

The contents of this document are preliminary and subject to change.

GRAY/05/3151

October 6, 2005

**Statement by Mr. Lynch and Mr. Jenkins on Vietnam
(Preliminary)**

Executive Board Meeting 05/86

October 7, 2005

Vietnam's authorities are to be commended for sustaining rates of economic growth and steady improvement in broader indicators of development, most notably progress toward achieving the Millennium Development Goals (MDGs). Progress on the MDGs has been particularly strong in areas such as health and life expectancy, where, until the last decade, significant gaps between performance and goals remained.

As the staff note, a key element of Vietnam's strategy has been successful efforts to increase the international integration of the economy, particularly by encouraging foreign investment. At the same time, we agree with the staff that Vietnam's outlook is subject to significant risks, many of which stem from the slow pace of structural reforms, including the lack of progress toward privatization of state-owned enterprises and reforms to the financial sector.

Macroeconomic stability requires containing surging credit growth...

The authorities' strategy could be represented as one of sustaining employment in the state-owned enterprise sector, while encouraging the development of a dynamic private sector that, ultimately, will be capable of absorbing resources now employed in the state sector. In order for this strategy to have a good prospect of success, it will be necessary to maintain a broadly stable macroeconomic environment that supports efficient resource allocation and the confidence needed to sustain private investment.

From this perspective, the tripling of the inflation rate over the last two years noted in the staff report, to 9.2 percent in the first half of 2005, is a cause for some concern, particularly given the suggestion in the report that underlying inflation, after taking account of the impact of freezes on certain prices, may be higher than the headline figure. Substantial further increases in the rate of inflation would distort price signals and erode confidence, undermining the prospects for continued strong growth. Moreover, given that the incidence of the inflation tax tends to fall primarily on the poor, measures to stem the rate of increase in the price level are also an important part of achieving sustainable poverty reduction.

For these reasons, we welcome the authorities' commitment to significantly reduce credit growth, which has surged over the last 18 months to some 40 percent per annum. In addition to fueling inflation, the rapid expansion of lending in an environment of weak credit standards risks undermining the stability of the financial system.

...which will require structural reforms to the banking system...

With Vietnam's financial sector dominated by state-owned banks, success in slowing the rate of credit growth will require measures beyond the implementation of tighter monetary policy by the State Bank of Vietnam (SBV). These include improvements in supervision and prudential standards and the corporate governance of the state-owned commercial banks that strengthen capacity and incentives to implement more commercially-oriented lending practices. In particular, it is important to eliminate remaining policy lending which, despite its formal abolition, the staff report suggests remains significant in the form of moral suasion by various levels of government.

In this respect, the measures announced earlier this year, notably the strengthening of loan classification, provisioning and lending standards, and the requirement for re-stated financial statements are welcome steps in the right direction. However, it is regrettable that important additional measures, in the form of changes to laws governing the SBV and credit institutions, have now been delayed to 2008. Given the importance of these measures to both macroeconomic and financial stability, passage of these changes in our view warrants a high priority.

...and would be supported by a clearer anchor for monetary policy

Development of a more clear, coherent, and transparent anchor for monetary policy is also an important element of the package of policies that will help Vietnam maintain a stable macroeconomic environment. Vietnam's current monetary framework is characterized by an exchange rate regime that is officially a managed float, but which appears *de facto* to be a peg to the U.S. dollar. In addition, the authorities are experiencing difficulties in achieving the target for their intermediate instrument – growth in credit. In this context, the question naturally arises of whether the authorities should consider adopting another target, either in the form of an intermediate instrument or as an ultimate policy variable, as a means of achieving monetary stability. *We would welcome the staff's views concerning the feasibility of other monetary instruments or targets.*

Action is needed to safeguard fiscal sustainability

Vietnam's fiscal situation is a source of some vulnerability. Although neither the public debt, at approximately 40 percent of GDP, nor the fiscal deficit, which has declined from 7.2 percent of GDP in 2003 to 4.5 percent in 2004, are presently at levels that would warrant the highest level of concern, there is a risk that underlying public sector liabilities could be considerably higher. This reflects the unknown, but possibly large, contingent liabilities associated with the operations of state-owned financial institutions. In this context, and given that oil revenues are expected to begin declining after 2007, we wonder if the staff's

recommendation that the authorities aim for a fiscal deficit of about 3½ percent of GDP goes sufficiently far toward containing fiscal risks.

Privatization is a key longer-term priority

Efforts to improve the performance of Vietnam's economy will require that state-owned enterprises respond to price signals and increasingly face market-related disciplines. The equitization of enterprises is an important step in this process. In moving forward, there should be clearer expectations for the financial performance of state-owned firms, based on a transparent accounting treatment of their operations, identification of elements of their operations that are presently not based on market principles, and clear accountability of management for results. In particular, a useful benchmark for enterprise performance is whether they are generating a rate of return comparable to the cost of funds faced by the government, as their owner.

Looking further ahead, it is thus not too early to begin considering development of a strategy to guide the privatization process. This should include clear policies on the circumstances (if any) under which existing firms' management and workers would acquire an ownership stake, the role of foreign investors and joint ventures, and the delineation, based on restrictive and well-defined criteria, of sectors in which state ownership might be retained over a longer horizon.