RESTRUCTURING FOR A MORE COMPETITIVE VIETNAM

MACROECONOMIC REPORT
SECOND QUARTER 2015

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INTRODUCTION

Vietnam's economic recovery has become more robust recently. Efforts to enhance ease of doing business, facilitate trade, stabilize exchange rate, restructure state-owned enterprises, etc. have brought about significant achievements. In 2015, Vietnam integrates more deeply into regional and global economy, with various important free trade agreements about to be finalized and implemented. However, the country still encounters cases of economic difficulties which have emerged since 2014. Restoring an orderly and disciplined macroeconomic environment, promoting and ensuring sound competition, and strengthening both consumer and business confidence have emerged as urgent needs. Access to international trade market has been enhanced for Vietnamese goods; nonetheless, Vietnam needs appropriate preparatory measures for effective participation in the global value chains. This in turn requires effective policy coordination by the Government, accompanied by matching efforts of enterprises, particularly domestic enterprises, to strengthen competitiveness.

The Macroeconomic Report for Q2 of 2015 serves several objectives, including: (i) to update macroeconomic developments and policy changes in Q2; (ii) to assess the macroeconomic outlook for Q3 of 2015; and (iii) to make recommendations for macroeconomic policies in line with domestic reforms.

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All remaining errors, views and opinions presented in the Report are solely of the authors and may not necessary reflect those of RCV Project and/or CIEM.

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ABBREVIATIONS

AFF	Agriculture – Forestry and Fishery
ASEAN	Association of Southeast Asian Nation
CIEM	Central Institute for Economic Management
CPI	Consumer Price Index
ECB	European Central Bank
EPA	Economic Partnership Agreement
EU	European Union
FDI	Foreign Direct Investment
FED	Federal Reserve System
FTA	Free Trade Agreement
GB	Government Bond
GDP	Gross Domestic Product
GSO	General Statistic Office
HNX	Hanoi Stock Exchange
HSBC	The Hong Kong and Shanghai Banking Corporation
IFS	International Financial Statistics
IIP	Index of Industrial Production
JETRO	Japan External Trade Organization
M&A	Merger and Acquisition
OPEC	Organization of the Petroleum Exporting Countries
PMI	Purchasing Managers Index
RCEP	Regional Comprehensive Economic Partnership
REER	Real Effective Exchange Rate
SB	State Budget
SBV	State Bank of Vietnam
SOE	State-owned Enterprise
TPP	Trans-Pacific Partnership
USD	US Dollar
VND	Vietnam Dong
WTO	World Trade Organization

EXECUTIVE SUMMARY

1. Economic recovery failed to reach even paces across major economies in Q2 and the first 6 months of 2015. Growth of the US economy slowed down while the Federal Reserves (FED) signaled no increase in the prime rate; Japan grew slightly more rapidly than in Q1, mostly attributed to more flamboyant investment; China still has to await further signs of robust economic recovery: production was stagnant, while exports and inflation have yet to resume long-term trend.

2. Notable headlines in Q2 were the negotiations to restructure Greece's debt; increasing uncertainty in the global financial market; strong USD relative to other major currencies; low crude oil price; and a fall in other commodity prices. Geopolitical tension among major economies overshadowed economic activities in Q2. The negotiation of high-quality FTAs (such as RCEP, TPP, TTIP, etc.) have produced limited tangible outcomes, but accelerated progress is expected towards the end of 2015.

3. Efforts to strengthen microeconomic foundations to promote and protect competition in Vietnam continued, despite obstacles to enforcing such reforms. Retaining business conditions has significant implications for market competition. Promoting competition markets is necessary and important, and requires further action to simplify business conditions and to discourage inefficient market concentration. In addition,

identifying and dealing with anti-competitive practices remains a real challenge. Administrative controls and remedies to control prices is generally inappropriate in a market-oriented economy. In other aspects, trade and investment liberalization is still ongoing, exerting additional pressure to enhance market access for foreign products and foreign investors. In this context, Vietnam should avoid strictly distinguishing the domestic private and FDI enterprises. Trade remedies and the protection of domestic industries - if necessary - must be transparent and consistent with international commitment, and include a credible retreat.

4. GDP grew by 6.46% in Q2 (YoY). Economic growth recovery became more robust, the growth target for 2015 (6.2%) becomes feasible. GDP growth in Q2 was below medium-term trend, though this trend decreased compared with previous quarter. Final consumption is an important factor for the recovery of aggregate demand.

5. The industry and construction recorded the most impressive performance. The Index of Industrial Production grew by 9.6% in the first 6 months of 2015. Recovery took place in all 4 sub-sectors but mining output remained volatile. PMI of Q2 remained high, albeit a slow-down in June. The shares of industry-construction and agriculture in GDP slightly increased.

6. Growth of the agriculture-forestry-fishery sector has been low; service sector growth in the first 6 months of 2015 was similar to previous quarters.

7. These were 26,357 newly registered enterprise in Q2/2015, with a total registered capital of VND 171.2 trillion. The numbers of dissolved and inactive enterprises decreased.

8. The consumer price index (CPI) increased by 0.65% in Q2, largely due to cost-push factors. Higher consumption and investment demand induced inflation, but this impact was relatively small. Retail prices of petrol and electricity have also contributed to the price increases in Q2. The determinants of inflation in Q2 are expected to be similar in the second half of 2015. In this context, overall inflation figure is expected to be within planned target of the Government.

9. VND-denominated deposit rates (for terms shorter than 6 months) were stable and below the ceiling imposed by the State Bank of Vietnam, despite increase at some commercial banks in May and June. Lending rates remained relatively stable in Q2, with some slight decrease. USD-denominated lending rate decreased slightly in joint-stock commercial banks; VND-denominated lending rate mainly decreased at state-owned commercial banks. Inter-bank interest rates remained relatively stable in the first 6 months, especially in Q2.

10. Credit grew by 3.54% in Q2, due to the following reasons : (i) more robust economic recovery; (ii) increase in borrowings to finance investment ahead of the opportunities from signed and pending FTAs of Vietnam; (iii) more abundant liquidity of banks; and (iv) less likelihood that inflationary expectation will ease further, thus enterprises and investors became more

confident with decision to borrow. Progress in resolving non-performing loans (NPLs) has not been sustained; the NPL ratio increased again to 3.59% in February. Measures to solve NPLs in 2013-2014 seemingly failed to address fundamental causes and thus have not resulted in long-lasting improvements.

11. Total liquidity grew at faster pace in Q2 compared to Q1, but at a slower compared to previous years. Main reasons include: (i) the smaller scale of Government bond issuance; (ii) the supply of USD by the SBV to help finance the trade deficit; *and* (iii) SBV's prudent management of total liquidity to avoid pressure on inflation.

12. The restructuring of weak commercial banks was accelerated in Q2. The SBV has not published detailed information on post-nationalization restructuring of commercial banks, on other banks that are potentially subject to restructuring, or on the severity of problems at other banks.

13. Q2 witnessed different phases of VND/USD exchange rate fluctuations. The SBV made some interventions into the foreign exchange market in Q2; the upward adjustment of VND/USD exchange rate indicates that the SBV might be shifting to a more flexible exchange rate regime. The USD appreciated by 1.8% relative to VND. The VND depreciated against the JPY, but appreciated relative to the Euro (all in real terms). While inflation was stable at low levels, the increase of VND/USD exchange rate made Vietnam's goods cheaper relative to foreign products.

14. Investment activities became more vivid in Q2 compared to Q1. The most significant shares and most rapid expansion of investment were by private individuals and enterprises, and FDI enterprises. The investment to GDP ratio rose to 31.7% in Q2. FDI inflows in Q2 exhibited insignificant YoY growth, albeit higher than Q1. Total newly registered and supplemented FDI in the first 6 months attained USD 5.49 billion, far from the target for 2015 (USD 23 billion). However, FDI disbursement was relatively stable in Q1 and Q2, with material YoY improvement.

15. Vietnam's trade growth continued to decelerate. Exports attained USD 41.5 billion, increasing by 10.6% (YoY) which is lower than in the period of 2011-2014 and below the growth target for 2015. Imports reached USD 42.1 billion in Q2, increasing by 14.2%. Import growth also outpaced export growth. FDI sector accounted for the lion shares of exports and imports. The trade deficit widened to USD 0.6 billion in Q2 and USD 3.07 billion in the first 6 months.

16. Total retail sales of goods and services in Q2 grew at significantly slower pace (only 5.9%, YoY) compared to Q1, and lower than Q2's of previous years. Revenue from tourism services continued to shrink in Q2, but at slower pace.

17. Q2 budget revenues attained VND 220.1 trillion, decreasing by 2.6% compared to Q1, equivalent to 49.0% of planned target for 2015. Budget expenditures were VND 267.6 trillion in Q2, increasing by 9.7% compared to Q1 and 9.1% compared to

2014 (YoY), equivalent to 47.3% of the planned target for 2015. The value of newly issued Government bonds declined, falling to VND 19.0 trillion in Q2, decline of 66.1% compared to Q1 m and 60.5% compared to Q2/2014. Government bond rates were stable in the first 6 months.

18. The forecast result shows that YoY economic growth can reach 6.42% in Q3. YoY Q3 export growth is forecast to be 10.6%. The trade deficit is projected at USD 0.8 billion. The CPI is projected to increase by 0.92% in Q3, compared to the end of Q2. The exchange rate at commercial banks will probably be stable in Q3 and Q4.

19. The macroeconomic environment in Q3 could be affected by several factors, including: (i) decision of FED to increase USD interest rate, thus affecting capital flows and/or interest rates and/or the VND/USD exchange rate in Vietnam; (ii) priority of economic growth in Vietnam's main export markets, albeit subject to geopolitical conflicts, European sovereign debt crisis, etc.; (iii) possible loosening of monetary policy in Vietnam, and its interaction with fiscal policy which may have material implications for investment and exports.

20. This Report includes in-depth analysis of trade imbalance between Vietnam and China. Total trade between Vietnam and China has been increasing rapidly, but Vietnam run a more drastic trade deficit with China. The structure of export goods of Vietnam to China gradually shifted from raw to processed goods. Informal trade is increasing, but exhibiting instability

and disadvantages for Vietnamese traders and producers. However, Vietnam-China trade is evolving in line with the advantages and advancement level of production levels in both countries. Vietnam is mitigating the risks from excessive dependence on China by diversifying markets, which in turn is promoted by FTAs with other partners.

21. The Report also analyses the differential treatment for SOEs such as easy access to credit, ODA and overseas loans; exemption of collateral requirements when borrowing; Government guarantees under various forms; loans being repaid by the State when SOEs default, even in the absence of prior guarantee; various supports such as debt freezing or rescheduling; increase of SOEs' charter capital and equity with funds originating from the State budget; exposure of SOEs to no threat of bankruptcy, even with accumulated losses; loose financial discipline without the strict control of shareholders.

22. Q2 witnessed a more robust economic recovery, under a firm and stable macroeconomic environment. A couple of newly signed FTAs broadened opportunities and access to export markets and external resources for production – export activities. The conduct of macroeconomic policies incorporated closer coordination of policy instruments and the creation/maintenance of room for using such instruments. Macroeconomic management in particular and socio-economic development in general still face several risks, such as pressures from public debts; building on the momentum for reforms of business environment, SOEs and commercial banks; or the pressure to strengthen competitiveness at product,

enterprise and economy levels. In this context, reforming microeconomic foundations and macroeconomic management should be in line with creating motivation, speeding up the implementation of Resolution 19 on tasks, key solutions for continuously improving the business environment, enhancing national competitiveness for stronger performance of business environment in the second half of 2015 and in the coming years. The Report concludes with specific recommendations on the conducts of monetary, fiscal, trade and price management policies.

I. ECONOMIC CONTEXT IN Q2

1. Global and regional economic context

1. Despite improvements and increased optimism, economic recovery was variable across major economies in Q2 and the first 6 months of 2015. Growth of the US economy decelerated, and the Federal Reserves (FED) signaled no increase in the prime rate[1]. Japan's economic growth in Q2 outpaced that in Q1, mostly due to more buoyant investment[2].

2. The headlines in Q2 were largely filled with information on the negotiations to restructure debts in Greece. In parallel with liquidity support for Greece, the European Union (EU) continuously pressed Greece to implement economic austerity measures and to improve debt service. Concerns about the risk of default and slow progress with negotiation (even Greece may step out of the Euro zone) have undermined investors' confidence.

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[1] On 24th June, the US Department of Trade announced the GDP growth rate in Q1 which shows a YoY decline of 0.02%, lower than the forecasted decrease of 0.7% in March.

[2] On the 8th of June, Japanese government announced the revision of GDP growth rate in Q1 to 3.9%, higher than the preliminary figure of 2.4% reported on the 20th May, 2015.

Table 1: Economic outlook in some major economies

Unit: %

	2013	2014	2015	2016	Difference *
World GDP (growth rate: %)	3.4	3.4	3.3	3.8	-0.2
Developed countries	1.4	1.8	2.1	2.4	-0.3
United States	*2.2*	*2.4*	*2.5*	*3.0*	*-0.6*
Japan	*1.6*	*-0.1*	*1.0*	*1.2*	*-0.2*
Euro zone	*-0.4*	*0.8*	*1.5*	*1.7*	*0.0*
Developing and emerging economies	5.0	4.6	4.2	4.7	-0.1
Developing countries in Asia	7.0	6.8	6.6	6.4	0.0
China	*7.7*	*7.4*	*6.8*	*6.3*	*0.0*
ASEAN-5	*5.1*	*4.6*	*4.7*	*5.1*	*0.0*
World trade (growth rate: %)	3.3	3.2	4.1	4.4	0.4
Non-fuel price (% increase, USD)	-1.2	-4.0	-15.6	-1.7	-1.5

Source: IMF (July 2015).

Note: * Difference between the forecast for 2015 as of July 2015 compared to April 2015.

ASEAN-5 includes Indonesia, Malaysia, Philippines, Vietnam and Thailand.

3. China still has to await further signs of robust economic recovery. Production was stagnant, while exports and inflation has yet to return to long-term trend levels. In June, the People's Bank of China cut the prime rate three times, and reduced the serve requirement ratio twice, in an attempt to help achieve the target growth rate for 2015 (7%).

4. Uncertainty in the global financial market increased due to two opposite stances of monetary policy. While the European and Asian countries loosened their monetary policy, the FED showed no clear signal on the prime rate. Thus, the capital flow

became more short-term with profound implications for capital markets in developing economies.

5. The USD remained strong relative to other major currencies in Q2. This was partly due to higher US Treasury bill rate - as the market anticipated an increase in the prime rate by FED.

6. Commodity prices continued to decrease. There was little recovery in crude oil price because (i) the US retains ample supply of crude oil; and (ii) the USD appreciated. Other commodity prices continued to decline (Figure 2). The World Bank projects that energy prices will fall by 40.5%, cereal prices by 3.7%, and raw materials by 6% throughout 2015.

Figure 1: International gold price

Source: Goldprice.org

Figure 2: Prices of crude oil and foods

Source: International Financial Statistics (IFS).

7. Geopolitical tension among major economies has overshadowed economic activities in Q2. The EU-US and BRICS intensified efforts to leverage global influence through infrastructure development projects, land and sea territory dispute resolutions, etc. Notwithstanding strategic economic implications, such initiatives proposed by China as the

Maritime Silk Road or Asian Infrastructure Investment Bank (AIIB) have heightened disagreements of other advanced economies because of concerns over securities and geopolitical issues in Asia.

8. During Q2, negotiation of high-quality FTAs (such as RCEP, TPP, TTIP, etc.) produced few tangible outcomes. TPP and TTIP remain stagnant, but they can be accelerated towards the end of 2015 after the "Trade Promotion Authority" was approved by the US Senate in late June. Another round of RCEP negotiation took place in early June, but concluded with limited results on the modalities for initial offers in goods, services and investment.

2. Strengthening microeconomic foundations to promote and protect competition in Vietnam

9. In Q2, Vietnam continues to prepare for implementing fundamental laws that legitimize the freedom to do business in Vietnam. Some major laws - such as the (amended) Enterprise Law, the (amended) Investment Law – were promulgated by the National Assembly in late 2014.[3] In the first half of 2015, two Decrees, three Decisions by the Prime Minister, and one Circular were issued to guide the implementation of the (amended) Enterprise Law. Corresponding figures for the (amended) Investment Law are three Decrees, three Decisions by the Prime Minister, and one Circular.

10. CIEM has reviewed business conditions stipulated in various under-law regulations issued by various Ministries. Out of the

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[3] See CIEM (2015a) for a summary of ideas and implications of these Laws.

5,850 business conditions, more than 3,000 were introduced in Circular-level documents. All these conditions were to be abolished from 1st July 2016 according to the (amended) Investment Law. Indeed, according to this Law, these 3,000 conditions should no longer apply from 1st July, 2015.

11. The above reforms still encounter a number of obstacles. The business conditions have only been reviewed from the legal documents *already* issued by ministries, excluding those in the drafting process. More importantly, various experts and market participants voiced concerns over the slowdown of reforms in the first half of 2015. Slowdown of business condition reforms could be attributed to several reasons, namely: (i) business conditions being in the interest of government agencies; (ii) the use of business conditions to implicitly protect domestic businesses[4]; (iii) convenience for government agencies (i.e. pre-screening), with fewer pressures and consequences related to post-screening, thanks to business conditions; and (iv) lack of mechanism to accelerate the simplification of business conditions.

12. Retaining business conditions, albeit in a more limited list of sectors/industries, has significant implications for market competition. Protecting competition is necessary, but protecting contestability is even more meaningful and essential to sustain a competitive environment for various sectors. Existing businesses should find it harder to carry out anti-competitive

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[4] Under the Principle of National Treatment in international treaties (including WTO), Vietnam must extend treatments to foreign investors and goods (once they access to market) which are no less preferential than those extended to domestic investors and goods.

practices or abuse market power, once market entry becomes simpler and less costly.

13. Encouraging competitive pressures should also be implemented by limiting economic concentration. Even when excluding industries, sectors that are dominated by the State, there are a number of industries in which market concentration of the three largest firms exceeds 65%, such as motorcycle production, non-alcoholic beverages production, etc.[5]

14. Identifying and addressing anti-competitive activities presents a material challenge in Vietnam. The Vietnam Competition Authority (VCA) has the mandate to: (i) oversee economic concentration activities; (ii) investigate the complaints related to competition restriction and unfair competition; and (iii) penalize unfair competition practices. However, VCA is only a department-level body directly under the Ministry of Industry and Trade, and is equipped with less than sufficient authority and capacity to carry out such activities. For example, in order to investigate the cases related to competition restriction and unfair competition, this agency is not authorized to request related businesses to provide information. In addition, the legal framework for competition is not closely related to consumer protection (in fact, Vietnam has a separate law on consumer protection). Therefore, the foundation for identifying and enforcing measures related to competition cases is not concrete, without being aligned with the core benefits of consumers.

15. Administrative control and remedies in dealing with price increases may prove inappropriate in a market-oriented

[5] See more in Vietnam Competition Authority (2015).

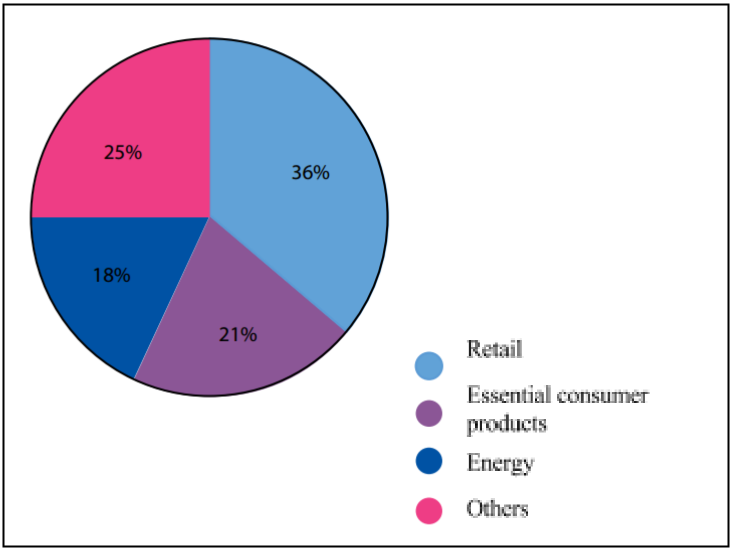
economy. Instead, Vietnam should improve its legal framework on competition by: (i) aligning competition protection with consumer protection, considering this as the most important principle of a competitive market; (ii) increasing competition pressure by simplifying conditions for business registration, and preventing economic concentration; (iii) improving the authority and capacity of VCA in order to receive, investigate, make decisions and enforce decisions on competition complaints.

16. In another aspect, trade and investment liberalization is still ongoing, exerting additional pressure on enhancing market access for foreign products and foreign investors. However, Vietnam pays little attention to upgrading capacity for trade remedies, market surveillance and ensuring fair competition. Therefore, pirated, counterfeit and low-quality products originating from imports are rampant. Competition in the related markets is then affected, since businesses suffer from uncertainty and weakened competitiveness due to such imported products.

17. Even domestic experts and agencies share opposite opinions on trade remedies and protection of domestic industries. Protecting some industries will increase the cost for downstream industries. Meanwhile, some agencies are reluctant to develop and implement trade protection measures, so as to avoid complaints by importers. In general, protecting domestic industries - if necessary - must be transparent and consistent with international commitments, and have a credible retreat. This will prevent excessive reliance of domestic firms on government protection, which is detrimental to motivating them to strengthen competitiveness.

18. In the context of deeper economic integration, Vietnam should avoid strictly unequal treatment of domestic private and FDI enterprises. Mergers and acquisition (M&A) activities between FDI and domestic firms - and vice versa – become increasingly popular. According to VCA (2015), a significant portion of M&A activities in 2014 are acquisition of domestic firms by FDI counterparts. The retailing sector accounted for the largest share of M&A value (36%), followed by essential consumer products (21%) and energy (18%). However, the legal framework on competition and competition authority should ensure such M&A activities do not hamper market competition. For example, upon managing M&A activities in the retailing sector, one should consider the possibility that foreign firms will prioritize imported products from their home countries (instead of allowing domestic firms to supply similar products in a competitive bid).

Figure 3: M&A activities by sector, 2014



Source: Thomson Reuters (cited from VCA 2015).

II. MACROECONOMIC PERFORMANCE AND OUTLOOK

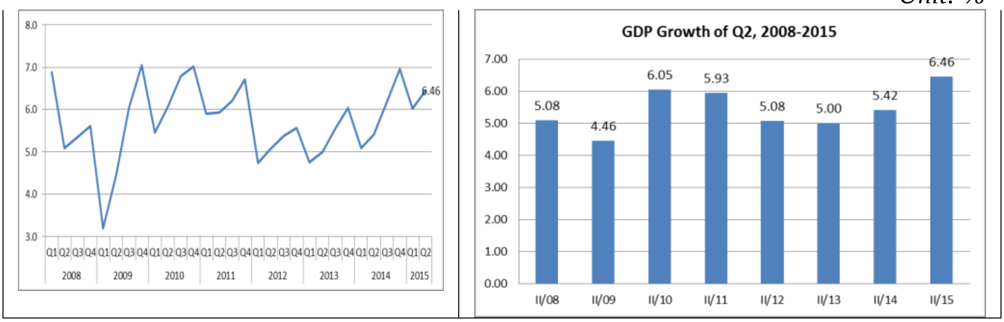
1. Macroeconomic performance in Q2

1.1. Real economy

19. Economic growth recovery is now more robust. GDP grew by 6.46% in Q2[6]. During the first 6 months of 2015, GDP growth rate accelerated to 6.28%. This growth rate exceeded that in Q2/2014 by more than 1 percentage point, and surpassed the same period of 2011-2014. If GDP grows faster in the second half of 2015, the growth target for 2015 (6.2%) is feasible.

Figure 4: GDP growth rate

Unit: %



Source: General Statistics Office (GSO).

20. Stronger consumption expenditure largely induced the recovery of aggregate demand. During the first 6 months of 2015, final consumption increased by 8.7%, contributing 7.7 percentage points to overall growth. Meanwhile, gross capital formation grew by 6.8%, reflecting a contribution to GDP of 2.2 percentage points. Increase of consumption and gross capital formation – without a matching increase in domestic production

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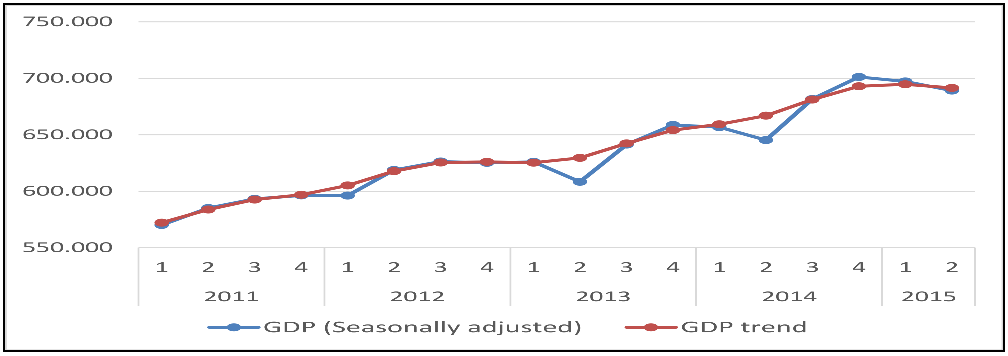
[6] In section 1.1, growth figures are on year-on-year basis, unless otherwise specified.

capacity – led to a widened trade deficit. The trade deficit in goods and services reduced GDP growth by 3.7 percentage points.

Figure 5: Quarterly GDP compared with trend

Unit: billion VND



Source: Authors' calculation.

21. Excluding seasonal variations, GDP growth in Q2 was below medium-term trend (Figure 5). Notably, medium-term trend in Q2 was lower than in Q1. This contraction of growth potential might be attributed to a slow-down in institutional reforms and economic restructuring measures. As economic growth in Q2 partly relied on short-term investment and consumption, it can only be sustained if deeper economic reforms take place in subsequent quarters.

22. Industry and construction saw the most impressive performance in the first half of 2015 (Figure 6). Value added of the sector rose by 9.1% in the first 6 months of 2015. Notably, the manufacturing sub-sector maintained high growth (of 9.9%); mining and quarrying exhibited remarkable growth (of 8.2%[7]).

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[7] Corresponding figure for the first 6 months of 2014 is -1.13%.

Figure 6: GDP growth by sector

Unit: %

Source: GSO.

23. The Index of Industrial Production (IIP) rose by 9.6% in the first 6 months of 2015; the figure in June was 11.1%. Recovery took place in all 4 sub-sectors, including: (i) production and distribution of electricity; (ii) manufacturing; (iii) mining and quarrying; and (iv) water supply, waste management and treatment. The manufacturing sub-sector exhibited rather stable growth in the first half, particularly in May-June, of 2015. However, mining and quarrying experienced ample fluctuations, even without increase in May (Figure 7).

24. More buoyant consumption and investment demand induced robust expansion of industrial production. Sale of manufacturing products increased by more than 12% in the first half of 2015. The PMI remained high in Q2[8], despite a slow-down in June (Figure 8). Inventory of manufacturing products rose by 11.8%, i.e. slower than corresponding period of 2014

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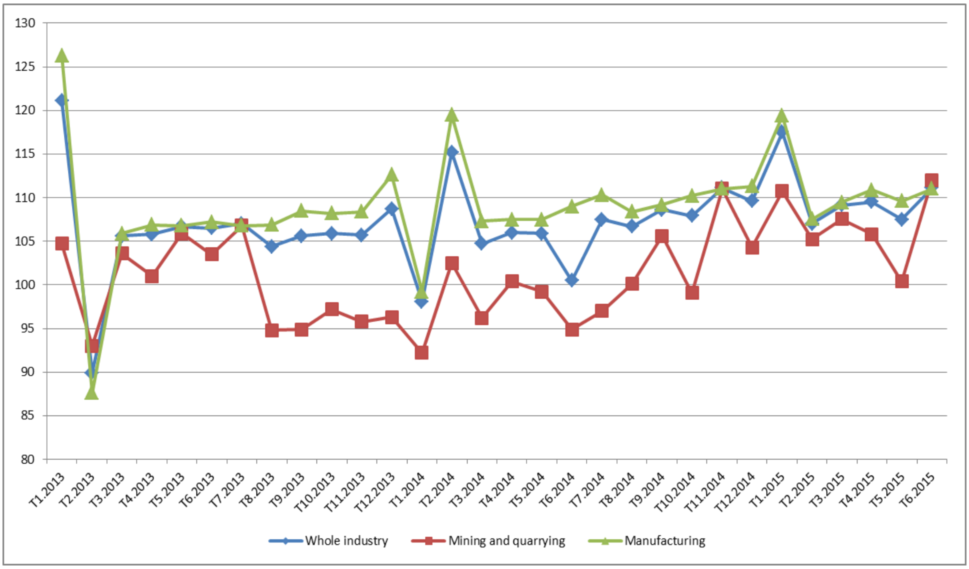
[8] According to HSBC, PMI was 53.5 in April, 54.8 in May, and 52.2 in June.

(12.8%). This was attributed to: (i) improved confidence in economic recovery[9]; (ii) investment expansion; (iii) rapid increase of (both domestic and export) orders; and (iv) a slow increase in input prices[10].

Figure 7: Index of Industrial Production, January 2013-June 2015

Unit: %

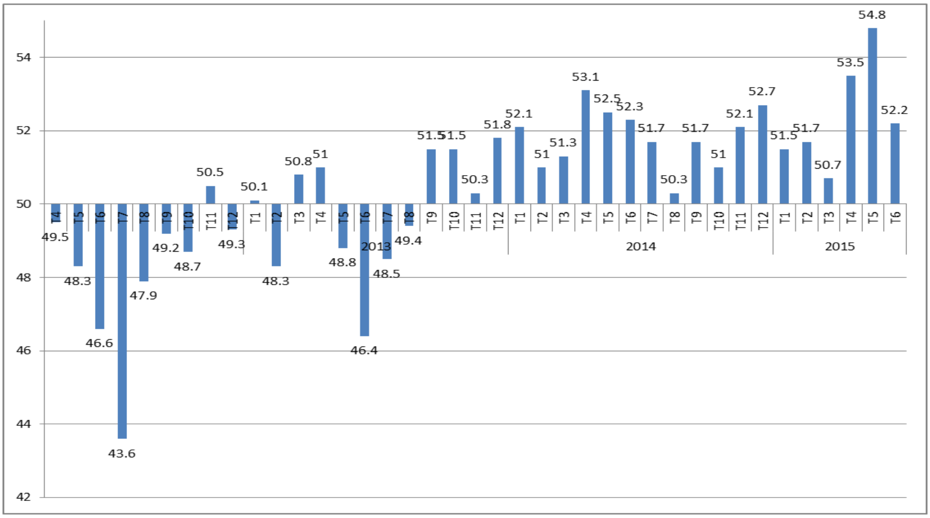


Source: GSO.

[9] A GSO survey found that 40.5% of enterprise saw an improved outlook for production-business activities, while 39.4% considered that production and business was stable in Q2 (compared to Q1).

[10] Prices of production materials only increased by 0.15% in Q2 (compared to Q1). Import prices only increased rapidly for such products as: cloth (1.18%), inputs and materials for textiles, garment and shoe leather (0.85%), animal feed and materials (0.58%).

Figure 8: Purchasing Managers Index, 2012-2015



Source: Markit, HSBC.

Note: PMI=50 means no month-on-month change.

25. Agriculture-forestry and fishery (AFF) grew by 2.2% in Q2 and 2.4% in the first 6 months of 2015. Gross output of AFF increased by 2.41% in the first half of 2015 –lower than that of 2012-2014.[11] AFF outputs encountered difficulties due to: (i) impacts of natural disaster; (ii) contraction of sales and world prices; (iii) contraction of food processing (by 3.7% in June compared to May); and (iv) higher prices for some agriculture inputs (eg. for animal feed and imported materials, prices increased by 0.58% in Q2 compared to Q1).

26. The services sector grew by 5.9% in the first 6 months of 2015, i.e. similar to that of previous quarters. Some sub-sectors grew more rapidly, such as wholesale and retail trade (by 8.3%);

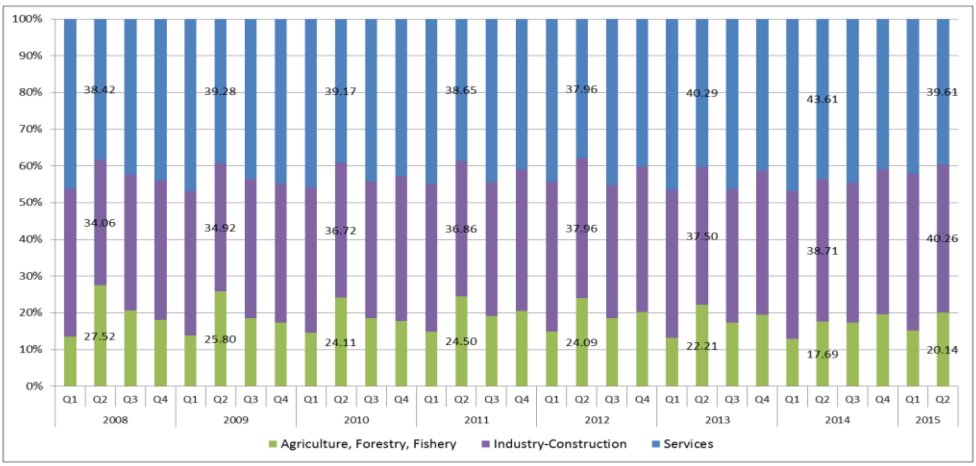
[11] Growth rates of the first halves of 2012, 2013 and 2014 were 2.81%, 2.53% and 3.4% respectively.

banking, finance and insurance (by 5.8%). Growth of the tourism sub-sector reached 2.9%[12], while international tourists dropped by 11.3%. Real estate market continued to recover with growth rate of 2.7% in the first half of 2015. Real estate transactions returned to growth,[13] in line with more rapid disbursements of real-estate lending .[14]

27. Economic recovery is accompanied by larger contribution of production sectors. In GDP structure, the shares of both AFF and industry-construction increased slightly in Q2, reaching 20.1% and 40.3% respectively. The service sector accounted for 39.6% of GDP, reflecting a decrease from that of 43.6% in 2014 (Figure 9).

Figure 9: GDP structure, Q1/2008-Q2/2015

Unit: %



Source: GSO.

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[12] Growth rate of tourism sector of the first 6 months of 2014 was 8.5%.

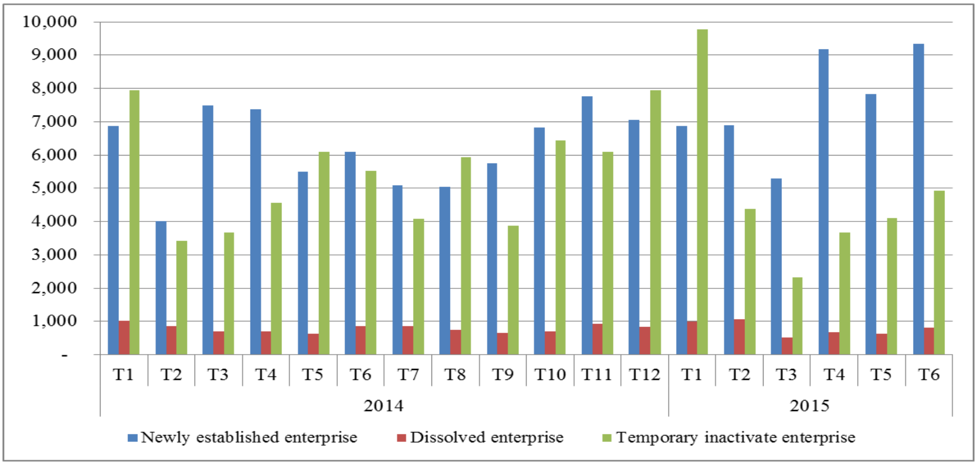
[13] According to the Ministry of Construction, during the first 6 months of 2015, the real estate market had more than 14,000 successful transactions, of which the number in Hanoi increased by 2.5 times and that in Ho Chi Minh City rose by 2.8 times (YoY).

[14] Credit for real estate sector went up by 10.89% in the first 5 months of 2015 (YoY).

28. The number of newly registered enterprises was 26,357 in Q2, with total registered capital of VND 171.2 trillion. For the first 6 months, Vietnam had 45,406 newly registered enterprises (up by 21.7%), with registered capital of VND 282.4 trillion (up by 22.3%). In Q2, the numbers of dissolved and inactive enterprises (including those registering inactive status or stopping temporarily before closing tax code or without registration) decreased by 0.9% and 6.4%, respectively (Figure 10).

29. During the first 6 months, 10,988 enterprises increased their capital, with total added capital of VND 308.8 trillion. Registered capital per enterprise reached VND 6.2 billion, or 0.5% higher than 2014 (YoY). Estimated number of jobs in newly registered enterprise were 651,398, increasing by 20.4%.

Figure 10: Selected indicators of enterprises' performance, 2014 - June 2015



Source: Business Registration Agency - MPI.

1.2. Inflation

30. The consumer price index (CPI) increased by 0.65% in Q2, in contrast to the deflation in Q1 (as CPI fell by 0.1%) and Q4/2014 (CPI dropped by 0.4%). In particular, MoM and YoY inflation rates as of June were 0.35% and 1%, respectively. CPI in June was 0.55% higher than in December 2014.

31. Positive inflation in Q2 could be largely attributed to the cost-push factors, including: (i) higher prices of production inputs, especially inputs for AFF;[15] (ii) depreciation of VND against the USD in Q2; and (iii) the increase of interest rates at some banks. Higher consumption and investment demand also induced inflation, albeit the magnitude of these impact was smaller.

32. Retail prices of petrol[16] mainly tended to increase in Q2. As a result, price of transport services rose considerably in June (by 3.54% compared to May). Meanwhile, upward adjustment of electricity price since March led to larger electricity bills for related manufacturing industries and the households. Prices of health services also went up since June 1, leading to a MoM increase by 0.43% of healthcare price index in June[17].

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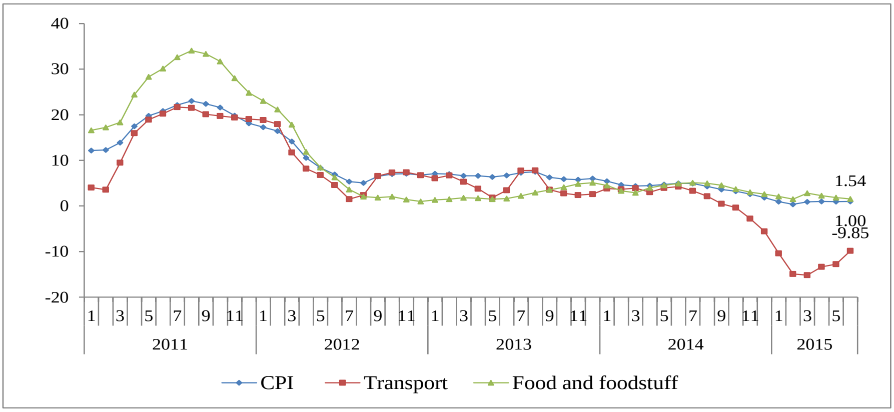
[15] See footnote No. 10.

[16] In Q2, petrol prices underwent 3 consecutive increases. On 11 March, petrol price rose by 1,616 VND/liter. On 5 May, petrol price went up by 1,950 VND/liter, the highest increase since the beginning of this year; and then up again by 1,200 VND/liter (i.e. 6.2%) on 20 May. Price of diesel was up by 640 VND/liter (equivalent to 3.9%) after two adjustments on 21 May and 4 June.

[17] In accordance with Joint Circular No. 04/2012/TTLT-BYT-BCT dated 29 February 2012.

Figure 11: YoY inflation, 2011-2015

Unit: %



Source: GSO, YoY growth rate.

33. Some commodity prices followed a downward trend in Q2. Price of telecommunication went down slightly (by around 0.1% in Q2). Food prices decreased continuously since March due to abundant supply while processing and export of AFF products grew more slowly.

34. The determinants of inflation in Q2 hardly changed in the second half of 2015. In this context, overall inflation figure is expected to be within planned target of the Government. However, inflation stabilization is subject to several factors, such as: (i) proposals to increase prices of some essential products and services (for example water, education, etc.), often justified by the argument of modest impacts on inflation; (ii) proposals to raise and levy additional taxes and charges - in order to increase budget revenues – which will lead to higher production costs and eventually higher prices; (iii) non-transparent justification of costs for important commodities (such as petrol, electricity and water). Thus, inflationary expectation is unlikely to ease further, which affects the

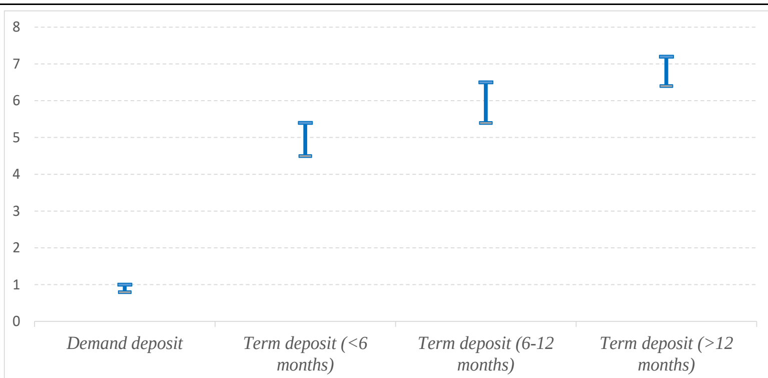
management of interest rate, exchange rate and prices in the last 6 months of 2015.

1.3. Monetary development

35. Deposit rates were relatively stable in the first 6 months of 2015. VND-denominated deposit rates (for terms shorter than 6 months) were stable and below the ceiling imposed by the State Bank of Vietnam (SBV, Table 2). Deposit rates were under little pressure in Q2 because of: (i) sufficient liquidity of commercial banks; (ii) restricted capital inflows to the stock market due to impacts of Circular No. 36/2014/TT-SBV; (iii) small values of issued Government bonds; (iv) market expectations that the FED would not raise USD-denominated interest rate before September; *and* (v) the stabilization of exchange rate after the increase in early May.

Table 2: VND-denominated deposit rate of commercial banks, June 2015

Unit: % per annum



Changes compared to	Demand deposit	Term deposit, <6 months	Term deposit, 6-12 months	Term deposit, >12 months
End of December	0	Decreased by	Decreased	Decreased by

2014		0.1-0.4	by 0.3	0.3-0.4
End of March 2015	0	0	0	0

Source: SBV.

36. VND-denominated deposit rates only increased at some commercial banks in May and June. The main reasons include: (i) large shares of these commercial banks in total deposits, which required higher deposit rates in competing for funds; *and* (ii) liquidity pressure of some commercial banks when credits were extended at faster pace, etc.

37. Lending rates declined slightly in Q1, and remained relatively stable in Q2. In the first 6 months, lending rate only fell insignificantly. USD-denominated lending rate decreased slightly in joint-stock commercial banks. VND-denominated lending rate mainly decreased at state-owned commercial banks with the maximum reduction of 0.2 percentage point per annum for short-term loans and of 0.2-0.5 percentage point per annum for medium- and long-term loans.

Table 3: Popular lending interest rate of commercial banks, June 2015

Unit: % per annum

	Types	Short-term	Medium and long-term
State-owned commercial banks	VND - Ordinary business and production	7.0-8.8 *(7.0-9.0)*	9.3-10.5 *(9.5-11.0)*
	- Agriculture, rural development; export; SMEs; supporting industries; high-technology	6.0-7.0 *(7.0)*	9.0-10.0 *(9.0-10.0)*
	USD:	3.0-4.5 *(3.0-4.5)*	5.5-6.5 *(5.5-6.5)*
Joint-stock commercial banks	VND - Ordinary business and production	7.8-9.0 *(8.0-9.0)*	10.0-11.0 *(10.0-11.0)*
	- Agriculture, rural development; export; SMEs; supporting industries; high-technology	7.0 *(7.0)*	10.0-10.5 *(10.0-11.0)*

	USD:	4.5-5.5 *(4.5-6.0)*	6.0-6.7 *(6.0-7.0)*

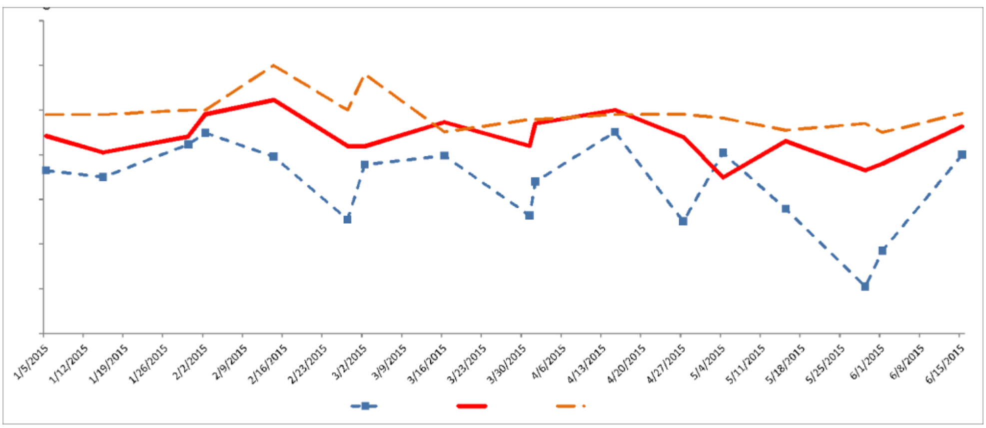
Source: SBV.

Note: Figures in brackets are lending rates in December 2014.

38. Inter-bank interest rates remained relatively stable in the first 6 months, especially in Q2. Interest rates for terms of 1 month and 6 months mostly varied in the range between 4-5% per annum. Overnight interest rate declined dramatically in May (reaching 1.05% per annum at the end of May), before recovering in June.

Figure 12: Inter-bank interest rate, January- June 2015

Unit: % per annum



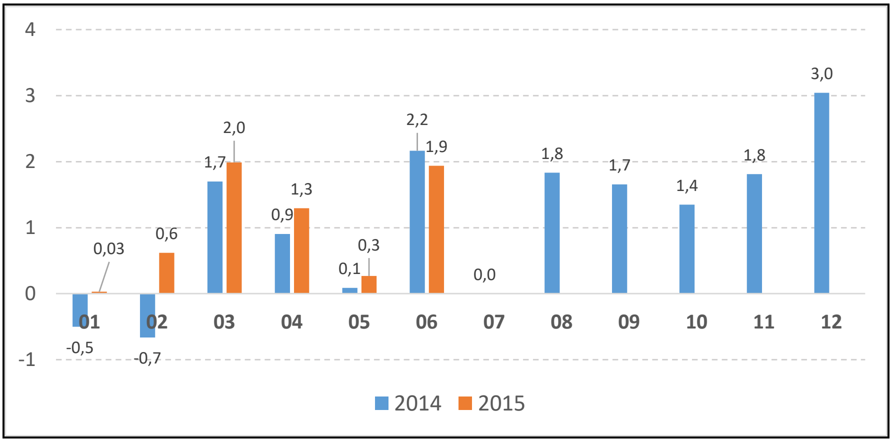
Source: SBV.

39. The evolvement of inter-bank interest rate closely reflected the expansion of outstanding credit in Q2. Credit grew by 3.54% in Q2 compared to Q1. Credit growth reached 1.9% in June (compared to that in May). Credit growth only decelerated in May. However, the YoY growth rate of outstanding credit in Q2 was similar to Q2/2014. Overall, credit growth attained

6.28% in the first 6 months, which outpaced the figure in the corresponding half of 2014 (3.72%).

Figure 13: MoM credit growth, 2014-2015

Unit: %



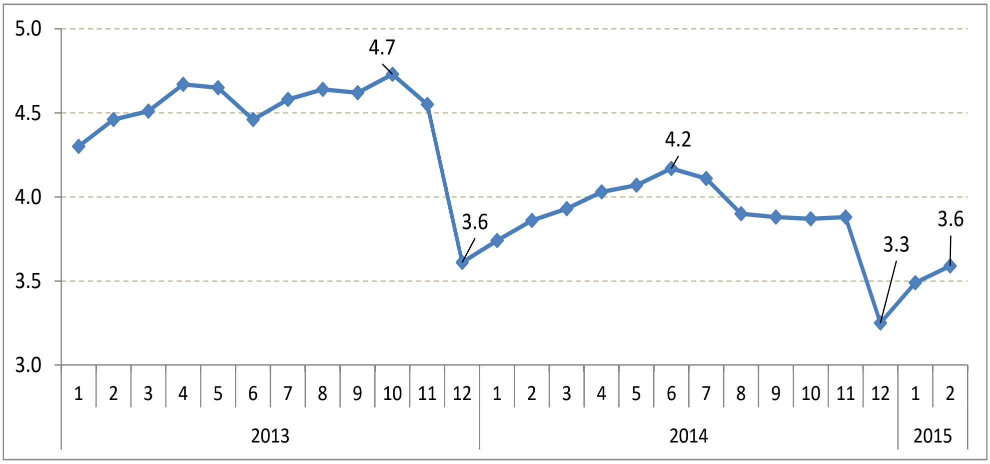
Source: Compilation from various sources.

40. More rapid credit growth in Q2 can be attributed to several reasons. *First*, economic recovery is more robust, while macroeconomic policies targeted economic growth and strengthening market confidence to promote investment and credit demand. *Second*, enterprises borrowed more to finance investment ahead of the opportunities from signed and pending FTAs of Vietnam (such as TPP, FTAs with the EU and Korea, RCEP, etc.). *Third*, banks' liquidity became more abundant to support credit, while the scale of Government-bond issuance is quite small. *Fourth*, inflationary expectation is unlikely to ease further; thus, enterprises and investors became more confident with their decision to borrow.

41. The progress in reducing non-performing loans (NPL) is far from being sustainable. After a sharp fall in December 2014, the NPL ratio increased again to 3.59% in February (Figure 14). Measures to solve NPLs in 2013-2014 failed to address fundamental causes and thus have not lead to long-lasting improvements. This issue is hardly surprising as Vietnam falls short of adequate legal framework,[18] adequate resources and institutional capacity to deal with NPLs. Reduction of NPLs is also subject to the progress in restructuring some weak commercial banks. Consequently, Vietnam needs bolder measures, including allocating more (financial and human) resources, to reduce the NPL ratio to below 3% by the end of September 2015.

Figure 14: NPL ratio of credit institutions, 2013-2015

Unit: %



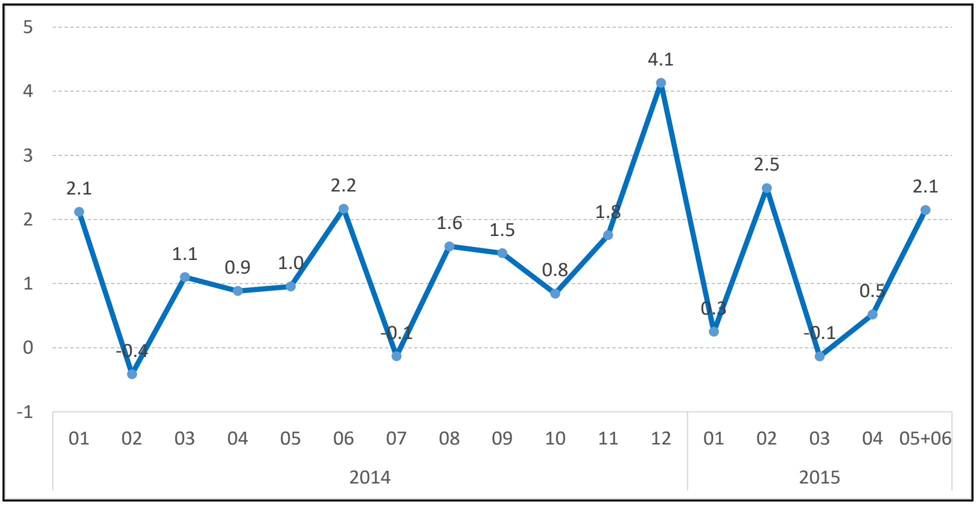
Source: SBV.

[18] Vietnam has not initiated the proposal of drafting a separate Law on Resolving NPLs. See *Macroeconomic Report for Q4 and 2014.*

42. Total liquidity grew at faster pace in Q2 compared to Q1. Respective growth rates of total liquidity in Q1 and Q2 were 2.35% and 2.68%. In the first 6 months, total liquidity increased by about 5.09% compared to the end of 2014. This figure was slower than those in corresponding halves of preceding years. The main reasons include: (i) smaller scale of Government bond issuance; (ii) the SBV had to supply USD due to trade deficit; *and* (iii) SBV's prudent management of total liquidity to avoid pressure on inflation.

Figure 15: Growth rate of total liquidity, 2014-2015

Unit: %



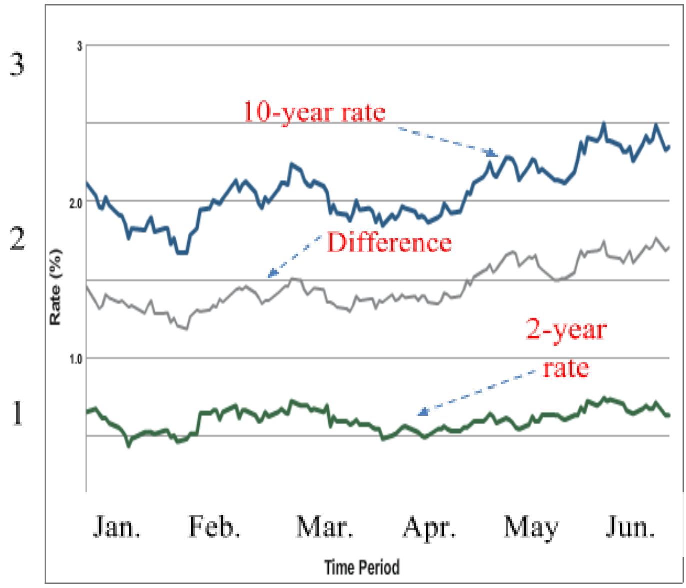
Source: Compilation from various sources.

43. As mentioned in the Macroeconomic Report for Q1 of 2015, the contraction of total liquidity in March could be attributed to divestment by foreign investment funds in the stock market. At the time, foreign investors expected that FED might raise USD-denominated interest rate. Due to this expectation, US-government bond rate went up continuously till mid-May and

early weeks of June. The expectation eased when FED signal delays of interest rate decision till September.

Figure 16: US-treasury rate in the first 6 month of 2015

Unit: %

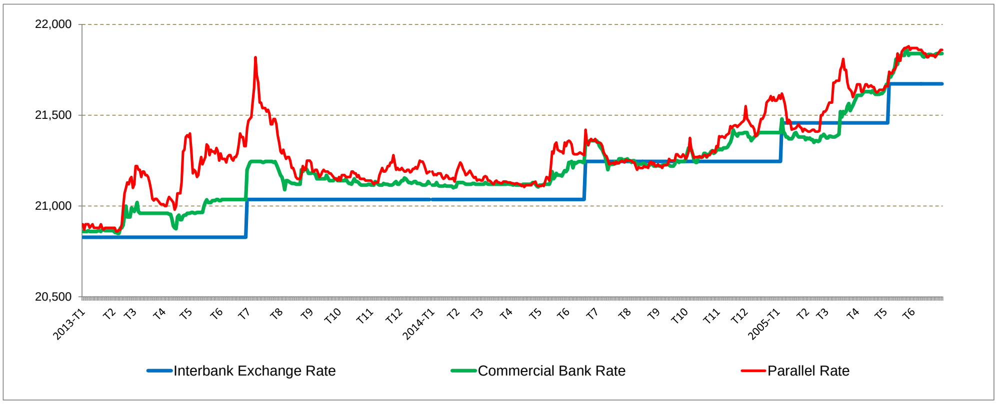


Source: The US Department of Treasury.

44. The restructuring of weak commercial banks accelerated in Q2. The SBV announced the decision to nationalize Ocean Joint-stock Commercial bank (Oceanbank) and Global Petrol joint-stock commercial bank (GPBank), after the nationalization of Construction Bank earlier this year. The SBV has published no detailed information on post-nationalization restructuring of commercial banks, on other banks potentially subject to restructuring, or on the severity of financial problems at such

banks.[19] Uncertainty remains in the operations of weak commercial banks that need to be resolved, in terms of both resolving methods and deadline for resolution.

Figure 17: Movement of VND/USD exchange rate, 2013- June 2015



Source: VNDirect.

45. Q2 witnessed different phases of VND/USD exchange rate fluctuations (Figure 17). In April, the exchange rate remained stable: the average interbank VND/USD exchange rate was fixed at 21,458 while both commercial bank and parallel rates were stable and below the permitted ceiling[20]. The market exchange rate then increased rapidly during late April and early May. The upward adjustment of interbank VND/USD exchange rate in early May made way for stabilization of market exchange rate. From mid-May to the end of June, the parallel and commercial bank rates were close to the ceiling imposed by the SBV. In general, exchange rate was more stable in Q2 than in Q1.

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[19] Report of the State Audit revealed the NPL ratio of Phuong Nam joint-stock commercial bank (SouthernBank) at 55.31% in November 2013, but the figure reported by SouthernBank was only 3.39% in December 2013.

[20] 1% higher than interbank exchange rate.

46. The SBV made some interventions into the foreign exchange market in Q2. The upward adjustment of interbank VND/USD exchange rate was the most notable, but not enough. The foreign exchange market was not stabilized immediately after the increase of interbank exchange rate. The SBV then had to supply USD (about USD 200 million) in mid-June to stabilize the market. Besides, the SBV announced its stance on monetary and exchange rate management in general, and orientation of exchange rate management and related market development (capital flows, balance of payment). Reserve requirement ratios were kept unchanged for both foreign-currency and VND deposits.

47. Mounting pressure on VND/USD exchange rate in Q2 was due to several reasons. *First*, the trade deficit rose continuously to cumulative level of USD 2.07 billion, USD 3.05 billion and USD 3.07 billion in April, May and June, respectively. Meanwhile, the SBV supplied limited USD to the market in the first 6 months (except for the sale of USD 200 million in mid-June). *Second*, the market expected VND/USD exchange rate to increase upon some rumors (the possibility of FED raising its prime rate; proposal to borrow from foreign exchange reserves to finance development investment; etc.). *Third*, estimation errors related to trade deficit made market participants weary of foreign currency supply and demand, which in turn led to the fluctuation of exchange rate.[21] *Fourth*, the bond issuance to raise USD 1 billion from Vietcombank resulted in higher demand for USD and created pressure on the VND/USD exchange rate.

[21] This issue was already noted in the Macroeconomic Report for Q4 and 2014. Initial estimates by GSO for trade deficits in the first 4 months and first 6 months of 2015 are USD 3 billion and USD 3.75 billion, respectively; but the official figures are USD 2,07 billion and USD 3.07 billion, respectively.

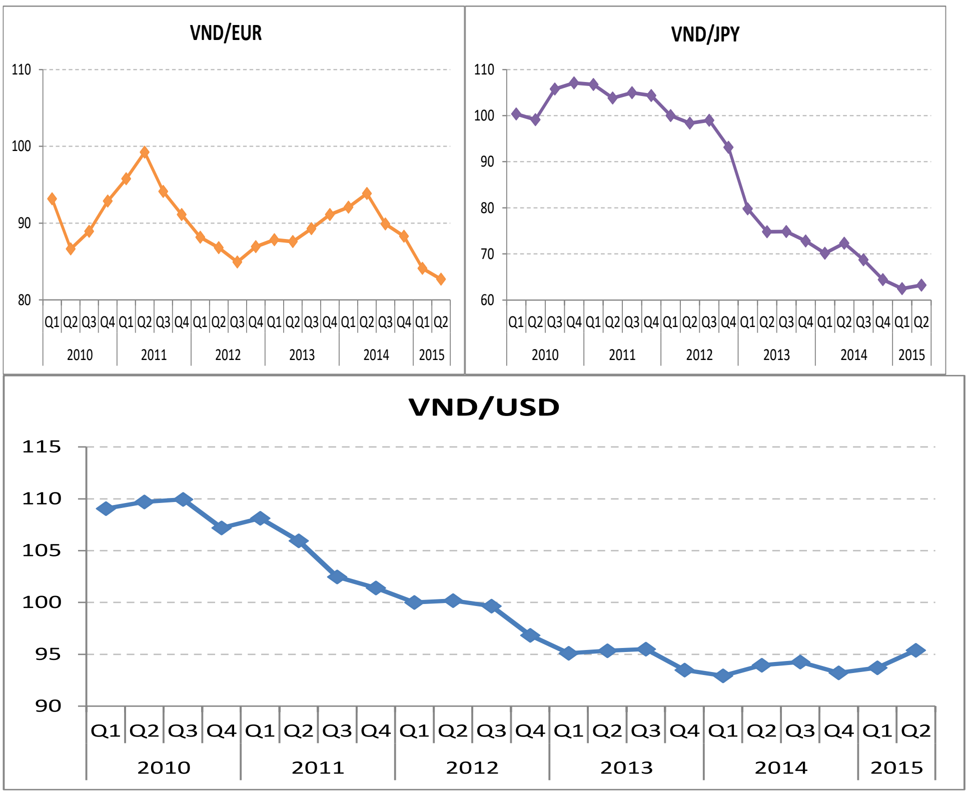
48. The decision to increase interbank VND/USD exchange rate in May did not receive broad consensus like the similar decision in early January. The market was partly concerned about the room for exchange rate adjustment in the last 6 months of 2015, as the maximum target of 2% was already utilized in full. Meanwhile, uncertainty still underlies global financial and economic developments in Q3 and Q4. In particular, freer flows of capital also make interest rates and/or VND/USD exchange rate in Vietnam subject to interest rate developments in the US.[22] Moreover, the upward adjustment of the VND/USD exchange rate was only justified ambiguously on "various factors", rather than the clear objective of promoting exports or retaining the value of VND as in previous occasions.

49. Adjustment of the VND/USD exchange rate, however, indicates that the SBV might be shifting gradually to a more flexible exchange rate regime. The room for exchange rate management remains ample. The trading band is still kept at +/- 1% and the SBV may widen this band, if necessary, to let VND/USD fluctuated more flexibly. Supply and demand of foreign currency in the market may also be altered if the SBV adjusts reserve requirement ratios on foreign-currency- and VND-denominated deposits, though this is accompanied by upward pressure on the lending rate as well. The upward adjustment of VND/USD exchange rate may have adverse impacts on inflation and public debt, yet these impacts seemed to have been hardly considered in full (even upon borrowing from overseas).

[22] Issue of "Impossible Trinity".

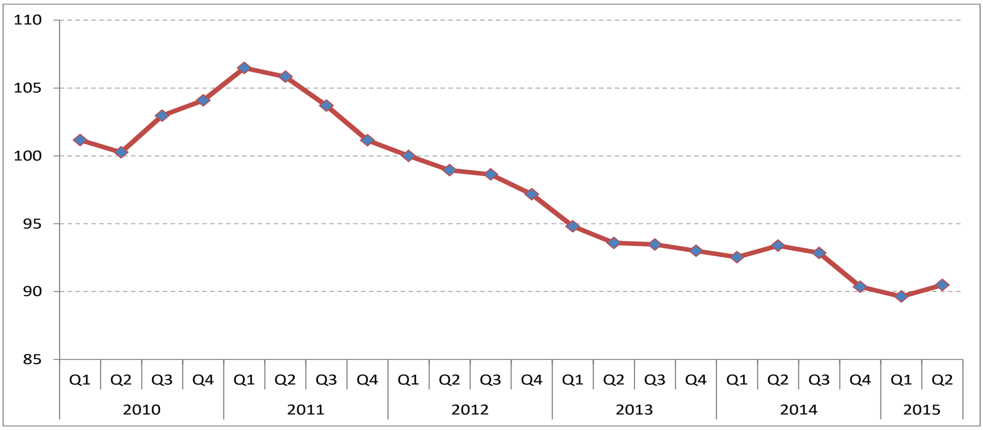
50. USD appreciated by 1.8% relative to VND in Q2 (in real terms, Figure 18). For the first 6 months, the corresponding figure attained 2.3%. This evolvement was mostly attributed to the appreciation of USD in international market while inflation rate was relatively low in Vietnam. The adjustment of VND/USD exchange rate – while JPY depreciated more slowly against USD – resulted in the depreciation of VND against JPY. In real terms, JPY appreciated by about 1.2% relative to VND in Q2, but still depreciated by 1.8% in the first 6 months. In contrast, VND appreciated against EUR by 1.7% and 6.3%% in Q2 and the first 6 months, respectively (adjusted for inflation).

Figure 18: **Real exchange rates of VND relative to major currencies**



51. Unlike previous quarters, Vietnam's goods became cheaper relative to foreign ones in Q2 (Figure 19). Thus, the upward adjustment of interbank VND/USD exchange rate – while inflation was stable at low levels – made Vietnam's goods become more competitive compared to foreign ones.[23]

Figure 19: Real Effective Exchange Rate (REER)



Source: Authors' calculation.

Note: Q1/2012 = 100, REER is calculated based on trade data with 21 largest trading partners and data on CPI; Data for Q2/2015 are estimated; Higher REER implies that Vietnam's goods become cheaper relative to foreign ones.

52. The conduct of monetary policy in Q2 partly received supporting stances of other macroeconomic policies. The scale of Government bond issuance – still with terms to maturity of 5 years or longer – became smaller compared to Q1 and Q2/2014,

[23] This result is consistent with the finding by Truong Dinh Tuyen et. al. (2011): Depreciation of exchange rate only helps increase export volume if macroeconomic stability (and low inflation) is retained.

which helped ease pressure on liquidity of commercial banking system. The authorities in charge of public debt and export management have to various extents consulted and cooperated with the SBV in exchange rate management.

53. Still, monetary policy and other macroeconomic policies need more effective coordination in some specific circumstances. The announced consideration of borrowing from foreign reserves to finance development investment – albeit at proposal stage – cast significant doubts among market participants. The reduction of Government bond issuance was partly based on Government's consideration of other borrowing schemes, which effectively means no more than a deferral of pressure on the money market to a later date.

1.4. Investment

54. Investment activities became more vivid in Q2 compared to Q1. For the first 6 months, gross investment increased by 9.4% (YoY; or 8.3% if excluding price changes). Most significant shares and rapid expansion of investment were by private individuals and enterprises, and FDI enterprises, with the respective YoY growth rates of 11.4% and 9.9% (Table 4).

Table 4: Gross investment, current prices

Unit: Trillion VND

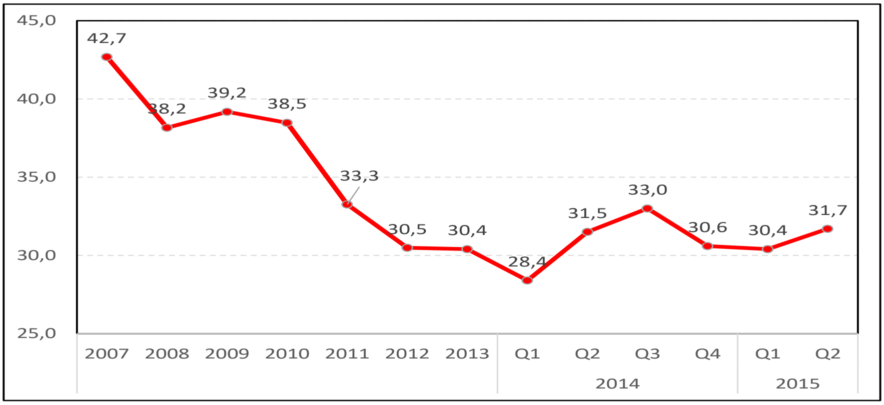
	2015 plan	Q1/2015	Q2/2015	First 6 months of 2015	Growth rate (%)
TOTAL	**1,343**	**246.1**	**307.7**	**553.8**	**9.4**
State budget investment	203	37.0	55.3	92.3	**1.7**
Government bonds	85	10.2	15.9	26.1	**5.2**
State credit	60	11.1	14.2	25.3	**0.4**
Borrowings from other sources (of the state sector)	90	15.4	19.8	35.2	**21.8**
Investment by SOEs (Equity)	90	12.3	15.1	27.1	**14.6**
Investment by individual and private sector	520	89.7	113.1	202.8	**11.4**
FDI	290	67.2	69.8	137.0	**9.9**
Foreign partners	*203*	*47.0*	*48.9*	*95.9*	***9.5***
Vietnamese partners	*87*	*20.2*	*20.9*	*41.1*	***10.8***
Other sources	25	3.2	4.5	7.7	**26.2**

Source: GSO.

55. However, gross investment in the first 6 months was only equivalent to 41.2% of the plan for 2015. The corresponding figures were very slow for investment by SOEs (30.1% of plan), Government bonds (30.7%), borrowings from other sources of the state sector (39.1%) and state budget investment (45.5%).

Figure 20: Investment to GDP ratio

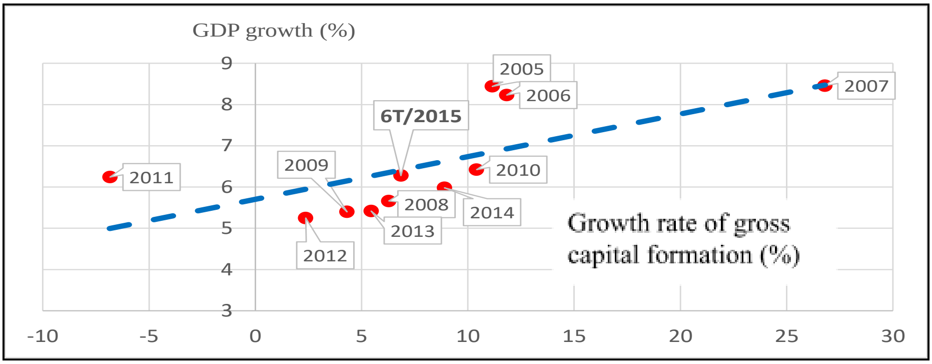
Unit: %



Source: GSO.

56. The investment to GDP ratio was 31.7% in Q2, higher than Q1 but only equivalent to Q2/2014 (Figure 20). Meanwhile, the quarterly ICOR tended to decline and became more stable recently,[24] showcasing some improved efficiency of resource utilization in Vietnam. This has been among the key driving forces for sounder economic recovery in Vietnam (Figure 21).

Figure 21: **Pace of gross capital formulation and economic growth rate, 2005-2015**



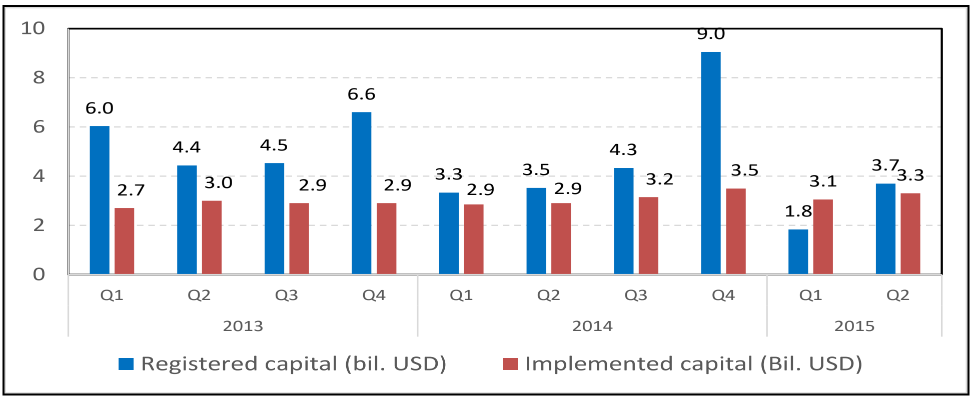
Source: GSO.

[24] CIEM (2015c).

57. FDI inflows in Q2 exhibited insignificant YoY growth, albeit higher than Q1. In the first 6 months, total newly registered and supplemented FDI attained USD 5.49 billion, reflecting a YoY reduction by 19.8%. This figure of newly registered and supplemented capital remains far from the target for 2015 (USD 23 billion). As a positive sign, FDI disbursement was relatively stable in Q1 and Q2, with material YoY improvement (Figure 22). Overall, implemented capital of FDI reached USD 6.3 billion in the first 6 months, showing a YoY growth of 9.6%.

Figure 22: FDI attraction to Vietnam

Unit: Billion USD



Source: GSO.

58. Korea was the biggest investor to Vietnam with total newly registered and supplemented capital of USD 1.52 billion, accounting for 27.7% of FDI inflows to Vietnam. Korean investment are being made in 51/63 provinces and cities across the country, 18/21 sectors and industries; with most going to manufacturing industry, accounting for 64.5% of total registered capital from Korea. Reasons for Korea's investment expansion in Vietnam include: (i) more signals of robust

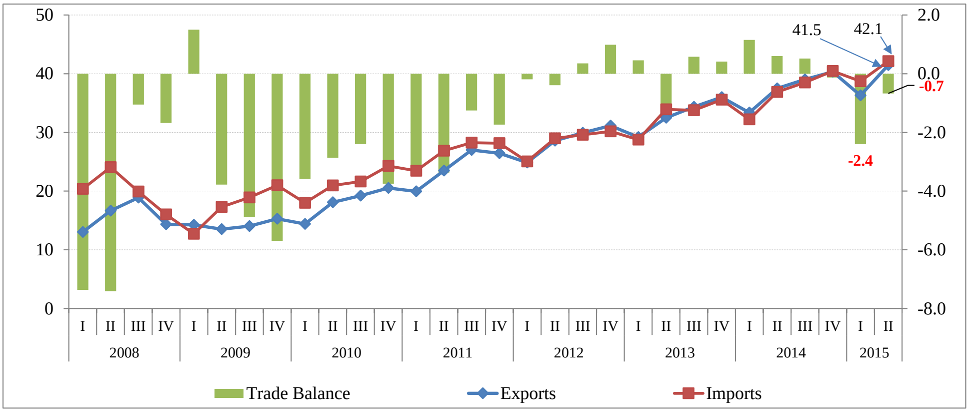
economic recovery in Vietnam; and (ii) preparation for opportunities induced by Vietnam-Korea FTA.[25]

1.5. Trade

59. Vietnam's trade growth continued to decelerate. In Q2, exports attained USD 41.5 billion (increasing by 10.6%, YoY). Corresponding figures for the first 6 months were USD 77.8 billion and 9.3%. The pace of export expansion was below the period of 2011-2014 (on YoY basis)[26] and distant from the target for 2015 (at least 10%).

Figure 23: Exports, imports and trade balance, 2008-2015

Unit: Billion USD



Source: General Department of Customs.

Note: Trade balance is indicated in the right axis; imports and exports are indicated in the left axis.

[25] The groundbreaking ceremony of the Project on Consumer Electronics Complex of HCMC Samsung-Vietnam was held on 19 May 2015, with total investment capital of USD 1.4 billion; the Project on telecommunication equipments and LED of KMW in Hanam province with total investment capital of USD 100 million.

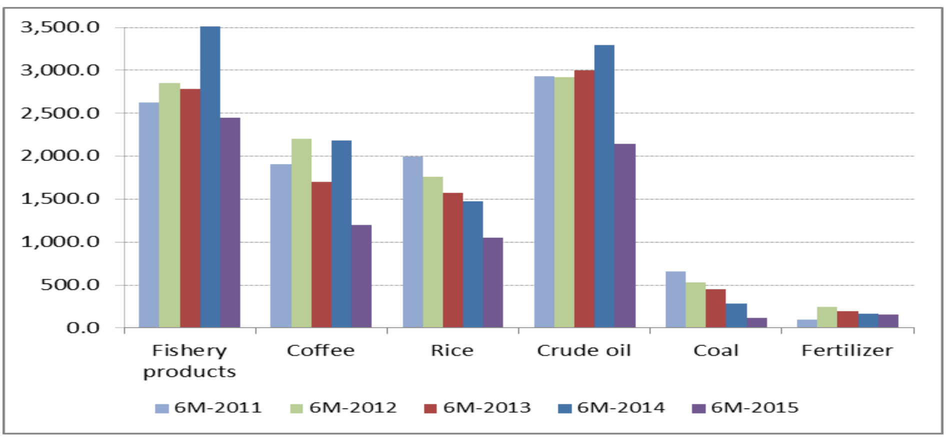
[26] YoY export growth rate for the first 6 months reached 14.9% in 2014, 15.4% in 2013, 23.0% in 2012, 33.8% in 2011, and 17.0% in 2010.

60. The slowdown of export growth could be attributed to some reasons. *First,* international prices of goods continued to fall, affecting the export values for various major products of Vietnam. In the first 6 months, the export price index fell by 2.89%.[27] Export prices dropped sharply in Q2 for various products, including crude oil (drop by 12.36%), cashew nut (by 8.73%), rice (by 6.36%), etc. *Second*, the appreciation of VND against EUR affected export to this market.

61. Exports of AFF products contracted significantly. In the first 6 months, exports of this product group decreased by 25.7% (on YoY basis). In particular, exports of rice fell by 12.1% (YoY); coffee by 35.4%; and fishery products by 15.2%. Exports of minerals and raw materials (including crude oil, clinker and cement, coal, etc.) also plunged drastically. Smaller exports of this product group resulted from both price decreases and the Government's restraint of raw material exports.

Figure 24: Major exported commodities in the first 6 months, 2011-2015

Unit: Million USD



Source: General Department of Customs.

[27] The reduction in QI and QII was 1.82% and 1.09%, respectively.

62. Imports reached USD 42.1 billion in Q2, increasing by 14.2% on YoY basis. Overall imports for the first 6 months attained USD 80.8 billion, 16.7% higher than in 2014 (YoY) – the largest increase since 2011.[28] Import growth also outpaced export growth in the early months of 2015.

63. Rapid import expansion in the first half of 2015 resulted from several factors. *First*, economic recovery and investment expansion[29] induced higher import demand for machines and materials to support production and business (Figure 25). Imports of CBU cars arguably contributed to higher import value, yet imports of production inputs also soared (Figure 26). In this aspect, Vietnam's growth paradigm exhibited hardly any change compared to previous years.[30] *Second,* import price dropped sharply by 3.73% in Q1 and 2.09% in Q2. Such drops were larger than the increase of VND/USD exchange rate, leading to smaller import prices denominated in VND and thus import expansion.[31] *Third,* some import tariff lines of Vietnam continued to be phased out under regional FTAs.[32]

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[28] YoY export growth rates for the first 6 months were 10.3% in 2014; 16% in 2013; and 6.4% in 2012.

[29] As discussed previously, recent investment activities in Vietnam is partly motivated by the emerging opportunities from FTAs.

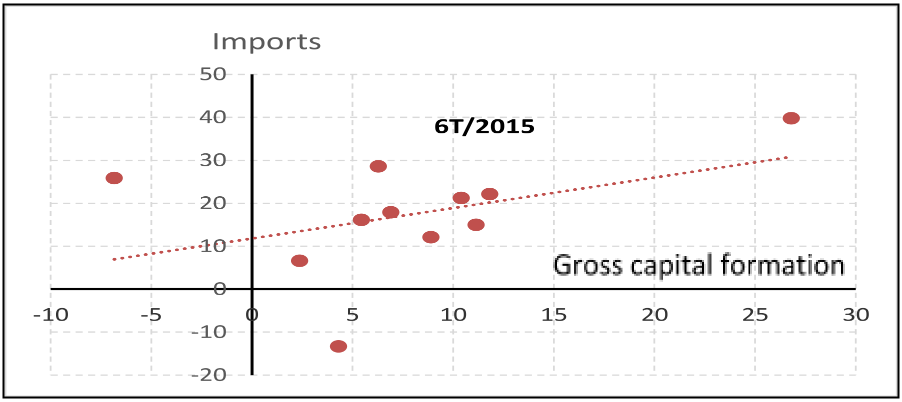
[30] Except the dramatic increase of imports in 2008 due to increasing consumption demand.

[31] Note that REER increases, implying that Vietnam's goods become cheaper in Q2; nonetheless, this evolvement might have no immediate impact on imports in Q2.

[32] See CIEM's report (2013).

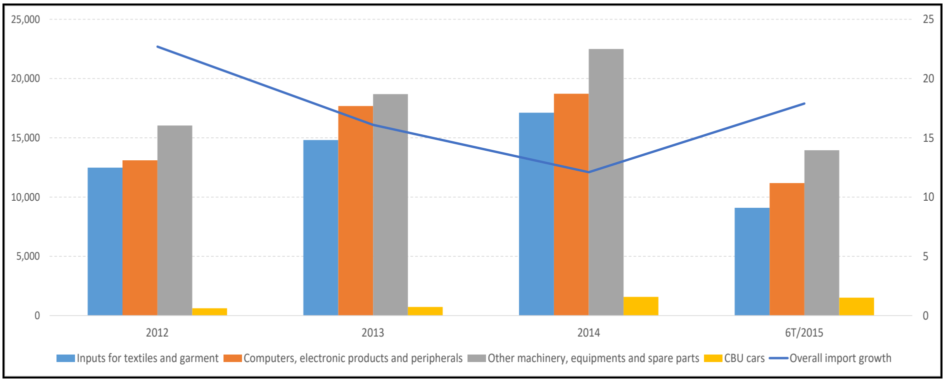
Figure 25: Growth rate of gross capital formulation and imports, 2005-2015

Unit: %



Source: GSO.

Figure 26: Growth rates of total imports and major commodities, 2012-2015



Source: General Department of Customs.

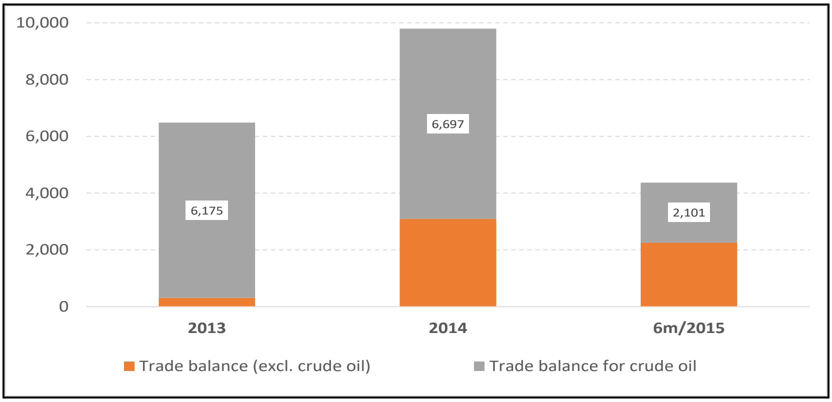
Note: Imports of products (USD million) is presented in the left axis; import growth rate (%) is presented in the right axis.

64. The trade deficit widened to USD 0.6 billion in Q2 and USD 3.07 billion in the first 6 months. By partner, Vietnam ran the

largest trade deficit with China (almost USD 16.5 billion in the first 6 months).[33] The product groups with largest trade deficit included: other machinery, equipment and spare parts (USD 10.2 billion); computers, electronic products and peripherals (USD 3.8 billion), oil and petrol products (USD 2.5 billion).

Figure 27: Trade balance of FDI sector

Unit: Million USD



Source: General Department of Customs.

65. FDI sector accounted for the lion shares of exports and imports. In the first 6 months, this sector contributed to 67.6% of exports, with YoY growth of 20.4%. The FDI sector accounted for 59.6% of total imports, with YoY import growth of 23.8%. The FDI sector had a trade surplus of about USD 4.4 billion (including crude oil) and USD 2.3 billion (excluding crude oil) in the first half of 2015. Even if crude oil is excluded, trade surplus of FDI sector tended to increase in recent years (Figure 27).

66. In the first half of 2015, both exports to and imports from Korea went up most rapidly (by 22.9% and 28.7%, respectively,

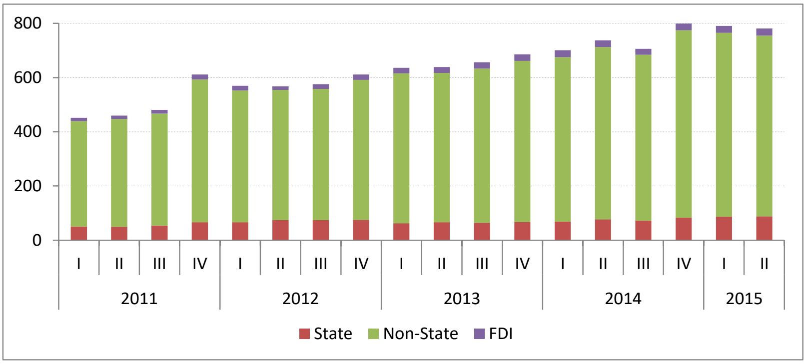
[33] Section III.1 presents a more detailed analysis of Vietnam-China trade.

YoY) compared to other trading partners. Exported products with notably high growth rates included plastic materials (by 144.6%); telephones and parts (by 115%, largely by Samsung); computers, electronic products and peripherals (by 90.2%); etc. Meanwhile, import growth rates from Korea were the highest for such product groups as glass (188.6%); CBU cars (152.1%); other machinery, equipment and spare parts (75.8%); steel products (102.2%); etc. The signing of Vietnam-Korea FTA on 5 May 2015 would broaden opportunities for bilateral trade with Korea in the coming years.

67. Economic recovery and production-business expansion induced increase in domestic trade. Yet total retail sales of goods and services in Q2 grew at significantly slower pace (only 5.9% on YoY basis) compared to Q1 (increased by 12.8%). The growth rate of total retail sales of goods and services in Q2 also was considerably less than Q2's of previous years.[34]

Figure 28: Total retail sales of goods and services, 2011-2015

Unit: Trillion VND



Source: GSO.

[34] YoY growth rates of total sales of goods and services in Q2/2014 and Q2/2013 were 15.4% and 12.6%, respectively.

68. Revenues from tourism services continued to drop in Q2 despite the summer holiday with high demand for tourism services. Nevertheless, the drop in Q2 (by 2.6%) was smaller than in Q1 (9.2%). This resulted mainly from the drastic reduction of foreign tourists to Vietnam (by 13.7% and 11.3% in Q1 and in the first half of 2015, respectively). The outbreak of MERS in Korea and economic recession in Russia also adversely affected revenues of tourism sector.

1.6. Budget revenues and expenditures

69. Estimated budget revenues of the first 6 months were equivalent to 49.0% of planned target for 2015. Budget revenues of Q2 attained VND 220.1 trillion, decreasing by 2.6% compared to Q1. The ratio of budget revenues to GDP fell from 27.9% in Q1 to 22.7% in Q2 – comparable to the level in 2012-2013. Domestic revenues accounted for 70.9% of total budget revenues in Q2 and 73.6% in the first 6 months. Corresponding shares of revenues from crude oil were 8.8% and 8.0%, respectively. Revenues from import – export taxes, special sale tax, and environmental protection tax on imports attained VND 47.7 trillion, equivalent to 57.2% of the planned target and increasing by 7.5% (YoY).

70. Budget expenditures were equivalent to 47.3% of the planned target for 2015. The estimate for Q2 was VND 267.6 trillion in Q2, increasing by 9.7% compared to Q1 and 9.1% compared to Q2/2014. The ratio of budget expenditures to GDP went down from 30.9% in Q1 to 27.6% in Q2, but remained significantly higher than in 2013-2014. Development investment accounted for 17.0% of total budget expenditures in Q2, slightly higher

than Q1 (16.8%). Current expenditures made up a larger proportion in total budget expenditures, attaining 83.2% and 83.0% in Q1 and Q2, respectively. Debt service (including both repayment of principal and interest) in the first 6 months reached VND 75.3 trillion, equivalent to 4.2% of GDP.

Table 5: Budget revenues and expenditures, 2010-2015

Unit: % GDP

	2010	*2011*	*2012*	*2013*	*2014*				*2015*	
					I	II	III	IV	I	II
Total revenues	**27.3**	**26.0**	**22.7**	**22.9**	**25.8**	**24.0**	**22.1**	**16.6**	**27.9**	**22.7**
Domestic revenue	17.5	16.0	14.7	15.7	17.7	16.1	14.7	11.5	21.5	16.1
Crude oil	3.2	4.0	4.3	3.4	3.4	3.1	2.5	2.2	2.1	2.0
Exports and imports	6.0	5.6	3.3	3.6	4.6	4.7	4.8	2.8	4.4	4.6
Grants	0.5	0.4	0.3	0.2	0.1	0.1	0.2	0.1	0.0	0.0
Total expenditures	**30.1**	**28.3**	**28.2**	**26.8**	**28.8**	**26.9**	**25.4**	**23.8**	**30.9**	**27.6**
Investment and development expenditures	8.5	7.5	8.3	6.1	4.4	4.9	5.0	3.2	5.1	4.7
Budget deficit	**5.5**	**4.9**	**5.4**	**5.5**	**4.9**	**4.6**	**5.3**	**7.3**	**4.6**	**6.4**
Budget deficit (excluding principle payments)	2.4	2.1	3.4	3.9	3.0	2.9	3.3	7.2	2.2	4.9

Source: Authors' calculation from data of the Ministry of Finance.

Note: Statistics of 2007-2012 are final accounts; statistics of 2013 are 2nd estimates; statistics of 2014 are 1st estimates (published on 15 December 2014).

71. The value of newly issued Government bonds tended to decrease, amounting to nearly VND 19.0 trillion in Q2, mostly with maturity terms of 5 years (accounting for 48.4%), a decline of 66.1% compared to Q1, and 60.5% compared to

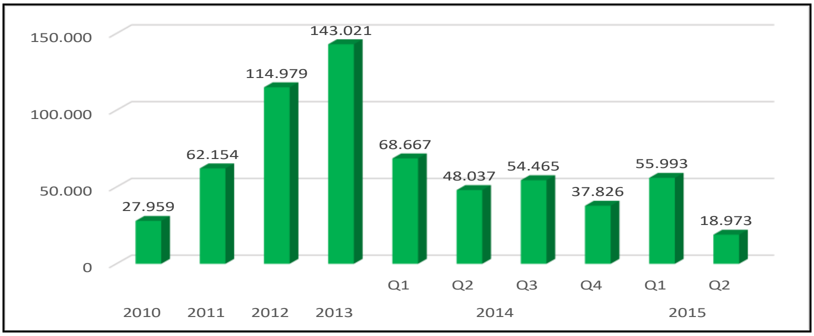
Q2/2014. Even if only those Government bonds with at least 5 years to maturity are considered, [35] the value of newly issued Government bonds in Q2 still dropped by about 6.0% (YoY).

72. Government bond rates were stable in the first 6 months. For 5-year terms to maturity, interest rates of successful bids in Q2 ranged between 5.35% p.a. and 6.4% p.a. (Figure 30). Corresponding ranges for 10-year and 15-year Government bonds were 6.35%-6.6% (p.a.) and 7.35%-7.64% (p.a.), respectively. Similar to the money market rates, Government bond rates hardly decreased because: (i) inflationary expectation has not eased; (ii) market expectation of increase in USD interest rate in the US (after the upward adjustment of VND/USD exchange rate). In fact, after the SBV's decision to increase interbank VND/USD exchange rate, Government bond rates rose to between 5.4-6.4% (p.a.) for 5-year term, between 6.5-6.6% (p.a.) for 10-year term and 7.6-7.64% (p.a.) for 15-year term (compared to the respective ranges of 5.35-5.48% p.a., 6.35-6.35% p.a., 7.35-7.52% p.a. during April-early May).

[35] In 2014, the issuance of Government bond with less than 5 years to maturity was still permitted.

Figure 29: Values of newly issued Government bond, 2010-2015

Unit: Trillion VND

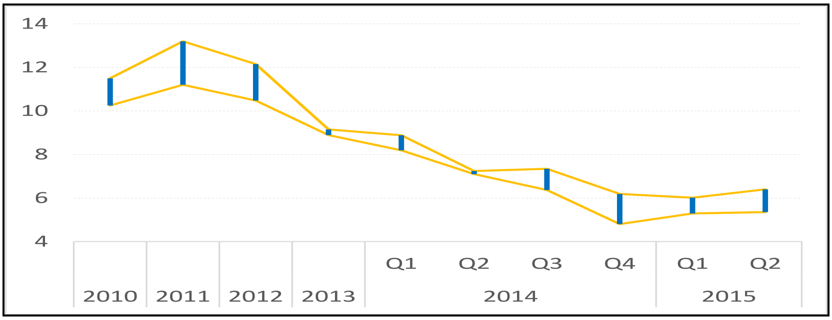


Source: HNX.

73. The smaller scale of new Government bond issuance can be explained by several reasons. *First,* the commercial banks had little appetite for bonds with terms to maturity of new Government bonds (at least 5 years), while the banking system is undergoing a restructuring process and Vietnam is short of a standard yield curve. *Second,* commercial banks were more reluctant to buy Government bonds, as they have to allocate funds for production-business activities. *Third,* the Government also considers other schemes to mobilize capital to finance budget deficit, and proactively reduces mobilization via Government bonds.

Figure 30: Government bond rate, 5-year-term

Unit: % per annum



Source: HNX.

74. Pressures to finance budget expenditures have not eased in the first 6 months, notwithstanding socio-economic improvement and more favorable context for macroeconomic policies. Such measures as the issuance of Government bonds; levy of more taxes and fees, etc. can only increase budget resources temporarily, whilst potentially leading to (even prolonged) adverse impacts on the economy. More fundamentally, excessive dependence on public investment usually intensifies capital demand from the state budget, especially when the Socio-Economic Development Plan for the years 2011-2015 is entering its final stage. Lack of budget expenditure disciplines may result in the vicious circle of increasing debt service – increasing budget expenditure – increasing borrowings to finance budget expenditures. In this context, the rising public debts and related risks[36] requires more drastic measures to economize on budget expenditures and/or to incentivize more effective budget expenditures.

[36] See newly released Report by the World Bank (2015).

2. Macroeconomic outlook

75. A forecast scenario is specified for Vietnam's economy in Q3/2015, in line with the general expectation of global economic recovery and domestic economic development. GDP growth in partner countries is projected at 3.3% YoY[37]. US inflation may reach 0.38%[38]. Export price of agricultural products declines by 1.4%[39]. The international crude oil price drops by 12.7% compared to Q2's[40]. The VND/USD exchange rate is not adjusted during Q3. Total liquidity increases by 3%. Credit grows by 4%. Import price decreases by 2%. Population and employment expands by 0.26% and 0.32%, respectively (YoY). Export volume of crude oil is assumed to equal to the average figure for Q1 and Q2. REER depreciates by 1% in Q3. On the balance of payment, Government transfer remains unchanged compared to Q2's. Implemented FDI capital (including foreign and domestic capital) is equivalent to Q2's. Investment from the State Budget and Government bonds will be VND 50 trillion and VND 25 trillion, respectively.

76. The forecast result shows that YoY economic growth can reach 6.42% in Q3 (Table 6). YoY export growth in Q3 is forecasted to be 10.6%. Trade deficit is projected at USD 0.8 billion. CPI in Q3 is projected to increase by 0.92% compared to the end of Q2.

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[37] IMF report (7/2015), projected that global economic growth is at 3.3% in 2015.

[38] http://www.tradingeconomics.com/united-states/forecast.

[39] EIU's forecast (July 15th 2015).

[40] EIU's forecast (July 15th 2015).

Table 6: Projection of macroeconomic indicators, Q3/2015

Unit: %

GDP growth rate (YoY)	6,42
Inflation (compared with Q1/2015)	0,92
Export growth (YoY)	10,6
Trade balance (*USD billion*)	-0,8

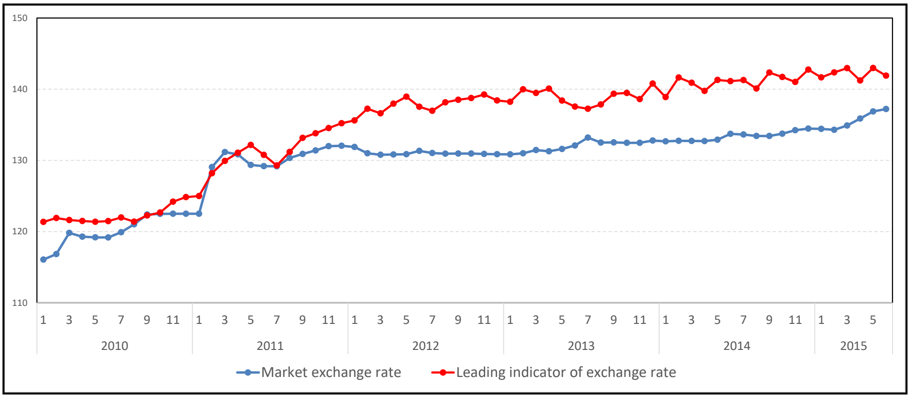
Source: CIEM's projection from macroeconometric model using quarterly data.

77. The CIEM leading indicator of exchange rate[41] exhibits no substantial change (over 3%), at the most recent time, implying that the exchange rate of commercial banks will probably be stable in Q3 and Q4 (with the probability of 94.1%).

78. The macroeconomic environment in Q3 could be affected by several factors. *First*, the FED may increase USD interest rate, thus affecting capital flows and/or interest rates and/or the VND/USD exchange rate in Vietnam. *Second*, Vietnam's main export markets still targeted economic growth; yet the process is subject to adverse impacts of geopolitical conflicts, European sovereign debt crisis, etc. *Third*, for the domestic economy, monetary policy could be loosened, and its interaction with fiscal policy will have material implications for Vietnam's investment and exports. Meanwhile, the large-scale FTAs that Vietnam has been negotiating (such as TPP, RCEP, and Vietnam - EU FTA) are yet to produce significant impacts on export and FDI in Q3.

[41] Monthly calculation, based on component indicators of inflation, interest rate and trade deficit.

Figure 31: Leading indicator of exchange rate



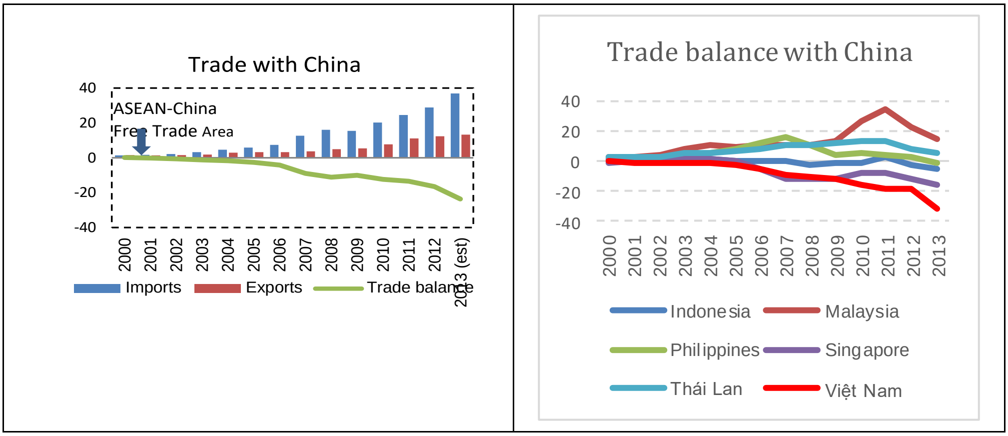
Source: Authors' calculation.

III. SELECTED MACROECONOMIC ISSUES

1. Addressing Vietnam's trade deficit with China

79. The trade deficit is large and rising: Total trade between Vietnam and China has been rapidly increasing for the last 13 years and may continue to grow in the forthcoming years. Import growth (30% p.a.) in excess of export growth (20% p.a.) solidifies the risk of widening trade deficit. Imports from China has increased by approximately 26 times, from USD 1.4 billion in 2000 to USD 36.9 billion, which outpaced export growth (only by 9 times, from USD 1.5 billion to USD 13.3 billion).

Figure 32: Trade with China, 2011 - 2015



Source: WITS calculation.

80. Vietnam has a trade deficit with almost all nearby trading partners, including ASEAN countries, South Korea, and China. The trade deficit with China is the largest. In contrast, Vietnam runs trade surplus with the US, EU, and Japan (albeit of small value). Among ASEAN countries, Vietnam has the largest trade deficit with China. Malaysia, Philippines and Thailand enjoyed trade surplus with China, whereas Indonesia, Vietnam and

Singapore recorded trade deficit. However, Singapore acts as a custom transit; therefore, its trade deficit with China does not entirely reflect the trade relations. Indonesia has a low trade deficit with China, approximately USD 5 billion in 2013. Trade deficit of Vietnam with China is thus the largest.

81. The structure of export goods of Vietnam to China is shifting away from raw and semi-finished goods towards more processed products. From 2000 to 2006, Vietnam mainly exported oil and semi-processed commodities (with total share of 87.5%, including food, semi-processed foodstuff and semi-finished intermediate industrial goods). Exports of oil and semi-processed commodities then saw their share falling to 31.4% at the end of year 2013. Processed and capital-intensive goods exported to China have increased in value and account for a larger share in Vietnam's exports.

Figure 33: Exports to China by product category

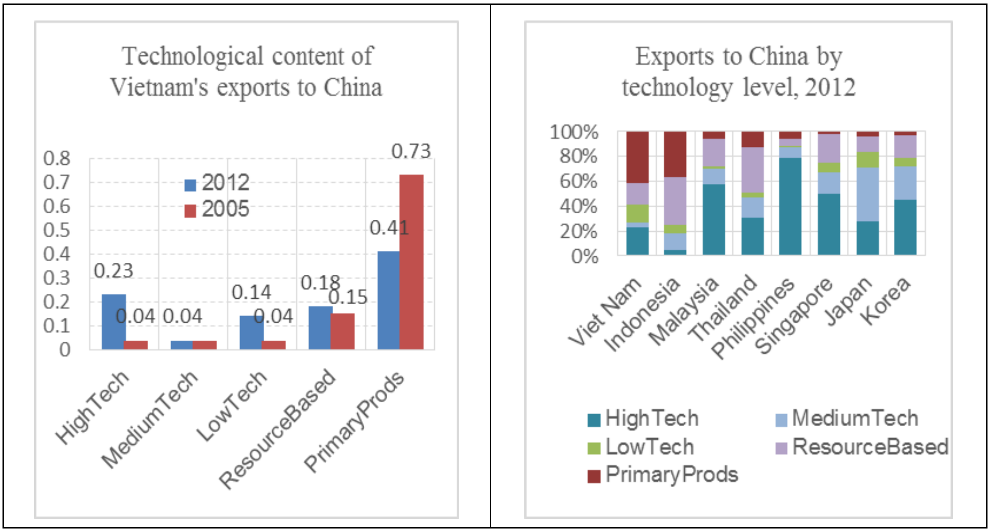
Source: Calculation from OECD database.

82. 82. Technological content of exports exhibits some improvement[42]. Still, the technological content of Vietnam's

[42] The authors divided products into 5 categories, including (i) basic goods (eg agricultural products, crude oil); (ii) resource-based commodities (such as butter, wine, sugar, honey ...); (iii) low-tech goods (textiles, clothing ...); (iv) medium-tech goods such as motor products, automotive, chemicals ...; (v) high-tech goods such as electrical products, electronics, aircraft, pharmaceutical ...

exports to China is below those of other countries in the region. Vietnam only outperforms Indonesia regarding share of high-tech exports, whilst lagging behind some ASEAN countries and more distant from South Korea and Japan. Insignificant improvement of medium-tech exports (while these products reflect actual industrialization level in early stage) should be a concern for Vietnam.

Figure 34: Technological content of Vietnam's exports to China



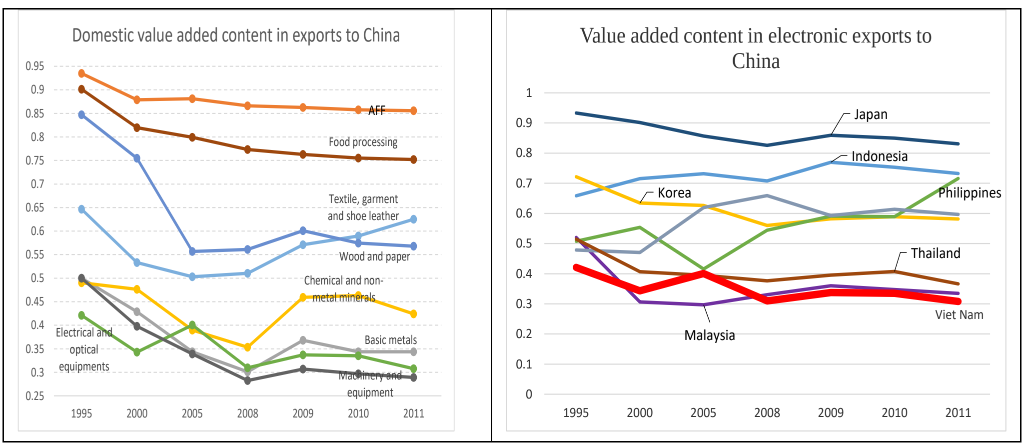
Source: Calculation from OECD database.

83. *Export concentration is decreasing*: Export concentration index went down from 0.078 to 0.062, indicating Vietnam's diversification of its export markets. Except for products such as rice, fruits and vegetables which are likely to focus on China market (market concentration index rose from 0.19 to 0.36 in the past 10 years), other export products have seen smaller concentration in Chinese market, including rubber (from 0.3 to 0.17), machine and equipment (from 0.13 to 0.05).

84. *Domestic value added content of exports is low and tends to decrease:* Except for raw and processed AFF products, other

product categories only have low added value content. More importantly, the content is decreasing over time; for example, the figure for wood products falls from 85% to 57%, machines and equipment from 50% to over 35%. The only group of products with improved domestic value added content is textiles and footwear. Domestic value added content of products requiring complex technology remains low. For example, electrical and optical products had nearly lowest domestic added value in Vietnam compared to other ASEAN countries. Added value from domestic production in Vietnam only accounts for 30.78% of total exports in 2011, lower than Malaysia (33.44%) and Thailand (36.6%), and much lower than Japan (83.09%), Indonesia (73.24%) and Philippines (71.56%). The share of value added in total exports indicates that while engaging more deeply into the global value chain, Vietnam is still producing export goods with low technological content and domestic value added content; as such, Vietnam finds itself vulnerable if advantage of cheap labor starts to decay.

Figure 35: Domestic value added content of exports to China



Source: OECD.

85. According to GSO, Vietnam's trade deficit with China in 2013 reached 23.7 USD billion; in 2014, this figure increased by 21.8% to USD 28.9 billion. In the first 5 months of 2015, Vietnam already had a trade deficit of USD 9.8 billion with China. China has been the largest source of imports for Vietnam. Intermediate goods accounted for the majority of such imports, with the share and value being 58.4% and USD 28.38 billion, respectively. Imports of intermediate goods from China has been more than doubled since 2010, with average annual growth rate in 2010-2013 is 30%. Imports of capital goods rose more slowly, at the average rate of 18% p.a. In 2013, imports of capital goods from China amounted to USD 18.68 billion. Each year, thus, capital goods and intermediate goods imported for manufacturing accounted for over 70% of imports from China.

Table 7: Structure of imports from China

	2000	2006	2010	2011	2012	2013
Consumer goods	8.30	7.20	15.50	17.90	21.40	20.80
Intermediate goods	41.3	66.0	55.80	56.50	57.40	58.40
Capital goods	38.7	18.0	21.00	19.70	16.10	16.70
Petroleum	9.60	8.80	7.70	5.90	5.10	4.10

Source: Calculation from OECD database.

86. Imports of consumer goods from China also expanded rapidly. In the period from 2010 to 2013, such imports increased by 41.3% on yearly average. In 2013, those imports reached USD 10.1 billion in value, or 2.8 times larger than in 2010. Chinese consumer goods are usually cheaper and more diverse than Vietnamese counterparts; therefore, they also appealed to the urban poor people as well as the rural consumers.

87. There are many explanations to Vietnam's sizeable trade deficit with China: apart from the increase in consumer goods, of which semi-durable goods account for the majority (for example, the share of apparel and consumer products having life span of at most 3 years increased from 35% in 2010 to 62.8% in 2013), Vietnam's trade deficit with China is also caused by the import of FDI enterprises. FDI enterprises in Vietnam mainly use imported input materials since domestic supply is insufficient, as well as other factors. According to the General Department of Customs, imports of FDI enterprises grew rapidly, and even this sector at times suffered from trade deficit. In 2012, FDI sector had trade deficit of USD 4 billion, and in 2013, it increased to USD 6.4 billion[43]. As another reason, Chinese EPC projects in Vietnam mainly use imported inputs from China. China won bids in many projects. For example, the cement industry has 23 factories of which EPC contractor is from China, with localization rate of 3%; coal-fired thermal power sector has 15 out of 20 plants built by Chinese contractors, with localization rate almost equal to 0. Two mining projects have localization rates of 2%. Other metallurgy and transportation projects also suffered from the same problem. In addition, domestic enterprises cannot secure sufficient domestic supply of input materials. Thus, imports from China with advantages of price and geographical proximity become the main input for domestic enterprises. For instance, textiles industry imported USD 15 billion in 2014, of

[43] Data from the General Department of Customs differs from GSO's data. According to GSO, the FDI sector runs a trade surplus. The data do not separate FDI sector's import from China.

which cotton accounted for USD 2.8 billion, fiber accounted for USD 5.4 billion. According to the Ministry of Industry and Trade, Vietnam's textile industry can only supply 50% of input materials, the rest has to be sourced mostly from China.

88. Notwithstanding imbalance in trade between Vietnam and China, such an imbalance is evolving in line with the advantages and advancement level of production levels in both countries. Vietnam is mitigating the risks from excessive dependence on China by diversifying markets, which in turn is promoted by FTAs with other partners.

Informal trade

89. The statistics of informal trade are hardly available, and mostly are estimates by some agencies. According to preliminary statistics of the Ministry of Industry and Trade in 2010, the value of informal trade between Vietnam and China was approximately USD 10 billion. 1/3 of agricultural exports were via informal trade. Vietnam Food Association estimates the volume of rice export via informal trade to China at 1.5 billion tons in 2013, accounting for more than 20% of Vietnam's rice exports via formal trade and 51% of rice exports to China[44]. According to Vietnam Rubber Group, 50% - 60% of rubber exported to China was via informal trade. According to Vietnam Fruits and Vegetables Association, 90% of dragon fruits exported to China were via informal trade.

90. Informal exports are preferred due to simplicity of procedures, requiring no written contracts and payment via banks. Therefore, this channel is suitable for trading of goods in small

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[44]http://songmoi.vn/kinh-te-kinh-doanh/xuat-khau-chinh-ngach-bi-truoc-tieu-ngach

volumes or those requiring swift delivery. However, informal exports are highly unstable and insecure which may cause damages for Vietnamese traders. This issue with informal exports comes from two main reasons. *First*, supply in Vietnam is not appropriately coordinated, which at times causes excess over demand. *Second*, the traded products exhibit high seasonality. Many products such as fruits and aquatic products need to be sold quickly during peak harvest and could thus earn only a low price. This in turn exerts downward pressure on the price in the domestic market and causes damages to Vietnamese farmers. The issue has persisted for years, without being fully resolved.

91. Two methods are mainly used to gather goods from Vietnam for informal exports to China. The first method is that Chinese traders purchase agriculture products from Vietnamese farmers, after which they can sell in the domestic market or transport those products to the border for export. As the second method, Chinese traders hire Vietnamese enterprises to collect and transport products. Decree No. 90/2007/ND-CP and Decree No. 23/2007/ND-CP grant foreign traders - with or without commercial presence - to have rights for exporting products; however, this right is not accompanied by the right to establish a merchant network to gather products; thus, foreign traders have to exercise their right via Vietnam traders. Therefore, Chinese traders are not legally permitted to directly purchase agriculture products from Vietnamese farmers.

92. Chinese traders often offer high purchase price. However, the offers are mostly made verbally, and are later replaced by lower ones in the absence of legal basis for dispute settlement. Moreover, verbal contracts lead to potential frauds: Chinese traders manipulate demand by setting initial high price, then wait for the price to go higher and resell products to the

collectors for arbitrage. Those who gather large inventory in anticipation of further price increase or to sell to Chinese traders will end up with sizeable losses. However, managing and addressing breaches are hardly easy, whilst lacking a legal basis for concrete actions.

93. Despite material risks, many enterprises and individuals still engage in small informal trade with China due to low quality standards and simplicity of trade procedures. Another reason lies in the policy of China. For example, China has a policy for tariff rate quota for rice importation. Rice imports in quota will be imposed tariff rate of 1%; however, volume of rice imports out of quota will be subject to the tariff rate of 65%. Rice imports that does not follow this mechanism will be considered as informal and against the law. Nevertheless, China often go easy on informal rice imports. With informal imports, Chinese traders usually have to pay informal costs of 20-30 USD/ton, instead of 70-80 USD/ton with formal imports. Large profits induce Chinese traders to import rice. However, when China wants to protect its domestic products, they enforce checks or import ban on rice from Vietnam[45]. The same issue applies to other agricultural products of Vietnam, indicating material risk in informal trade.

94. The risks with informal trade mostly resulted from the lack of professionalism in production and exports of Vietnam's

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[45] Since August 2014, China shut down rice imports via informal channel, and Vietnam's rice exports to China dropped sharply. Since early March 2015, China relaxed control over rice imports; thus, Chinese traders approached Vietnamese enterprises to purchase goods. Yet when Vietnamese enterprises transported rice to the border gate, China re-imposed import control. 30,000 tons of rice were then stuck at the border gate, causing huge damages to enterprises. http://tuoitre.vn/tin/kinh-te/20150325/trung-quoc-dim-gia-gao/724868.html

enterprises and farmers, as well as the weak law enforcement. However, the key weakness is with the production management in Vietnam. Agricultural products - often with small scale production and high heterogeneity in terms of quality, price and design – can hardly be exported to other markets such as the US, Japan or even China via formal channel. Since Vietnam cannot alter production promptly, one can expect the continuance to maintain informal trade with China. Still, Vietnam should strengthen the legal basis to reduce risk. In the mean time, Vietnam needs to:

a. Disseminate more information about market development and risks of non-contractual trade for Vietnamese people and farmers, especially prior to the harvest time of agriculture products.

b. Establish information channels, and enforce more effective market control and cooperation between the Ministry of Industry and Trade and local agencies to: (i) timely detect and prevent illegal purchases of agricultural products; and (ii) support agricultural producers to get access to commodity exchanges, large distributors such as supermarkets, domestic and foreign markets.

c. Support farmers to upgrade technology in producing and processing clean and high-quality agricultural products. To do this, Vietnam needs to establish and maintain research and development centers that undertake research, collaborate with and transfer technology to farmers.

d. Vietnam and China need formal cross-border trade arrangements requiring improved transparency and stability of their trade policies. China also needs to publicize quality standards and quarantine information, so that Vietnamese enterprises are well informed and prepared ahead of trade with Chinese counterparts.

2. Differential treatment for SOEs in Vietnam: Current practices, causes and consequences

95. After nearly 30 years of Renovation, reforms of State-owned enterprises (SOEs) remained an important structural priority, and has become integral in the current processes of economic restructuring and institutional reforms in Vietnam. The legal framework on business has arguably been improved to create a more level playing field for enterprises irrespective of ownership. Differential treatments for SOEs have gradually been phased out in the regulatory framework. Still, such preferential treatments persist and take various forms in practice.

96. Differential treatments effectively reflects the efforts to retain soft budget constraint for SOEs, causing adverse consequences to aggregate economic activity in general and the SOE sector in particular. Such consequences include: (i) distortions to allocation of resources; resources are not allocated and utilized efficiently, which undermines the development potential and quality of growth at both economy and enterprise levels; (ii) gradual reduction of economic efficiency derived from resource misallocation, weakening resilience of the economy and giving rise to more persistent risks of macroeconomic instability; (iii) less transparent, unfair, and unequal business environment, where supports to SOEs crowd out opportunities and development space of private sector; (iv) less than full compliance of SOEs with market principles and rules, as they are not subject to equal and fierce competition; this weakens the incentives for SOEs to effective manage and utilize resources; failure to mobilize external resource then prevents the development of each SOE and the SOE sector as a whole.

2.1. SOEs in Vietnam

97. SOE reforms have always been one pillar of Vietnam's reforms and transition to a market-oriented economy. In comparison with other economies, however, Vietnam still has a significant SOE sector. Notwithstanding fewer SOEs, the number of such enterprises still reached 3.100[46] by the end of 2014. Among them were 796 enterprises which are wholly owned by the State, 8 business groups, and 100 state-owned corporations. This number is high compared with those of developed countries with fully functioning market economy, such as 17 in Australia, 51 in France, 59 in Germany, 56 in Korea and 21 in the UK (OECD, 2011)[47].

98. Accounting for less than 1% of number of enterprises, SOEs had total assets of VND 2,869,120 billion – equivalent to 80% of GDP. This ratio is much higher than the average level of OECD countries (15%). SOEs currently contribute about 28-29% of GDP; the figure is similar to China (29.7%), but far exceeds those in other regions such as 15% in Africa, 8% of Asia average and 6% of Latin America (World Bank, 2014).

99. By the end of 2013, total equity of business groups and corporations was VND 1,150 trillion; but their outstanding debt already exceeded VND 1,500 trillion.

100. According to GSO report on some main indicators of enterprises as of 31 December 2014, the SOE sector still held a significant of capital, reaching VND 4,870 trillion in the economy, while the

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[46] SOEs are defined as enterprises of which the State holds more than 50% of equity. It is notable that this definition is different with the one mentioned in Investment Law (amendment in 2014).

[47] Christiansen, H. (2011), "The Size and Composition of the SOE Sector in OECD Countries", OECD Corporate Governance Working Papers

respective figures for non-state enterprises and FDI sector were VND 11,700 trillion and VND 5,410 trillion.

101. SOEs only created 1.4 million out of 11.8 million jobs at enterprise level. Meanwhile, foreign-invested enterprises employed nearly 3.4 million workers and non-state enterprises employed more than 7 million workers

102. According to the Central Economic Committee of the Communist Party of Vietnam (6/2014), SOEs hold 70% of land areas for production and business. Such SOEs as Vietnam National Coal – Mineral Industries Holding Corporation Limited (TKV), Vietnam Rubber Group (VRG) and other state farming-forestry units directly use and, at the same time, act as state management agencies on land.

103. Fixed assets and long-term investment of SOEs amounted to over VND 3,000 trillion, higher than the FDI sector (over VND 2,300 trillion), but lower than non-state enterprises (VND 4,600 trillion).

104. Total revenues generated by SOEs reached only VND 3,400 trillion, lower than the FDI and non-State sectors with respective figures of VND 3,800 trillion and VND 1,700 trillion (GSO, 2014). In 2013, SOEs contributed VND 276.063 trillion to the state budget and their profit was VND 181.530 trillion[48].

2.2. Differential treatment for SOEs – Practical evidences

105. In fundamental, related regulatory documents have arguably eliminated differential and preferential treatments for SOEs.

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[48] Report of the Government on financial performance and production-business results in 2013.

However, in practice, such treatments still take various forms. Below are some differential treatment for SOEs compared with other sectors, particularly domestic private enterprises.

2.2.1. SOEs enjoy easy access to credit, ODA and borrowings from overseas

106. According to Government report on financial performance of SOEs in 2013, SOEs' operations were mostly financed by bank loans. Total debts of general corporations and business groups in 2013 reached VND 1,500 trillion, or 9% higher than in 2012. The average debt to equity (D/E) ratio is 1.45. Alarmingly, 41 general corporations and business groups have debt-to-equity ratio of over 3. *Loans from commercial banks and credit institutions were estimated at VND 489,260 billion, increasing by 12.3% compared with the previous year.* Bank loans accounted for the majority of the rise in SOEs' debts. Loans to SOEs was even expanded more rapidly than overall credit growth of the whole banking system in 2013 (reported at 8.8%). In 2013, thus, a much larger part of the increase in bank credits became loans to SOEs.

107. The 12 general corporations and business groups already account for 9% of outstanding bank loans. The SOEs with major debt stocks are EVN (VND 78,583 billion) and Vinacomin (VND 49,566 billion).

108. The general corporations and business groups also borrowed VND 325,936 billion from overseas. Of which, on-lending from Government's ODA amounted to VND 125,061 billion; VND 122,543 billion was Government-guaranteed debt; the rest is borrowed at the SOE own risk.

109. Large SOEs continuously asked for preferences when applying for bank loans. For example, Vietnam Airlines proposed to retain some preferences even after equitization: e.g., complete Government guarantee when purchasing aircrafts, exemptions from the collateral requirement when applying for export credit and guaranteed mixed loan to purchase aircrafts.

110. According to the Economic Commission of the National Assembly, a large share of credit by the banking sector has been channeled to SOEs, estimated at over 50% during the late 20th century and currently at around 30%. Apart from credit from commercial banks, SOEs also receive "soft" budget support from the Government when they slip into difficulties.[49] Examples of such supports include repayment, rescheduling, freezing of debts for SOEs or increase charter capital of SOEs.

2.2.2. SOEs could borrow without collateral or with Government guarantee in various forms

111. According to a Report by the Ministry of Finance, as of September 2011, loans with explicit Government guarantee accounted for 17.5% of loans to SOEs, equivalent to VND 72,686 billion.

112. Beside the loans explicitly guaranteed by the Government, SOEs also receive indirect guarantees of the Government via loans borrowed from the Vietnam Development Bank (VDB). Sources of funds for VDB include the issuance of securities and ODA. According to annual VDB report, as of 2012, proceeds from issuing bonds guaranteed by the Government amounted to

[49]Economic Commission of the National Assembly (2013), Public debts and sustainability in Vietnam: Past, present and future.

VND 115,504 billion. VDB also management VND 107,061 billion from ODA. These two sources (either under Government's guarantee or from state budget) already contributed VND 222,565 billion, accounting for 85.6% of funds for VDB (VND 274,708 billion). Credits from these funding sources are guaranteed by Government.[50]

Figure 36: Proceeds from issuing securities with guarantee by the Government and from ODA funds in total funds resources of VDB

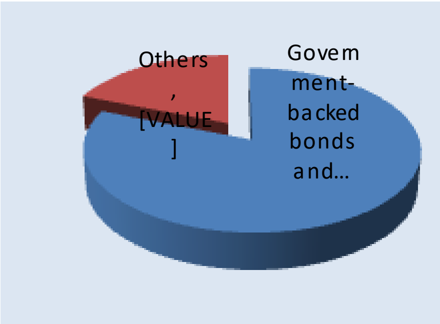
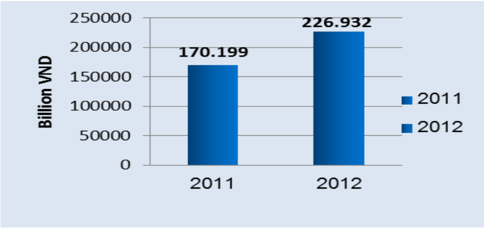


Figure 37: Estimated VDB loans to SOEs



Source: VDB's annual reports of 2011 and 2012 and authors' calculation.

113. Most of VDB funds are later extended as loans to SOEs under preferential treatment, and normally requires no collateral. According to VDB, *"General corporations and business groups account for 75% to 80% of total outstanding loans of VDB…"*[51]. Assuming that 75% of VDB loans were made to SOEs, the total credits to SOEs under indirect government guarantee through VDB would be approximately VND 170 trillion in 2011 and VND 226 trillion in 2012.

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[50]Vietnam Development Bank (2012), *2012 annual report*.

[51] "General corporations and business groups: Losses, non-performing loans and capital appropriation", accessed at VnEconomy on 13 September 2011 (www.vneconomy.vn)

114. As such, total loans to SOE with (explicit and indirect) guarantee by the Government amounted to VND 242,900 trillion at the end of 2011.

Table 8: Loans and payables of SOEs under Government guarantees

Unit: Billion VND

INDICATOR	2011
Total bank loans to SOEs	415,347.00
Oustanding loans of VDB to SOEs (including loans from ODA)	226,932.00
Total outstanding loans to SOEs by both the banking system and VDB	642,279.00
Total outstanding loans made by banking system and VDB under Government guarantee (direct and indirect)	242,884.73
Overseas loans of SOEs under Government guarantee	122,000.00
Total debts of SOEs (estimated)	1,200,000.00
Proportion of SOEs' debts under Government guarantees (out of total outstanding loans to SOE of both the banking system and VDB)	**38%**
Proportion of SOEs' debts including overseas loans, debts with direct and indirect guarantee by the government (out of total debts of SOEs)	**30%**

Source: Authors' calculation based on the data provided in the annual reports of SBV, VDB and the Government's report on the performance of SOEs

115. These statistics lack comprehensiveness because the indirect Government guarantees on loans by SOEs may take other forms. [52] However, these statistics still evidence the material share of loans to SOEs which is guaranteed by the Government, either explicitly or indirectly. A quick estimate shows that loans to SOEs with explicit and indirect guarantee of the Government accounted for: (i) 38% of outstanding loans of the whole banking system and VDB to SOEs; and (ii) 30% of debts of SOEs (estimated at VND 1,200 trillion in 2011).

[52] For example, according to Government report on financial performance in 2013, the business groups and general corporations had overseas loans of VND 325,936 billion. Of which, the Government-guaranteed amount was VND 122,543 billion.

Figure 38: SOEs' debts under Government guarantee (out of total outstanding loans to SOE of the banking system and VDB)

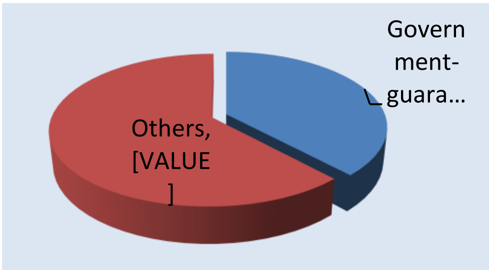
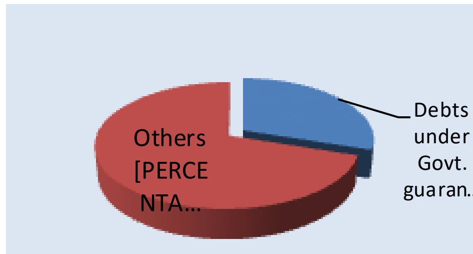


Figure 1: SOEs' debts including overseas debts, debts under explicit and indirect Government guarantees (out of total SOEs' payables)



Source: Authors' calculation based on the data provided in the annual reports of SBV, VDB and the Government's report on the performance of SOEs.

Box 1: The Government extended guarantees to loans for 16 cement projects with total amount of USD 1,365 million

"Out of 16 cement projects receiving Government-guaranteed overseas loans, 4 faced difficulty in debt repayment with total outstanding loans of USD 382 million (equivalent to 27.9% of total guaranteed loans for cement projects)," as reported by the Minister of Finance. These projects are Dong Banh Cement with USD 45 million (guarantee granted in 2008); Thai Nguyen Cement with USD 59 million (2005); Tam Diep Cement with USD 133 million (2000); and Hoang Mai Cement with USD 145 million (1998).

Since cement is a priority investment sector, the Government had the policy of extending guarantees on overseas loans to finance projects in the sector.

2.2.3. Loans under no Government guarantee are still repaid by the State once SOEs default

116. SOEs also receive implicit guarantees on loans even in the absence of explicit Government guarantee. The past few years witness a number of cases where SOE loans are repaid by the Government, though such loans are not guaranteed by the Government. A typical example is the Vinashin loans from banks are being frozen. Parts of Vinashin debts were then

transferred to Vinalines and PVN, leaving Vinalines with even more difficulty. The State then has to take action to support Vinalines. In 2010, the Ministry of Construction requested some supports to subsidiary companies of Song Da Corporation which could not repay overseas debts. Of which, Dong Banh Cement joint stock company defaulted on the principal and interest of over VND 141 billion and needed another VND 607 billion for debt service in the period 2011-2015. In addition, some SOEs can borrow from bank designated by authorized agencies. According to CIEM study on SOEs and market distortions published in May 2015, in 2014 alone, 22 executing documents were issued by the authorities on lending activities to enterprises, of which 21 documents specifically targeted SOEs.

2.2.4. In case of default, SOEs received various supports by the State such as debt freezing or rescheduling

117. In principle, the Government only extends guarantees to some SOEs when they borrow from overseas. All domestic loans by SOEs are made at the own need and risks of SOEs. However, when SOEs are in difficulty or become unable to repay domestic loans, they will receive various supports by the Government such as increase of capital, freezing, rescheduling, transferring or even write-off of debts. Therefore, the State or the society effectively has to compensate for the failures by SOEs, putting more burdens on the State.

118. A recent example is the guarantee by the Ministry of Finance for Construction Machinery Corporation (COMA) and Machines and Industrial Equipment Corporation (MIE) upon borrowing from ANZ Bank an amount of USD 45 million when their projects made losses and could not repay. As another example, in early August 2014, the Ministry of Finance permitted VDB to restructure debts by the parent company and

the companies transferred from Vinashin. Accordingly, about VND 2,800 billion of principal would be frozen in 2014 and 2015. The accumulated interest of VND 760 billion was written off on 31 December 2013[53]. As for VND 9,000 billion of outstanding loans at other credit institutions, Vinalines reported that they would actively negotiate with the concerned credit institutions to sell the debts to Debt and Asset Trading Corporation (DATC) or introduce other measures: e.g., debt freezing, rescheduling, interest reductions under the Government's direction

119. According to the report of the Ministry of Transport at the National Assembly meeting in late 2013, Vinashin, DATC and credit institutions have completed the first phase of restructuring by issuing debt-swap bonds with term to maturity of 10 years and at the interest rate of 8.9% p.a. Thus, Vinashin reduced the principal and interest by VND 13,152 billion and post-restructuring debt was valued at VND 3,462 billion, to be repaid in single installment after 10 years. To repay the debt of USD 600 million borrowed from foreign credit institutions, Vinashin and DATC also completed the issuance of Government-guaranteed corporate bonds in Singapore market. Under this report, after financial restructuring, Vinashin would have its debts reduced, interest written off, and interest rate lowered. Some debts would be bought back by Vinashin. The remainder would have repayment deadline extended until 2023 and 2025.

120. The Ministry of Transport reported that Vinalines also succeeded in restructuring its debts of VND 7,855 billion at VDB, and of VND 20,412 billion at domestic institutions by way of debt rescheduling

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[53]http://kinhdoanh.vnexpress.net/tin-tuc/doanh-nghiep/vinalines-se-co-them-2-000-ty-dong-de-tai-co-cau-no-3074387.html, accessed in January 2015.

and by making smaller periodical installments in 2013-2014. Moreover, the corporation completed the procedure for increasing charter capital by VND 900 billion.

2.2.5. SOEs' charter capital and equity are supplemented with funds originating from the State budget

121. In early 2010, the Prime Minister requested the municipal and provincial People's Committees to review and approve the proposals and roadmaps for increasing charter capital in each wholly-state-owned enterprise. The additional capital is sourced from local budget and profit after tax of enterprises. As the last resort, proposal for support will be submitted to the central Government for decision.

122. According to the Official Letter No. 316/TTg-DMDN, charter capital is increased for the enterprises of which the State needs to hold 100% charter capital as per the approved master plan for reorganizing and reforming SOEs. The maximum support level from the Corporate Restructure Support Fund is 70% of required increase in charter capital.

123. If provinces retain the proceeds from SOE equitization and have not yet transferred to Corporate Restructure Support Fund, the amount will then be deducted from the approved supplemented capital. For those who have deposited all to the Corporate Restructure Support Fund or do not have enough supplemented capital, they will receive support from this Fund.

124. The Prime Minister assigned Ministry of Finance to lead and to coordinate with municipal and provincial People's Committees in reviewing the proceeds from equitization and making decision on supplementing capital from Corporate Restructure Support Fund for enterprises under the above-mentioned principles.

125. Recently, in the report to the National Assembly meeting in November 2013, the Ministry of Transport said that Vinalines completed the procedures of supplementing VND 900 billion of charter capital[54]. Also, as per the Decision No. 926/QD-TTg of the Prime Minister, Vinashin has become one member limited liability company since 1 July with charter capital of VND 14,655 billion. The charter capital of Vinashin has been increased from VND 9,000 billion to 14,655 billion. The capital increase of the conglomerate presents a notable exception because it does not require the approval of the National Assembly[55]. It is done by way of the Ministry of Finance supplementing charter capital by using the central Corporate Restructuring Fund (with State-budget origin).

[54]It is a sad fact that the additional charter capital was used in a very wasteful manner. According to the news from Vinalines, the group received the Decision No.09/2014/QD-PQTT dated 3 October 2014 of Hanoi People's Court on the proposal to cancel the arbitration award of the dispute No. 28/12 with SK E&C (South Korea) in the Bid Package 1b of Van Phong international terminal development project (kick off phase). Hanoi People's Court decided not to cancel the award and not to allow the related parties to further complain and appeal. Therefore, Vinalines was obliged to repay VND 65.26 billion to SK E&C and the interest of late repayment as per the arbitration award of the Board of Arbitration of Vietnam's International Arbitration Center. According to the assessment of Vinalines, if the arbitration award is enforced, it will adversely affect the financial situation of the No. 1 sea transportation business in Vietnam. To have USD 3.2 million to deposit into escrow account, the Board of Directors of Vinalines had to temporarily use VND 68 billion from the funding of VND 9,000 billion used by the Government for supplementing charter capital. "Given unfavorable condition like today, it seems impossible for Vinalines to recover the charter capital", said a leader of Vinalines.

[55]Decree No. 09/2009/ND-CP regarding the financial management at SOEs and the management of state capital invested into other enterprises regulating that: "SOEs have right to mobilize capital for business activities within the ratio of liabilities over charter capital and not exceeding 3 times of the ratio... The representative of owner is responsible for working with the Ministry of Finance to strictly oversee the mobilization and use of capital at SOEs. In case of using state budget to supplement charter capital, the Ministry of Finance will submit to the Government and National Assembly for decision."

2.2.6. Unlike private enterprises, SOEs are not that worried about bankruptcy in case of accumulated losses

126. The report of the State Audit listed the SOEs making huge losses and/or those with negative owners' equity. The list announced by the State Audit includes the parent company of Cienco 5 with financial investment loss of VND 11.4 billion; 5/50 companies invested by EVN with total losses of VND 3,702 billion and 11/31 companies invested by PVN with total losses of VND 6,342 billion. In addition, 7/24 companies invested by the Urban Infrastructure Development Investment Corporation (UDIC) have cumulative losses of VND 339.6 billion; 6/57 companies under Vinacomin have losses of VND 118.3 billion; 3/8 affiliates and associates under Song Da Corporations as well as 5/24 affiliates and associates under Vinamotor are making losses.

Box 2: Regulations on submitting bankruptcy applications in SOEs as per the Bankruptcy Law 2004

Article 3. Enterprises, cooperatives which fall into the state of bankruptcy

Enterprises, cooperatives, which are incapable of repaying their due debts at creditors' requests, shall be regarded as falling into the state of bankruptcy.

Article 16. The State enterprise owners' right to submit applications for opening of bankruptcy procedures

1. When realizing that State enterprises fall into the state of bankruptcy but the enterprises decline to fulfill the obligation to submit the applications for opening of bankruptcy procedures, the representatives of the enterprises' owners shall have the right to submit applications for opening of bankruptcy procedures for such enterprises.

127. The list continues with SOEs having negative owners' equity, including 3/10 companies under Cienco 5 (with negative net worth of VND 53.7 billion); the Northern Food Company under

Vinataba (with negative equity of VND 166.74 billion). The cases of accumulated losses larger than charter capital/owners' equity include series of joint-venture between Vietnam and overseas in real estate, construction and even financial sectors, with the losses of 1.3 to 3 times bigger than owners' equity.

128. Vinashin alone had outstanding loans of approximately VND 86,000 billion with due debt of VND 14,000 billion. It has failed to balance its cash flow. However, such support as debt transfer (to other business groups and general corporations), debt rescheduling (Government's guarantees at banks) and capital supplementation (increasing charter capital from VND 9,000 billion to VND 14,655 billion), Vinashin continued to exist.

129. Although many SOEs are teetering on the verge of bankruptcy or are *de facto* in bankruptcy already due to poor financial health, rarely (not to say never) do the representatives of enterprises' owners (or the State and specifically the agencies representing ownership in SOEs) file the case for bankruptcy in accordance with the Bankruptcy Law.

2.2.7. Loose financial discipline without strict control of shareholders like private enterprises

130. Breaches of principles and regulations on expenditures and procurements were quite popular in SOEs, and were rarely taken actions against. By the end of 2012, according to the statistics by Ministry of Finance, total assets of 127 business groups, general corporations and subsidiary companies were VND 2,500 trillion, but their debts were close to VND 1,350 trillion (i.e. more than 50% of total assets). According to current regulations, the debt-to-equity ratio must be below or equal to 3; however, 48 business

groups and general corporations went past this threshold, even at the alarming level[56].

131. Recently, the State Audit published the audit results of 2013, indicating clearly: "The fact that many SOEs and conglomerates did not strictly collect receivables has resulted in large amount of overdue and bad debts among SOEs. Some large items of receivables have not been recovered for years; some debts within business groups or between different business groups have not been addressed completely, etc.” For example, PV Power (under PVN) had overdue debts of VND 9,650 billion. The corresponding figures are VND 2,314 billion at VNPT, VND 558 billion at CIENCO 1, VND 482.4 billion at LILAMA, VND 325 billion at Vinacomin, and VND 36.5 billion at Vinatex, etc.

132. In accordance with the roadmap to restructure SOEs, the Government issued the Decree No. 206 on “management of debts at wholly-state-owned enterprises". The Decree stipulates that these enterprises are responsible for developing and issuing regulations to manage debts (including receivables and payables), separating clearly the responsibilities of organizations and individuals in debt collection and repayment. The regulations by SOEs must be formulated and issued within 90 days after the Decree took effect (1 Feb 2014). Or in other words, the deadline for SOEs to issue such regulation is 1 May 2014. However, by September 2014, some general corporations and business groups still ignore above mandate. Recently, on

[56] Specifically, this ratio of Lilama is 53.19, Bach Dang Construction Corporation: 20.97; Cienco1: 18.41. As of 2013, 41/108 business groups and general corporations had debt-to-equity ratio of over 3, reflecting ample risk of financial insecurity and insolvency.

21 August, the Department of Corporate Finance (Ministry of Finance) reported directly to the Government on the slow progress by SOEs. Up to 30 general corporations and business groups have not issued debt management regulations. Among those are SOEs which high levels of bad debts and receivables as listed by the State Audit: e.g., Vietnam Airlines, Vinalines, COMA, Vincem, Vinatex, Military Petroleum Corporation, Housing and Urban Development Investment Corporation (Ministry of Defense), Truong Son Construction Corporation and Saigon New Port Corporation, etc.

133. On 6 September 2014, the Office of the Government conveyed the request by Deputy Prime Minister Vu Van Ninh to ministries, general corporations and business groups to report progress of their regulations on debt management by October 2014. However, disciplining these SOEs remains a major concern. Non-compliance of SOEs with top-down orders is ubiquitous. Meanwhile, no executive of SOEs was dismissed for purposefully ignoring directives from the Government – the main shareholder of the SOEs.

2.3. Causes and consequences

134. The above-mentioned practices reflect preferential treatment of SOEs in reality. Those preferential treatments exist at all three stages: market entry; market operation; and market exit.

2.3.1. Causes

135. Preferential treatments arguably distort market operations, leading to competitive non-neutrality, resource misallocation and reduction of business efficiency. It can arise from both primary and secondary reasons.

* Primary reason

136. The primary reason lies in the misperception of roles and functions of SOEs. So far, SOEs have still been considered as the key driver of the economy. As an implication, SOEs cannot be reduced in size, and should be expanded. Therefore, large-scale SOEs cannot be equitized thoroughly and consistently; or cannot go bankrupt, or even they are "too big to fail". Vinashin and Vinalines present typical examples for this ideology.

* Secondary reason

137. SOEs, according to current regulations, are closed limited liability companies; that is, they can not mobilize fund from other investors. Thus, SOEs mainly rely on loans for their financing needs, from long-term development investment to working capital and short-term expenditure; any deficiency of capital must then be met by the State Budget or other similar sources. Since corporate governance in Vietnam has not yet complied with international rules as well as afore-mentioned non-market treatment, it is difficult for SOEs to raise capital, especially in international capital markets. In summary, there is a conflict between sizeable capital requirements and the limitation in raising capital for SOEs. Therefore, to fulfill the requirements and statutory leading role in the economy, SOEs have to seek support from the State. The above-mentioned supports, by nature, reflects soft budget constraint on SOEs, which is no longer consistent with market principles and disciplines.

2.3.2. Consequences

138. The afore-mentioned differential treatment apparently exempt SOEs from fair market competition, reduce or destroy own incentives for SOE development; and weaken their competitiveness

and operational efficiency. Those differential treatments also distort incentives and behavior of representatives of State ownership, managers and employees of SOEs.

139. While the SOE sector in Vietnam is still large, they do not comply with the popular market principles and disciplines, which distorts market operations. It can lead to resource misallocation and misuse. This fundamental reason undermines efficiency, competitiveness as well as growth potential of the economy. Widespread and excessive expansion of investment into non-core industries – without considering efficiency of most SOEs in recent years - presents typical evidence for this issue.

140. Differential treatment also leads to misperception of the roles and functions of State management. This in turn creates tensions, conflict of interests and inequality in the economy. This does not only cause distortions and increase market failures, but also exacerbate the State failure. Consequently, State management becomes inefficient and ineffective, with more room for corruption, and rent-seeking and self-interested behaviors.

141. Differential treatments for SOEs are among the major causes for crowding out effect on private sector development, resulting in unequal access to resources and business opportunities. Consequently, private enterprises experienced slow growth and development, even after nearly three decades of efforts under the Renovation. Differential treatments are detrimental to competitive neutrality. Many activities by SOEs distorted market operations, causing inappropriate market signals and reduced business efficiency for the private sector.

142. Commercials banks also encounter material and potentially increasing risks. Commercial banks can readily extend loans to SOEs under implicit Government guarantees. Therefore, loans can be made even on subprime basis.

IV. RECOMMENDATIONS

143. Q2 witnesses more robust economic recovery, under a firm and stable macroeconomic environment. Economic growth in Q2 outpaced Q1 as well as Q2's of previous years. Inflation rate is stable at a relatively low level. Production and business activities were more buoyant, accompanied by solid investment expansion, reflecting improved business confidence over the economic recovery process. Vietnam also achieved some early but significant successes in reforming business environment, strengthening competition, addressing a few weak banks. A couple of newly signed FTAs broadened opportunities and access to export markets and external resources for production – export activities.

144. The conduct of macroeconomic policies incorporated closer coordination of policy instruments and creation/maintenance of room for using such instruments. Attempts to increase flexibility for monetary policy were deepened, especially in exchange rate, interest rate and credit management. Export growth target seemed to receive less priority, which partly eased the management of exchange rate and foreign currency liquidity. Fiscal policy, albeit still expansionary, has considered other potential channels for mobilizing capital, instead of sole reliance on issuing Government bonds like previous years.

145. Macroeconomic management in particular and socio-economic development in general still face several risks. Public debt places more pressure on the State Budget, which will need to reduce funds for investment capital (in both public and private sectors). Building on the momentum for reforms of business environment, SOEs and banking system is no easy task –

especially as Vietnam is about to complete its Socio-Economic Development Plan for 2011 – 2015 and begin the Socio-economic Development Plan for 2016 – 2020. The process of international economic integration – with more liberalization commitments and the possibility to conclude some high-quality FTAs in Q3/2015 – necessitates bolder efforts to strengthen competitiveness at product, firm and economy levels. Finally, Vietnam can hardly avoid the impacts of international financial market volatilities (especially interest rate on USD and the exchange rate with the USD), and geopolitical conflicts in various regions.

146. Keeping that context in mind, the recommendations for reforming microeconomic foundations and conducting macroeconomic policies in the previous series of *Quarterly Macroeconomic Reports* by the Central Institute for Economic Management remain valid. The following measures and policies should be tailored for implementation in Q3, taking into account the context of the last 6 months of 2015.

1. Further reforms of microeconomic foundations

147. To motivate and accelerate the implementation of Resolution 19 on the key tasks and measures to reform business environment and strengthen competitiveness in 2015-2016 and its related measures, in order to create momentum for stronger reforms of business environment in the second half of 2015 and beyond.

a. During the implementation, it is necessary to regularly evaluate the results and outline intermediate tasks and targets to make sound adjustments if needed.

b. The implementation of measures, particularly business environment reforms, requires effective public and stakeholders consultations.

148. To urgently issue official guidelines for implementing the (amended) Investment Law, (amended) Enterprises Law, etc.

149. To review and develop a roadmap to reduce discriminatory and differential treatments (such as access to land and credit, Government procurement, etc.) that could affect competitive neutrality between SOEs and private sector in Vietnam.

150. Establishing institutions for market-oriented economy requires efforts to reduce the pressures from SOEs and improve management of SOEs. The resolutions should mainly focus on:

a. To review and alter the role and functions of SOEs; SOEs should no longer serve as a tool for macroeconomic stabilization, nor are they a physical force for the Government to intervene into the economy, as Vietnam is embarking on a rapid and bold transition towards a comprehensive and modern market economy.

b. To further improve institutions for market economy; to renovate the structures and functions of Government agencies; to establish specialized agencies to assume State owner's rights and to manage state investment in enterprises. Enforcing and protecting ownership of SOEs is a fundamental issue that needs improvement.

c. To enforce hard budget constraint, financial discipline and market discipline. To improve regulations on SOEs in line with the Constitution 2013 and legal documents on competition and monopoly. Many theoretically sound policies can hardly be applied in reality. Therefore, the legal framework should be accompanied by enforcement of disciplines and monitoring measures. For instance, average market return and costs should also incorporate opportunity costs; inefficient and loss-making enterprises and individuals should be taken actions against, with determination.

d. To effectively equitize SOEs. In recent years, Vietnam only made progress in terms of number of SOEs being equitized. The quality of equitization remains vague. It is necessary to specify the minimum percentage of State equity at SOEs that needs to be sold or the types of buyers. Only in this way can SOE equitization become more meaningful.

151. To coordinate among Ministries, domestic business associations and enterprises to monitor and review competition in the markets, especially those involving FDI enterprises. To identify and strictly punish anti-competitive behaviors and abuse of market powers that reduces welfare of domestic enterprises and consumers.

2. Recommendations of macroeconomic policies

** Monetary policy*

152. To assign highest priority to finish restructuring commercial banks. To retain flexibility with intermediate targets (such as credit growth, total liquidity, etc.) to ensure necessary supports for the process of restructuring commercial banks.

a. Restructuring of commercial banks needs to be in line with resolution of NPLs. The deadline for reducing NPLs to below 3%[57] may be reconsidered, depending on the progress and actual results. The most important point is to fundamentally improve debt quality and credit flows in commercial banks.

b. To rapidly implement measures to restructure the management and operations of commercial banks that have been nationalized.

[57] Currently, SBV aims to reduce bad debts below 3% no later than September 30th 2015.

153. To prudently conduct monetary policy, aiming to stabilize inflation[58] at low rate (equivalent to Q2) in the long term. This will mark a transition for a more dedicated monetary policy framework, with more suitable long-term targets.

154. To avoid administratively push for interest rate reduction. To consider phasing out discriminatory and differential treatments, and preferential interest rates for selected sectors or even enterprises under different credit packages. This will reduce the costs of monitoring over provision of preferential interest rate, whilst preventing distortions to interest rates and resource allocation.

155. Stability of the VND/USD exchange rate remains an essential requirement in Q3. However, the SBV should consider more flexibility in its exchange rate policy. Exchange rate management with reference to a basket of strong currencies (such as USD, Euro and Japanese Yen) needs to be considered more thoroughly. To closely follow the fluctuations of interest rates in the US, especially in the second half of Q3, for appropriate adjustments. To consider communication of more flexible stance in exchange rate management (possibly via widening of trading band and/or increase in interbank exchange rate).

156. To closely monitor and carry out open market operations at an appropriate scale to ensure liquidity (of both VND and USD) for the financial market and commercial bank system. The reserve requirement ratio (in both VND and USD) should be kept unchanged.

157. To retain similar level of commercial banks' purchases of Government bonds as in Q2. Commercial banks should not be

[58] Could be CPI inflation or core inflation, depending on SBV's consideration in specific context.

seen as the funding sources for public investment projects (including PPP) in any circumstances, even though that the pressure for fund disbursement is mounting. To do so, coordination with fiscal policy remains a prerequisite.

158. To carefully contemplate before any communication attempt or dissemination of information that potentially affect the conduct of monetary policy.

* *Fiscal policy*

159. The role and dominance of fiscal policy can hardly diminish in the last 6 months. However, fiscal policy should coordinate with monetary policy more actively to help mitigate risks and other related issues in macroeconomic management. Coordination should not be restricted to any specific measures or transactions; instead, it should also be incorporated in fiscal programming, depending on specific circumstances.

160. To collect State Budget revenues with Q3 amount equivalent to Q2. To consider external borrowings, associated with a transparent and credible repayment plan, to finance State Budget expenditure. To refrain from excessive collection, advanced collection or unreasonable taxes and fees. To avoid short-term mobilization (including borrowings and repayments within a year) since it is basically similar to issuing short-term Government bonds in previous years, while the costs of management and monitoring could be more expensive.

161. To further simplify procedures and reduce time of tax payment and refund for enterprises.

162. To accelerate disbursement of proceeds from Government bonds for investment, so as to increase efficiency and reduce capital costs for the State Budget.

163. To maintain the requirement to issue Government bonds with at least 5 years to maturity, to ensure sufficient medium-term and long-term credit for enterprises.

164. To develop and publicize transparent medium- and long-term plan to repay public debt, which helps enhance confidence and improve sustainability of public debt.

165. To consider control of State Budget deficit with the ceiling of 4-4.5% GDP in the near future (at least until 2020). This proposal can be incorporated in the draft (amended) Law on State Budget.

* *Trade policy*

166. To consider participation in, negotiation of and level of commitments in FTAs to ensure sufficient policy space for developing domestic manufacturing industries, especially key industries.

167. To analyze, monitor and closely assess the impacts of exchange rate volatility on exports and imports, so as to appropriately and efficiently adjust exchange rate policy to leverage exports while maintaining macroeconomic stability.

168. To provide information on world prices of key products as well as demand and supply in major markets, aiming to actively react to the changes in those markets. To disseminate information on concluded or pending FTAs (especially the rule of origin) to better prepare enterprises ahead of those FTAs.

169. Trade promotion should simultaneously focus on: (i) promoting export associated with marketing, business connection, trademark development and protection, etc. and (ii) imports of

important input materials that Vietnam has not been able to produce (sufficient in quality and quantity) and which still helps utilize the rule of origin in the FTAs.

170. To further simplify administrative procedures for trading across border (including taxes, customs, certificate of origin, etc.).

171. To propose and conduct more efficient propaganda for tourism, increase service quality, etc. and attract tourists from other potential markets. Vietnam's visa exemption for tourists from 5 EU countries within 15 days (which takes effect as of July 1st 2015) is considered as effective solution; however, such measure is insufficient in the absence of unique and diverse and affordable services for tourists from those markets.

172. To improve domestic connectivity to promote domestic consumption, especially for agricultural products, which helps mitigate the risks for agricultural exports to China via informal trade.

* *Price policy*

173. To manage prices of some commodities whose prices are controlled by the State such as electricity, water, petroleum, etc.; to increase transparency in costing of those products to avoid adverse impacts on inflationary expectations, thereby supporting the Government's target of inflation stabilization.

3. Other related recommendations

174. To further improve the coordination between fiscal policy, monetary policy and other policies to ensure macroeconomic stability. Consultation and sharing of information and policy priorities between relevant agencies still need further improvement, notwithstanding material improvement in Q1 and Q2.

175. To further study and improve statistical data to support macroeconomic management. Improving estimates of trade data

remains an urgent requirement. Besides, the surveys of business tendency, consumer confidence or inflationary expectation need to be more rigorous, periodic and broad-based./.

Phần bảng ngang

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