. On the other hand, it may also indicate the non-recording of deficit in informal trade between Vietnam and China, as well as of unrecorded operations of the military segment.



Table 4 EFR and its coverage (% of GDP)

| | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|-------|-------|-------|-------|-------|-------|
| EFR | -12.0 | -11.2 | -5.7 | -6.9 | -6.6 | -9.4 |
| Current account balance | -3.8 | 0.2 | 6.0 | 4.5 | 4.9 | 0.6 |
| Amortization of external debt | -8.2 | -11.4 | -11.7 | -11.4 | -11.5 | -10.0 |
| – Medium and long terms (M<) | -1.7 | -1.8 | -2.2 | -2.8 | -2.2 | -2.5 |
| – Short term (ST) | -6.5 | -9.6 | -9.5 | -8.6 | -9.3 | -7.5 |
| EFR coverage | 13.7 | 16.2 | 17.3 | 11.2 | 14.6 | 8.5 |
| Debt-creating flows | 11.6 | 15.1 | 15.3 | 13.5 | 15.1 | 13.0 |
| M< loans | 4.1 | 4.2 | 5.0 | 4.8 | 5.2 | 5.2 |
| – Official | - | 2.9 | 2.9 | 2.8 | 2.8 | 2.3 |
| – Private | - | 1.3 | 2.1 | 2.1 | 2.4 | 2.9 |
| ST loans | 47.4 | 10.8 | 10.3 | 8.7 | 9.9 | 7.8 |
| Non-debt-creating loans | 8.4 | 6.0 | 5.9 | 4.9 | 4.4 | 3.2 |
| Net FDI | 6.3 | 4.9 | 4.6 | 4.1 | 4.3 | 3.2 |
| Portfolio investments (PI) | 2.1 | 1.1 | 1.3 | 0.9 | 0.1 | 0.0 |
| Currency and deposits | -6.3 | -4.8 | -3.9 | -7.2 | -4.9 | -7.8 |
| E&O | -3.3 | -4.1 | -3.9 | -4.0 | -3.5 | -2.2 |
| Foreign reserve variation (- = decline) | -1.6 | 0.9 | 7.6 | 0.3 | 4.5 | -3.1 |

Source: SBV; AMR (AFD) calculations.

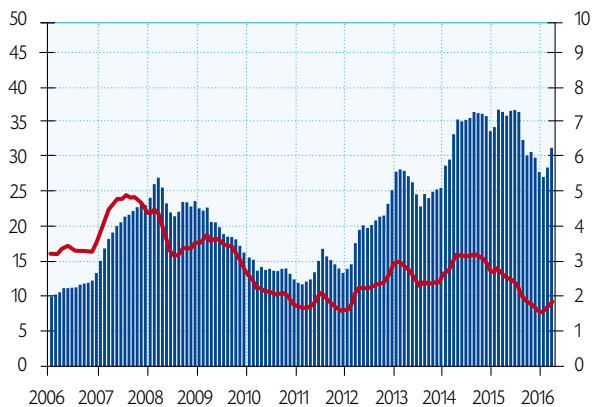
The EFR structure and its coverage indicate that external financing is highly volatile; this is a source of fragility.

4.3. Pressure on foreign reserves and the exchange rate

Graph 31

Official foreign reserves

- Reserves in foreign currency (except gold) in months of imports – right scale
- Reserves in foreign currency (except gold) in USD bn – left scale



Source: IMF (IFS); GSO.

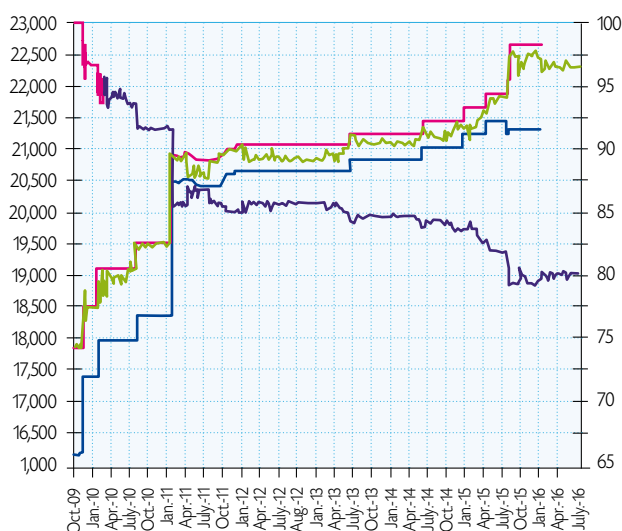
Except for the period between 2006 and 2009, the level of foreign reserves was structurally strained with regard to the Vietnamese exchange system. According to the IMF reserve adequacy metric (Article IV of June 2016), the Vietnamese exchange reserves are significantly below the minimum level desirable, within the framework of a fixed-exchange policy. The threshold of three months of imports, reached in the first half of 2014 when the reserves exceeded USD 35 bn, was thus not enough. The situation deteriorated in 2015, when there was an upturn in imports resulting from recovery in domestic demand (nominal decline of reserves to USD 30 bn and moderate decline to less than two months of imports). The situation calmed down again in early 2016.

This situation led to strong tension on the exchange rate, forcing the central bank to carry out three successive 1% devaluations against the USD in January, May, and August 2015, and above all to expand the fluctuation band from 1 to 3% in August 2015. Exchange rate is a political marker, and this action, made under constraint, may have been interpreted as a failure in Vietnam's economic policy. Nonetheless, the depreciation of the VND was limited (5% over 2015) and certainly insufficient (real appreciation of the currency was 3.4% between 2014 and 2015, and 40% between 2010 and 2015). The closeness of the exchange rate with its ceiling (cf. Graph 31) shows the persistent pressure throughout 2015. This pressure decreased at the end of that year.

Graph 32

Foreign exchange trends VND/USD

- Floor – left scale
- Ceiling – left scale
- Exchange rate – left scale
- Base 100 Oct-2009 – decline = depreciation – right scale



Source: SBV; AMR (AFD) calculations.

Faced with the structural weakness in the level of official foreign reserves and with the continued real appreciation of the VND, from an economic point of view it seems that exchange policy must be reformed for greater flexibility, even if the underlying political elements must not be underestimated. Moreover, the first aspects of this reform appeared in early 2016, once the CPV Congress was over. These could be seen in the decision to make daily calculations of the VND reference rate (around which the exchange rate can vary within a band of 3%), based on a basket of eight currencies. This modification also has similarities with the changes made recently in the Chinese exchange policy.

5 / Monetary policy and financial sector

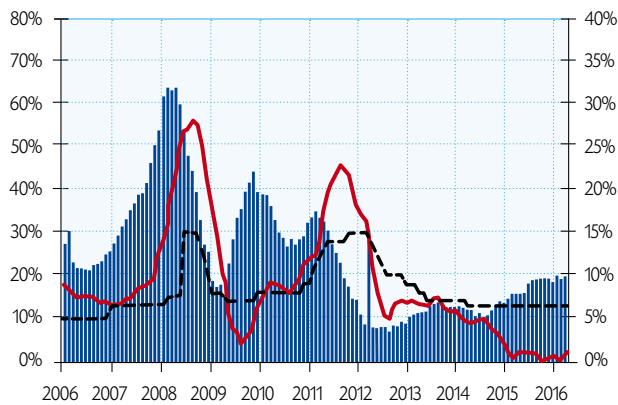
This section focuses on the interactions between the banking sector and monetary policy, against a background of hyper-financialization of the economy. Recent Vietnamese economic history is characterized by massive and jarring changes in the banking sector, with regulations still far from international standards, especially in terms of transparency. In this context, the reliability of available statistics on financial solidity is particularly limited.

5.1. Success in limiting inflation

Graph 33

Trends in inflation and credit to the economy

- Annual year-on-year variation of credits to the economy. (non-gov't.) (%) – left scale
- Annual year-on-year inflation (%) – right scale
- SBV* key interest rate – right scale



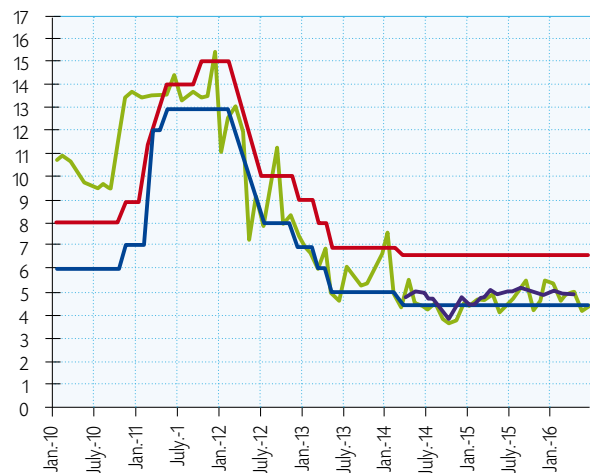
*SBV: State Bank of Vietnam
Sources: GSO, IMF (IFS); SBV.

The central bank carries out the monetary policy, whose final objective is inflation, and it submits this policy (5% in 2015) to the National Assembly. Besides inflation, SBV also announces various intermediate objectives, on the exchange rate or the overall growth of credit. It intervenes in many different ways: interventions on the exchange markets to maintain the exchange rate of the interbank market within the fluctuation band (which rose from 1 to 3% in 2015), traditional tools for managing liquidity (reference rate and deposit/credit facilities), guidelines for credit growth for each bank, and the ceiling for deposit remuneration (in VND and USD).

Graph 34

Interest rates (%)

- Policy Rates, Discount rate
- Policy Rates, Refinancing Rate
- Interbank Rates, 3 month
- Government Benchmarks, Macrobond, 1 Year, Yield



Sources: SBV.

We can see a quite clear correlation, with a time gap, between the growth of credit to the economy and inflation (cf. Graph 33). The 2000s were marked by significant growth (systematically higher than 20% year-on-year), as well as erratic credit to the economy. Inflation saw peaks higher than 20% in 2008 and 2011.

The money-tightening policy undertaken in 2011 and 2012 (raising of key interest rates to higher than 10%) enabled significant reduction in inflationary pressure, within a band of 5 to 7% until mid-2014. Faced with easing of prices, the SBV was able to progressively reduce its key interest rates between March 2012 and March 2014. These rates have remained stable since then.

Despite the recovery in domestic consumption, the slowdown in inflation intensified in the second half of 2014, due initially to the decline in international prices of raw materials, especially energy. Throughout 2015, inflation declined to an almost 0% level.

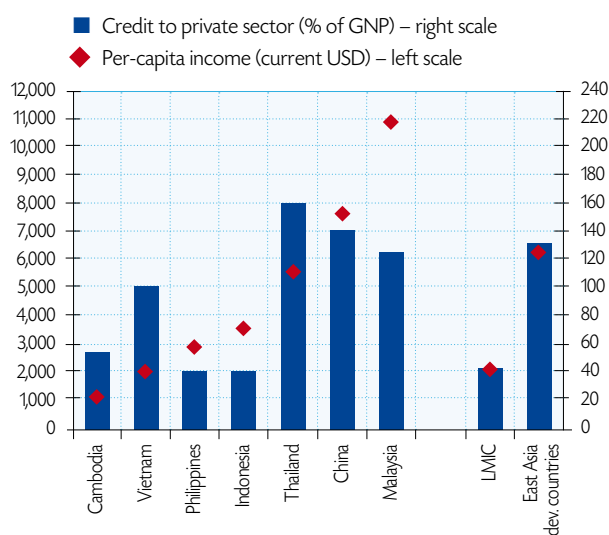
After having stabilized at around 10% from 2012 to mid-2014, annual year-on-year growth of credit to the economy swung upwards again from the second half of 2014 to reach a level close to 20% at the end of 2015. This credit robustness is

remarkably stronger than the nominal growth in GDP (real growth plus inflation). It could also become a factor behind increase in inflation in the coming months (an increase that could also result from the effects of poor climate conditions in 2016 on agricultural production). This significant recovery in credit also raises the question of banks' readiness to incorporate lessons learned about past credit overheating into their prudential policies, as well of the central bank's regulatory capacity to supervise the activity of banks.

5.2. Bank sector reform: progress despite lack of transparency

Graph 35

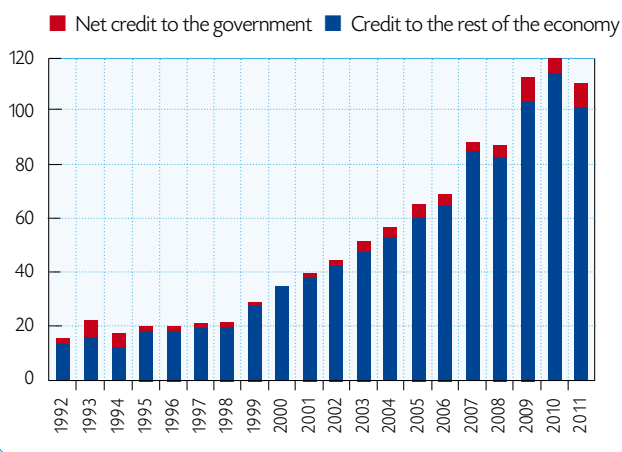
Share of credit to the private sector (% of GDP, 2014) compared to per-capita income (USD)



Source: WDI.

Graph 36

Trends in credit to the economy (% of GDP)



Sources: WDI, IMF.

The level of financialization of the Vietnamese economy is especially strong compared to its level of development. The credit to the economy in the "private sector" (including public enterprises) reached 100% of GDP in 2014, for a per-capita income level of "only" USD 2,000 (cf. Graph 35 for international comparisons). This financialization was rapid during the 2000s. It reached its apex in 2010, before starting to self-adjust up until 2012. After this adjustment, the trend from the 2000s seems to have returned (cf. Graph 36).

In mid-2015, total assets of the banking sector were VND 6,613,907 bn (USD 305 bn), representing 155% of GDP. The public banks and the domestic private banks held 46 and 40% of bank assets respectively, compared to 11% for foreign-capital banks (subsidiaries and joint ventures) the remaining 3% of bank assets are held by the cooperative bank and people's credit funds on the one hand, and leasing and finance companies on the other.

Besides the banking sector, the capital market is made up of:

- A "securities" market, which at the end of 2014 had capitalization of USD 46 bn, representing 25% of GDP. More than 300 companies are listed. After strong adjustment in 2011, the market tended to be bullish again (capitalization increased 9 points of GDP in 3 years), and securities exchanges represented USD 22 bn in 2014, or 12% of GDP.
- A more limited "corporate" bond market in VND, with outstanding debt of USD 1.3 bn at the end of 2015, for maturities mostly between 5 and 10 years.

While the banking sector started off in conditions at the end of the 1990s that were already unfavorable (from public bank exposure to generally inefficient public enterprises), the strong growth in credit throughout the 2000s led to greater deterioration of the quality of bank assets.

This deterioration is acknowledged by the authorities, despite the lack of transparency in the overall balance sheet approach of the banking sector. However, the real scale of latent losses remains unknown, given the regulatory weaknesses and big deficiencies in statistics. The authorities consider that bad debts represent 8% of all bank loans; meanwhile, the IMF has mentioned a minimum rate of 12% (2013 Financial Sector Assessment Program) and people working in the banking sector rates at least twice as high as those of the authorities.

The Vietnamese authorities have started rehabilitating the sector through a multi-form process with three main pillars. The first pillar concerns strengthening bank supervision and the gradual implementation of international standards. The second pillar was the creation, in 2013, of the Vietnam Asset Management Company (VAMC), and whose capital was quadrupled in 2015. It was initially designed as a mere instrument



to supply liquidity to banks (through temporary purchase of bad debts at face value, in exchange for public obligations). However, the authorities have recently turned the VAMC into a real defeasance institution, with the possibility of definitively purchasing questionable assets at their market price. The third pillar is the banking sector consolidation process, which is being guided by the SBV very closely, through bank mergers (bringing the number of banks down from 42 to 30) and reduction of crossed shareholding between banks and enterprises, etc.

In a context of financial repression from 2011 to 2013, banks also rehabilitated their balance sheets by limiting their loans to the private sector, instead giving priority to acquisition of public debt securities. This demand for government securities helped inflate government debt, allowing the government to finance itself in VND at limited interest rates. This phenomenon reached a turning point in the second half of 2014, along with recovery in domestic demand. This stimulated credit

demand of the “private” sector, increased the arbitrage capacities of the banking sector, and led to renewed rise in the credit/GDP ratio. However, it remains to be seen whether the new conditions for granting loans (linked to strengthening of the institutional framework, etc.) will be able to prevent the slip-ups of the previous decade.

Up to now, the authorities have been able to avoid a systemic crisis whose cost could be significant at the national level. They seem to be bringing under control a rehabilitation process that is especially complex due to the both visible and not obvious interactions among economic actors. Nevertheless, the lack of transparency of the institutional framework and the absence of a credible and easily available system of information are a significant obstacle to serene analysis of the financial sector’s inherent risks. Furthermore, the credit recovery since mid-2015, to a level largely superior to economic activity, raises questions about the bank sector’s learning curve in terms of prudential policy.

Acronyms and abbreviations

| | | | |
|----------------|---|-----------------|--|
| AMR | Macroeconomic and Country Risk Analysis (AFD division) | IMF | International Monetary Fund |
| ASEAN | Association of Southeast Asian Nations | IP | Portfolio investment |
| bn | Billion | LMIC | Lower middle-income country |
| CIF | Cost, insurance, freight | m | Million |
| CPV | Communist Party of Vietnam | M° | Imports |
| DPO | Development Policy Operation | M&LT | Medium and long terms |
| E&O | Errors and omissions | MIC | Middle-income country |
| EFR | External financing requirements | MoF | Ministry of Finance |
| EU | European Union | PPP | Purchasing power parity |
| FDI | Foreign direct investment | REER | Real effective exchange rate |
| FERDI | <i>Fondation pour les Études et Recherches sur le Développement International</i> | SBV | State Bank of Vietnam |
| FIE | Foreign-invested enterprise | SOE | State-owned enterprise |
| FOB | Free on board | ST | Short term |
| G&S | Goods and services | TFP | Total Factor Productivity |
| GDP | Gross Domestic Product | TPP | Trans-Pacific Partnership |
| GFDDR | Global Facility for Disaster Reduction and Recovery | UNCTAD | United Nations Conference on Trade and Development |
| GFSM | Government Finance Statistics Manual | USD | United States dollar |
| GSO | General Statistics Office | VAMC | Vietnam Asset Management Company |
| IBRD | International Bank for Reconstruction and Development | VND | Vietnamese dong |
| IDA | International Development Association | WDI | World Development Indicators |
| IFS | International Finance Statistics | WEO | World Economic Outlook |
| IG | Public investment | WHO | World Health Organization |
| | | WTO | World Trade Organization |
| | | X° | Exports |

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