



The United Nations Development Programme Viet Nam

A Policy Discussion Paper

THE GLOBAL ECONOMIC CRISIS AND ITS LONG-RUN IMPLICATIONS FOR VIET NAM

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Abstract

In Vietnam, as elsewhere in the developing world, questions are being raised about the viability and appropriateness of an outward-oriented development strategy in the wake of ongoing global economic crisis. Globalization was the driving force of growth in many developing countries in the decades preceding the crisis, but it was also the conduit by which the financial crisis and subsequent economic downturn in the United States and Europe was spread to developing countries. The question naturally arises as whether developing countries, like Vietnam, should seek a new growth strategy and take measure to reduce their reliance on global trade and investment.

These issues are the focus of this study. We begin with an examination of Vietnam's economic performance in the decade preceding the crisis, with the aim of identifying the key challenges to sustainable growth that were present before the crisis and to assessing the role that globalization played in Vietnam's remarkable success. It is clear that the growing importance of exports and foreign direct investment has been the key to structural changes in the economy that allowed Vietnam to achieve rapid growth. It is also evident that the sustainability of Vietnam's rapid growth was threatened by internal weaknesses before the global crisis erupted. Two key weakness are identified—one, the weakness of the private corporate sector, which two decades after the reforms began still plays a relatively small role in the industrial sector and, two, the weakness of the economic and social infrastructure, broadly defined, that provides the foundation for long-run growth.

The study examines the financial crisis in the U.S. and Europe (and in an appendix offers an explanation of its causes) and how it developed into a full-fledged economic crisis and spread to the developing world. The impact of the global crisis on Vietnam is assessed from a comparative perspective. Clearly the crisis has had a severe impact on Vietnam, and even if a relatively quick recovery is achieved will leave behind long-lasting negative effects on per capita income. The hardest hit part of the economy is of course the external sector, exports, FDI and foreign financial inflows, but the external sector is closely tied to the rest of the economy; hence the damage is widespread. Of particular importance is its impact on the fiscal balance, since the crisis has put pressure on the government to increase expenditure at the same time it has reduced the government's ability to finance increased spending, either domestically or from abroad.

The final part of the study examines the prospects for recovery in developed countries and the long-run implications for Vietnam. The principal conclusion of the study is that whether global economic recovery is rapid or prolonged, the implications for Vietnam's long-run development strategy are much the same. The hard fact is that Vietnam has no viable alternative to the globalization-based strategy it has pursued successfully the past 15 years. The potential for "uncoupling" from the global economy, either by greater reliance on regional trade or by greater reliance on domestic consumption, is extremely limited at Vietnam's current stage of development. The global crisis has presented Vietnam with an additional challenge to sustainable long-run growth, namely the prospect of relatively weak external demand for the next few years, if not longer. This challenge does not provide an excuse to seek a new strategy, but instead a reason to redouble efforts to improve and maintain international price competitiveness and to address the key challenges that Vietnam faced before the crisis erupted. If that happens then it is possible that the sustainability of growth in Vietnam may be stronger coming out than it was going into the crisis.

Contents

Acknowledgements	i
Abstract	ii
I. Will the World Ever Be the Same Again?	1
II. Economic Performance Before the Crisis and the Role of Globalization	3
1. Real GDP Growth	3
2. Inflation	4
3. Structural change	4
4. Role of trade	6
5. Foreign Direct Investment (FDI)	7
6. Vietnam's mini crisis: 2007-08	7
7. The foundation of economic growth	10
III. Fallout from the Crisis Globally and in Vietnam	11
1. Global fallout	11
2. Impact on Vietnam	14
a. Impact on GDP growth	14
b. Impact on expenditure by sector	16
c. Impact on exports	17
d. Impact on capital flows	18
e. Impact on the fiscal balance	19
IV. Prospects for Recovery and Long-Run Implications for Vietnam	21
i. The Shape of Recovery	21
ii. Long-term Implications for Vietnam	23
Appendix: The Causes of the U.S. Financial Crisis	25
References	32

The Global Economic Crisis and Its Long-run Implications for Vietnam

I. Will the World Ever Be the Same Again?

The current crisis in the world economy is judged to be the most severe since the Great Depression. No country has been spared, though the impact on individual countries varies in terms of the severity of the consequent losses in output, employment and wealth. The crisis originated in the U.S. financial system and then spread through global trade and financial networks to the developing world. Since globalization had become the main driving force of growth in developing countries in the decades leading up to the crisis, many have begun to question whether a development strategy based on openness to international trade and financial flows is any longer appropriate. Pronouncements of the 'end of capitalism' and the 'death of globalization' have become commonplace. Developing countries are being urged by some to abandon the liberal policies that worked well in the past and seek some new yet-to-be-defined growth strategy.

Dire pronouncements in the wake of turmoil in the world economy have a long history and generally proved unfounded by subsequent events. W. Arthur Lewis, in his Nobel lecture (1979), argued that trade, the supposed engine of growth in the developing world from the end of WWII to the early 1970s, could no longer be relied upon because the quadrupling of oil prices in the mid 1970s had sent developed countries, the main market for LDC exports, into a long-term economic slowdown.¹ His solution was for developing countries to reduce their reliance on trade with developed countries and foster trade with each other through various special trading arrangements. As it turned out, the real price of oil came down after a few years, the growth of developed countries rebounded and trade between developed and developing countries soared over the next two decades, indeed until the current crisis erupted at the end of 2008.

The 1980s debt crisis, likewise, spawned apocalyptic pronouncements about the future of capital flows to developing countries. The conventional wisdom at the time was that international investors, having been burned by debt defaults in Latin America and elsewhere, would be unlikely any longer to lend or invest in developing countries. But, as it turned out, private capital flows to emerging and to developing countries grew at an unprecedented rate of 38 percent annually from 1990 to 2008.² Even Latin American countries enjoyed a resurgence of capital inflows once they began to liberalize their economies in the second half of the 1980s.

When the Asian financial crisis erupted in Thailand in July 1997, it was likened to Mexico's 1982 debt default, precursor to the 'lost decade' in Latin America. In 1997, a leading development economist argued that "In both Asia now (1997) and in Latin America then (the 1980s), this is the moment when a particular paradigm or growth model has come to an end."³ Writing in 1997, Paul Krugman went even further, comparing the Asia financial crisis to the Great Depression. Krugman worried not just about a lost decade of economic growth in Southeast Asia, but instead "the kind of slump that 60 years ago devastated societies, destabilized governments, and eventually led to war."⁴ All of the afflicted countries rebounded after a couple of years, however, and other countries in the region, in particular China and Vietnam, went on to achieve great success following essentially the same strategy that the Southeast Asian countries followed the decade leading up to the Asian Financial Crisis.

¹ W. Arthur Lewis, "The slowing down of the engine of growth," *American Economic Review*, vol. 70, no. 4, September 1980, pp. 49-54. Lewis' thesis was critiqued by James Riedel, "Trade as the Engine of Growth in Developing Countries, Revisited," *The Economic Journal*, vol. 94, no. 373, March 1984, pp. 56-73.

² IMF, World Economic Outlook online data base.

³ This quote is attributed to Professor Victor Bulmer-Thomas, the head of London University's Institute of Latin American Studies, by Stephen Fidler, "Asia gets a lesson in Latin economics," *Financial Times* (London), December 6, 1997, p. 20.

⁴ This quote is attributed to Professor Paul Krugman by Fareed Zakaria, "The Return of Capitalism," *The Washington Post*, June 16, 2009, p. A21.

Paradigm change and rethinking globalization are common themes again today. Globalization was, of course, under attack well before the outbreak of the current crisis, but according to Professor Dani Rodrik, a prominent globalization skeptic, the nature of the debate has changed fundamentally. “There was a time when global elites could comfort themselves with the thought that opposition to the world trading regime consisted of violent anarchists, self-serving protectionists, trade unionists, and ignorant, if idealistic youth,” Rodrik writes, but economics luminaries such as Paul Samuelson, Paul Krugman, Joseph Stiglitz and Larry Summers have recently joined the ranks of the globalization skeptics, “not to turn back globalization, but to create new institutions and compensation mechanisms—at home and internationally—that will render globalization more effective, fairer, and more sustainable.”⁵ Liberalization and economic integration as practiced in the 1980s and 1990s, according to Rodrik, has been shown to be unsustainable. Thus, he argues, “if globalization is to survive, it will need a new intellectual consensus to underpin it.”⁶

In the midst of the current turmoil in the world economy and in economic thinking about the appropriateness of past strategies and policies, what are policy-makers in developing countries to do? They must of course consider policies to contain the immediate fallout from the crisis (such as stimulus packages and bailouts), but they must also consider the long-run implications of the current crisis and their responses to it. Considering the long-run implications of the current crisis from the perspective of Vietnam is the aim of this study.

In Part II, Vietnam’s economic performance in the decade and a half preceding the crisis is examined, with a focus on the contribution of globalization. It is argued that, while the outward-oriented strategy has been successful, Vietnam nonetheless faced at least two major challenges to sustaining that success before the current global crisis erupted—one, the need for further change in the structure and ownership of industry and, two, the need for expansion and improvement in the economic and social infrastructure that forms the foundation for sustainable growth.

The fallout from the global economic crisis worldwide and specifically in Vietnam is examined in Part III. The crisis poses yet another major challenge to the sustainability of rapid growth by weakening external demand for Vietnam’s exports and diminishing the inflow of foreign capital on which Vietnam became increasingly dependent over the past 15 years.

Finally, in part IV, the long-run policy implications for Vietnam are assessed. Given the current uncertainties about recovery in the developed countries, the question naturally arises as to whether Vietnam should shift away from the outward-oriented strategy that worked well in the past. It is argued that prospects for “uncoupling” from the world economy by relying more on internal demand and/or on intraregional trade are extremely limited. For the foreseeable future, Vietnam’s economic fate is tied to an outward-oriented industrialization strategy, for better or worse. The main policy message is that it is incumbent on Vietnam to redouble its efforts to meet the challenges it faces, both those that were present before the crisis and those that have arisen from the crisis. These challenges require measures to further industrial restructuring, build a stronger foundation for growth by investing in much more (and much more efficiently) in the social and economic infrastructure of the economy, and to protect and enhance the country’s international price competitiveness. The case for going forward with the same strategy that worked successfully in the past is simply that there is no better alternative.

The causes of the financial crisis in the U.S. that spawned global economic crisis in which Vietnam currently finds itself embroiled are discussed in an appendix. The global crisis is, from Vietnam’s perspective, an exogenous event, but it is nonetheless important for policy makers in Vietnam to understand of its causes.

⁵ Dani Rodrik, “Death of Globalization Consensus,” *Korean Times*, July 15, 2008.

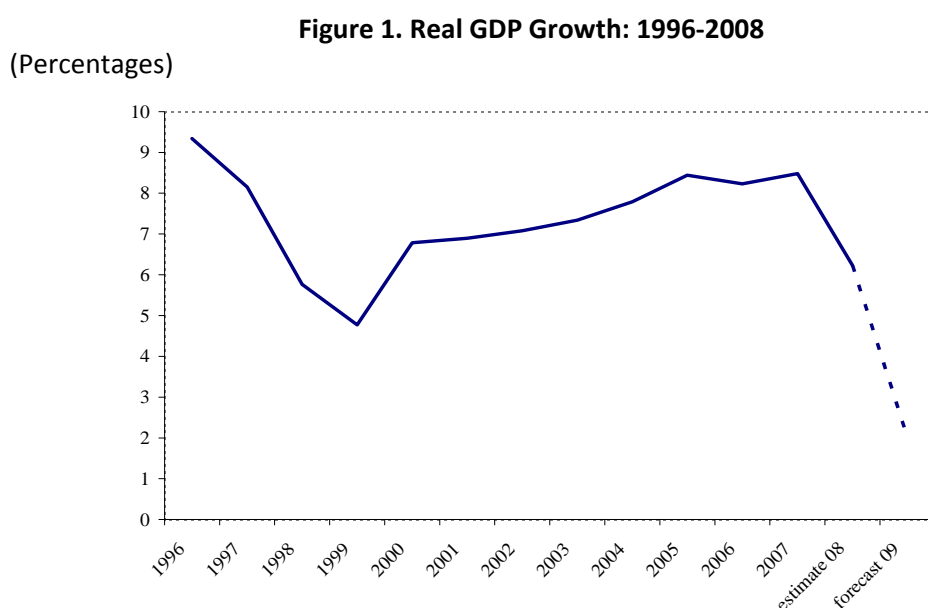
⁶ Ibid.

II. Economic Performance Before the Crisis and the Role of Globalization

The early 1990s was a watershed in Vietnam's economy. The first milestone was the decision taken at the Sixth Communist Party Congress (December 1986) to move from a socialist centrally planned economy to a "socialist economy with a market orientation" under the slogan "doi moi" (renovation).⁷ The transition did not gain traction, however, until the early 1990s, when the authorities applied "shock therapy" to the macro economy by slashing government spending and reining in credit growth. In just two years the inflation rate fell from about 400 percent per year to a single digit rate in 1992. Concurrently, the real GDP growth accelerated to 8 percent in 1992, following measures taken by the government to open the economy to international trade and direct investment and remove (or at least reduce) gross inefficiencies in the economy inherited from the era of central planning.⁸ Since the mid 1990s, Vietnam has ranked as one of the world's fastest growing countries, perhaps second only to China.

1. Real GDP Growth

Figure 1 reports the annual rates of real GDP growth since 1995. Over the period from 1996 to 2007 (the last year for which there are hard data), the average annual real GDP growth rate was 7.4 percent, with the average in the last four years (2003-2007) at 8.2 percent. The economy went into a marked slowdown in the aftermath of the Asian financial crisis in 1998 and 1999, but rebounded thereafter. In 2008, the economy suffered another downturn, the growth rate falling two percentage points from 8.5 percent in 2007 to 6.2 percent in 2008. The slowdown in 2008 was mainly the result of a mini macroeconomic crisis, unrelated to the ongoing global crisis that erupted in mid 2008 (discussed below). The current crisis began to take its toll toward the end of 2008 and has pushed GDP growth forecasts for 2009 to as low as 2 percent.⁹



Source: General Statistics Office of Vietnam (GSO), online data.

⁷ Perhaps a more apt (but less politically correct) slogan would be a "market economy with a socialist orientation." Since there is no longer a functioning central plan, by default Vietnam is a market economy, although this is disputed by the U.S. Commerce Department in applying trade remedies to Vietnam.

⁸ Vietnam's sweeping macroeconomic and structural reforms in the late 1980s and early 1990s are described in detail James Riedel and Bruce Comer, "Transition to Market Economy in Viet Nam," in Wing Thye Woo, Stephen Parker and Jeffrey D. Sachs, eds., *Economies in Transition: Comparing Asia and Europe*, Cambridge, MA: MIT Press 1998, 189-216.

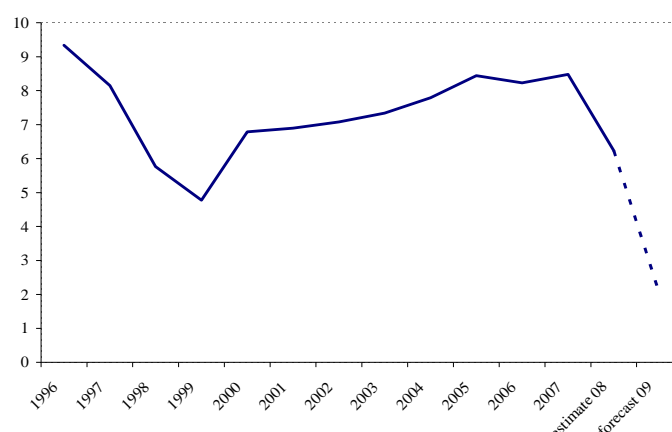
⁹ EIU, 2009. The IMF forecast is for 4.5 percent GDP growth in 2009.

2. Inflation

After the economy was stabilized in the early 1990s, the inflation rate remained in the single-digit range until the second half of 2007 when it reached 12.5 percent and then peaked at 30 percent in mid 2008. The spike in the inflation rate in late 2007 and early 2008 is attributable, in part, to the surge world commodity prices in 2007 and, in part, to the emergence of a massive macroeconomic imbalance in the economy in 2007 and the first half of 2008 (discussed below). Since mid 2008, the inflation rate has fallen steadily, initially due to measures taken by the government in mid 2008 to deal with its over-heated economy and subsequently, toward the end of the year, as a result of the effects of the deepening global crisis on commodity prices and aggregate demand.

Figure 2. Consumer Price Inflation: 1996-2008

(percentages)

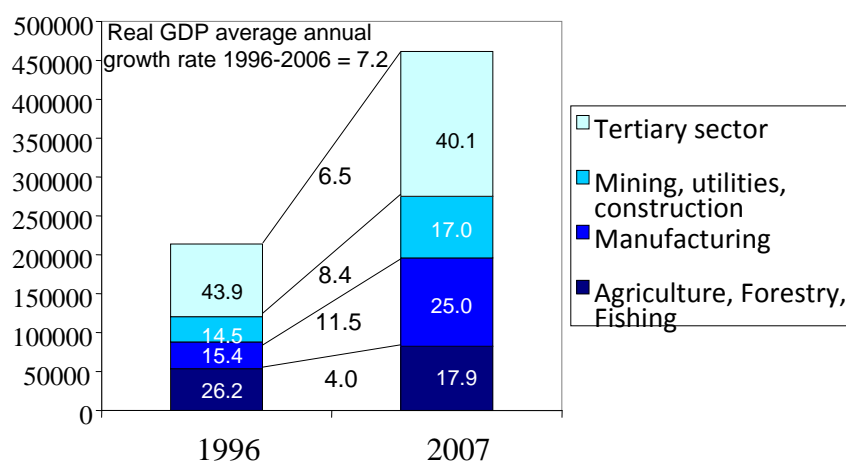


Source: General Statistics Office of Vietnam (GSO), online data.

3. Structural change

Accompanying rapid growth in Vietnam over the past dozen years have been major changes in the structure of the economy. Indeed, it is fair to say that these changes are what made rapid growth possible. As Figure 3 indicates, industry, and in particular manufacturing, has been the most dynamic sector in the economy, accounting for over 50 percent of the increase of real GDP over the period 1996 to 2007. Because the potential for continuous productivity growth is much greater in industry than in the primary and tertiary sectors, industrialization has been the driving force of growth in Vietnam, as it was in most developing countries.

Figure 3. GDP by Sector (dong billions, 1994 prices); average annual growth rate 1996-2007; sector share in GDP



Source: General Statistics Office of Vietnam (GSO), online data.

Equally important, given that Vietnam only two decades ago began the transition from a centrally planned to a market economy, have been significant changes in ownership structure of industry. Ownership is important because it has an impact on the efficiency of the industrial sector. State-owned enterprises (SOEs), because of their special political status and the subsidies and protections they thereby enjoy, are typically less efficient and less profitable than private companies, and tend to be concentrated in capital-intensive industries in which low-wage labor-abundant countries lack international comparative advantage. Such is the case in Vietnam where, as Table 1 indicates, the output-capital ratio for SOEs is less than half that for private companies, and the capital-labor ratio for SOEs, on average, is almost three times higher than for private companies. That means that every dollar invested in a private company, on average, generates three times more jobs and twice as much output as when invested in the average SOE. Thus, the growing share of private companies in the industrial sector has no doubt been an important contributor to Vietnam's rapid growth.

Table 1. Ownership Structure of Industry

	Ratio of turnover to capital	Ratio of capital to labor	Share in industrial output %		Growth of output p.a. %
	2005	2005	1996	2007	1996-2007
State-owned Enterprises	0.5	711	49.3	27.7	9.5
Non-State Owned	1.2	236	24.0	33.4	18.9
Private Companies	n.a.	n.a.	7.4	24.3	28.6
Collectives & Household	n.a.	n.a.	16.6	9.1	9.1
Foreign invested Enterprises	0.8	432	26.7	38.9	19.4

Source: General Statistics Office of Vietnam (GSO), online data, and David Dapice, et.al., "Choosing Success: The Lessons of East and Southeast Asia and Vietnam's Future," Harvard University, mimeo, 2008.

A recent study noted that Vietnam's rapid growth in recent years (7.6 percent per annum from 2001 to 2006) required a relatively high rate of investment (33.5 percent of GDP), implying an economy-wide incremental capital-output ratio (ICOR) of 4.4, higher than for China (4.0) or any other East Asian economy at a similar stage of development.¹⁰ Taiwan, for example, after it began its own "doi moi" reforms in 1960, grew over the next 20 years at 9.7 percent per annum, but invested on average only 26.2 percent of GDP, implying an ICOR of 2.7, 40 percent lower than Vietnam's. Although Taiwan began in 1960 with private companies accounting for only about 35 percent of industrial value-added, only fifteen years later their share had risen to about 80 percent; in Vietnam, by comparison, the share of domestic private companies in industrial output is still only 25 percent. Little wonder then that Taiwan got more growth from less saving and investment than Vietnam. Vietnam's relatively high ICOR has been attributed corruption and waste in public investment projects and state-owned enterprises, which not only lower the return on public sector investment, but also have a heavy opportunity cost by absorbing resources that could otherwise be invested in more efficient and profitable private companies.¹¹ Thus, while structural change has contributed to growth in Vietnam over the past decade and a half, much more is required to sustain growth in the future.

¹⁰ David Dapice, et.al., "Choosing Success: The Lessons of East and Southeast Asia and Vietnam's Future," Harvard University, mimeo, 2008.

¹¹ *ibid*, p. 37.

4. Role of trade

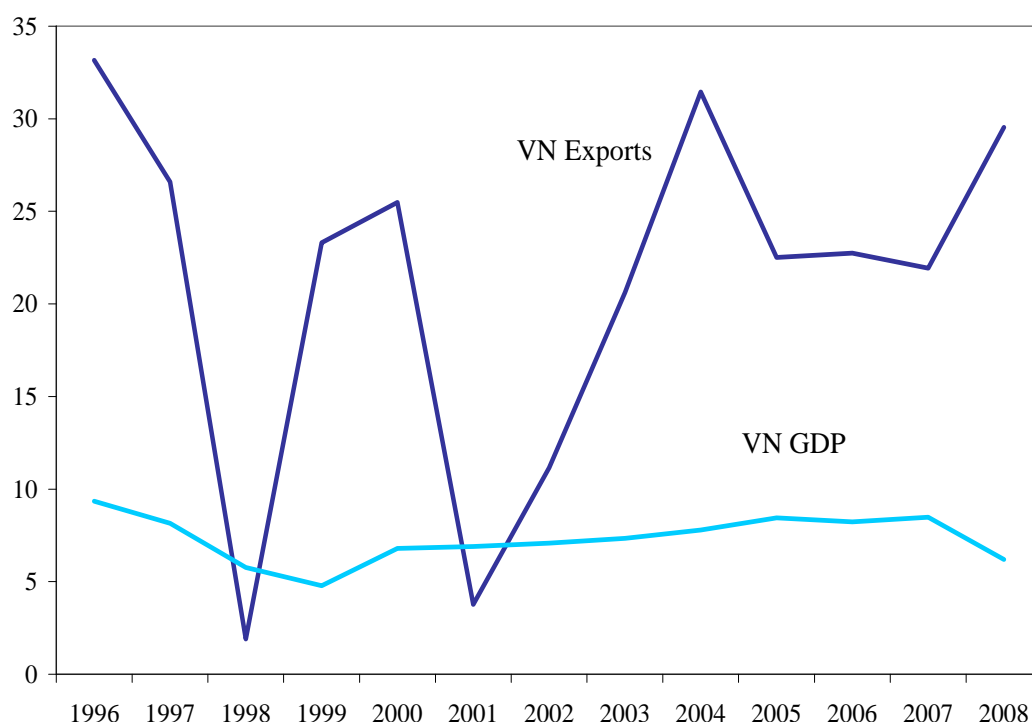
Trade (read exporting) is often described as the “engine of growth” of developing countries, especially those in East Asia where export growth rates have typically been high. The metaphor is misleading, however, because selling domestically produced goods in foreign markets (or in domestic markets for that matter) does not expand domestic productive capacity. Only investment does that. Openness to international trade does, however, allow a country to specialize in the production of goods in which it has a comparative advantage, allowing it to achieve a higher level of income from a given endowment of resources and, in turn, expanding its capacity to save and invest more and grow faster than would otherwise be possible. Openness also gives a country access to technology (embodied in imported capital goods) and exposes domestic producers to increased competition which spurs productivity growth. Thus, while trade cannot be described as an “engine of growth,” it is clearly a crucial, indeed indispensable part of a successful growth strategy.¹²

There is no doubt that trade has become increasingly important in Vietnam’s economy. From 1996 to 2008, exports grew at an average annual rate of 20 percent and increased as percent of GDP from 29 percent in 1996 to 70 percent in 2008, albeit domestic value-added in exports is probably no more than half the value of exports due exporters’ heavy reliance on imported intermediate inputs.

Belying the notion of trade as an engine of growth, as Figure 4 indicates, there is no close relationship between the growth rates of exports and GDP. While GDP growth and export growth declined together in the aftermath of the Asian financial crisis, no close relation appears in the data thereafter, at least until the current crisis struck Vietnam at the end of 2008 (analyzed below).

Figure 4. Growth rates of Vietnam Exports and GD

(percentages)



Source: General Statistics Office of Vietnam (GSO), online data and IMF, *International Financial Statistics*, online.

¹² We prefer the metaphor “trade as the handmaiden of growth,” coined by Irving Kravis, “Trade as the Handmaiden of Growth: Similarities between the Nineteenth and Twentieth Centuries,” *Economic Journal*, 80, Dec. 1970, 850-872.

5. Foreign Direct Investment (FDI)

Contributing to Vietnam's rapid integration into the world trading system has been a dramatic expansion of FDI in Vietnam. FDI inflows accelerated steadily after Vietnam concluded a Bilateral Trade and Investment Agreement with the United States in December 2001 and virtually exploded with Vietnam's accession to the WTO in January 2007, with the inflow in 2007 at a level equivalent to 11 percent of GDP, almost double the inflow in the previous year. As Table 2 shows, in 2007 FDI accounted for 13 percent of GDP, 57 percent of total exports and almost 40 percent of industrial output, substantially more, in fact, than the domestic private sector (25 percent).

FDI has become a favorite measure of the success of the economy and the government's overall policy stance, cited routinely by international donors, not to mention the government itself. The dominance of FDI in the industrial sector raises a concern, however, that perhaps Vietnam's heavy dependence on FDI has come at the expense of a more vibrant private corporate sector. There is ample evidence that this occurred in China. It has been shown that ownership biases favoring foreign over domestic private investors, in terms of access to bank credit and property rights protection, have led to the crowding out of private investment and in some instances have pushed private firms into joint venture arrangements with foreign firms in order to benefit from the special privileges accorded foreign firms.¹³ Unfortunately, no rigorous analysis of this issue has been done for Vietnam.

Table 2. Implemented FDI in Vietnam: 2003-2007

	2003	2004	2005	2006	2007
<i>FDI implemented annually</i>					
Value (\$ millions)	2,650	2,853	3,309	4,100	8,030
Value (% of GDP)	7	6	6	7	11
YOY rate of growth (%)	2	8	16	24	96
<i>Contribution of FDI to:</i>					
Value-added (% of GDP)	11	12	12	13	13
Industrial output (% of total)	36	36	37	38	39
Employment (% of total)	2	2	3	3	3
Exports (% of total)	50	55	57	58	57

Source: General Statistics Office of Vietnam (GSO), online data.

6. Vietnam's mini crisis: 2007-08¹⁴

The year 2007 was exceptional and much of what made it exceptional was rooted in the euphoria that surrounded Vietnam's long-awaited accession to the WTO in January. Caught up in the euphoria were foreigners investing directly in the economy (FDI) and indirectly in Vietnam's fledgling equity, bond and real estate markets. As shown in Table 3, net capital inflows in 2007 reached a staggering 24 percent of GDP, more than three times higher than in the previous year.

¹³ Yasheng Huang, "Ownership Biases and FDI in China: Evidence from Two Provinces," *Business and Politics*, Volume 9, Issue 1, 2007.

¹⁴ This section draws heavily on James Riedel, "Confronting the Macroeconomic Challenges Facing Vietnam," mimeo, June 2008.

Table 3. National Income Accounts and the Balance of Payment: 2002-08

(percent of GDP)

National Income Accounts	2005	2006	2007	2008E	2009F
Gross National Saving	35	37	32	31	25
Private	27	28	26	26	23
Public	8	8	6	5	2
Gross Investment	36	37	42	42	33
Private	24	26	30	32	24
Public	12	10	11	9	9
Saving-Investment Balance	-1	0	-10	-10	-8
Private	3	2	-4	-6	-1
Public	-4	-2	-6	-4	-7
Balance of Payments					
Current Account Balance	-1	0	-10	-11	-8
Net Capital Inflow	5	7	24	11	6
Net FDI	4	4	9	9	4
Medium- & Long-term Loans	2	2	3	1	1
Net Portfolio & Other S-T Flows	0	2	12	0	0
Change in Reserves (increase (-))	-4	-7	-14	0	2

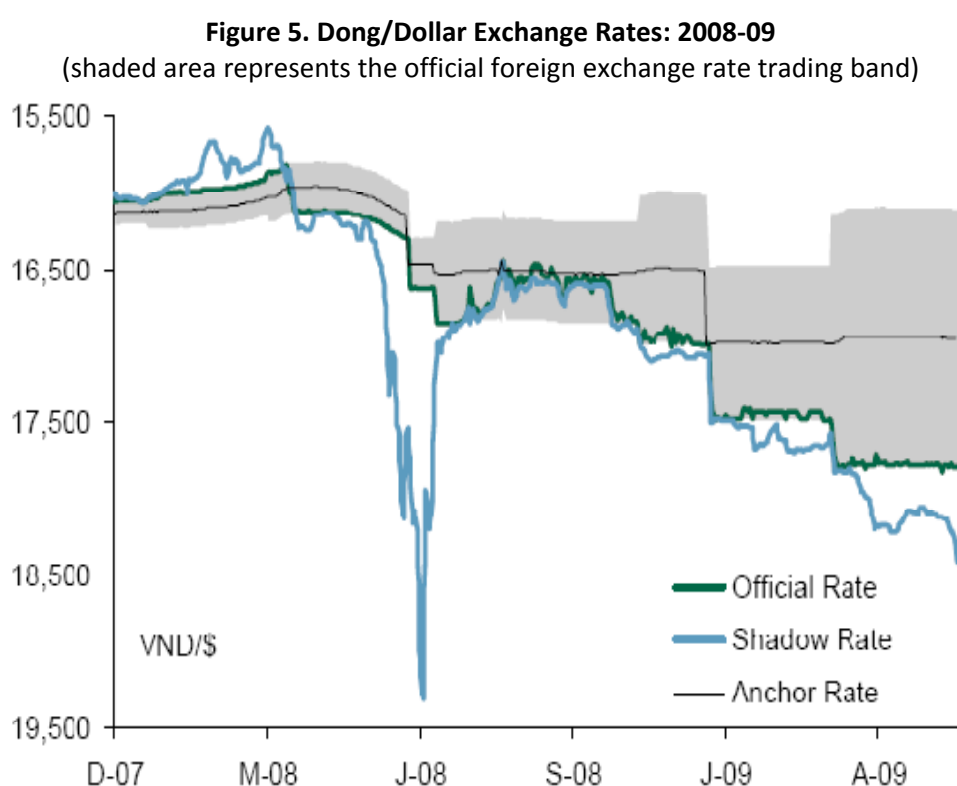
Source: IMF, Vietnam: 2008 Article IV Consultation—Staff Report, April 2009.

Not only were foreigners caught up in WTO euphoria, the domestic private and public sectors were as well. Significant increases in both public and private consumption reduced the overall saving rate 5 percentage points of GDP in 2007. At the same time, both public and private investment rates increased, especially in the private sector where the surge in FDI in 2007 raised the private sector investment rate 4 percentage points of GDP. The combined effect of declining saving rates and rising investment rates was a decline in the domestic saving-investment balance (the counterpart of the current account balance) of 10 percentage points of GDP.

Financial inflows in 2007 (at 24 percent of GDP) exceeded the financing requirement of the current account deficit (10 percent of GDP), requiring the central bank, following its policy of pegging the domestic currency to the dollar, to buy the surplus foreign exchange flowing into the country through the capital account (equivalent to 14 percent of GDP) and add it to its foreign reserves. Since foreign reserves are a component of the monetary base, the massive accumulation of reserve assets in 2007 and early 2008 led to a large increase in money and credit and an acceleration of inflation, which as noted above peaked at 30 percent in May 2008. When, in 2007 and early 2008, the SBV resisted purchasing the excess foreign exchange flooding the banking system, the result was strong pressure on

the currency to appreciate against the dollar. Foreign hedge funds and other foreign investors in Vietnam's sovereign domestic-currency bond market interpreted the pressures on the currency to appreciate as further reason to invest, propelling the economy toward a crisis that was inevitable in the absence of controls on foreign inflows into domestic asset markets.¹⁵

When, in May 2008, it became apparent to investors that the trade deficit and inflation rate were rising to unsustainable levels, there ensued a run on the currency, as investors (domestic and foreign) attempted to flee the domestic currency and domestic-currency denominated financial assets (see Figure 5). The run on the currency propelled the government into action, clamping down on black market currency exchange, raising interest rates more than 50 percent, redoubling administrative measures to control credit and vowing to make substantial cuts in government spending. As Figure 6 indicates, these measures were sufficient to contain the crisis and return the exchange rate to the official trading band. Since the fall of 2008, however, the currency has again come under downward pressure, but from the effects of the ongoing global crisis over which Vietnam's authorities have little control.



Source: Dragon Capital, "The Daily Financial Market Report," 21 July 2009.

Vietnam's mini crisis in the summer of 2008 gave Vietnam an early warning of the fallibility of investment bankers and the dangers of financial globalization in an economy with an underdeveloped financial system and a weak regulatory regime. The crisis was, however, something the government could have prevented had it adopted a more prudent fiscal policy in 2007 and taken measures to control the "hot money" inflows that financed the large increase in public and private spending. There was, however, no support for such measures, either from the government or its foreign donors/advisors, until after the market on its own curbed foreign investors' enthusiasm and brought short-term financial inflows to a halt in mid 2008.

¹⁵ Even though a crisis was inevitable, but it wasn't apparent to everyone, including Vietnam's major donors and policy advisers. The IMF, for example, wrote in its December 2007 report that "Vietnam's balance of payments is basically sound," and noted that "This is a propitious time for a move toward a more flexible exchange rate."

7. The foundation of economic growth

Rapid growth in Vietnam has occurred mainly in what could be termed the “superstructure” of the economy—industry, agriculture, construction, distribution and commerce—much of which is now in private hands. Underpinning the expansion of the economy’s superstructure is the economic and social infrastructure, broadly defined, that constitutes the economy’s foundation and is provided and maintained mainly by the government. There is a growing recognition in Vietnam that development of the economy’s foundation has not kept pace with the growth of its superstructure and that, as a result, the sustainability of rapid growth is threatened.

The economic and social infrastructure, broadly defined, includes the physical infrastructure (roads, bridges, ports, power, etc.), the health and education systems, legal institutions and government policies that affect the working of goods and factor markets, and importantly the functioning of the financial system. The mini crisis that erupted early 2008 (discussed in the previous sector) exposed a weakness in one part of the foundation, the financial system, and underscored the urgent need for policies to improve financial sector regulation and promote financial sector development. Other parts of the infrastructure, such as the health and education systems, are as weak, if not weaker than the financial system, but their weaknesses rarely get the attention that a financial crisis attracts. Arguably, however, their weakness poses an even greater threat to the long-run sustainability of growth in Vietnam.

The main reason that weaknesses in the economic foundation do not get the attention they deserve is that they are obscured by a lack of information. Those who drive on Vietnam’s roads, seek treatment in Vietnam’s hospitals and send their children to Vietnam’s schools are vividly aware of the weaknesses, but the hard data that are necessary for analysis of these issues are lacking. What data there are, routinely cited in World Bank reports, give a very incomplete and distorted picture of the state of Vietnam’s economic foundation. For example, primary and secondary school enrollment rates in Vietnam are relatively high, but the number of hours most students spend in the classroom (around 3 hours per day) and the quality of the education they receive there are low. Life expectancy and infant mortality rates are close to international norms, but access to quality health care for all but a few elites is exceedingly limited. Annually Vietnam invests about 10 percent of GDP in the physical infrastructure (mainly transportation and power), proportionately more than many other countries, but the return on these investments is seemingly low. Anecdotes of waste, corruption and delays in infrastructure projects are well documented in the Vietnamese press. Electricity shortages and rolling blackouts are too commonplace to make the news.

The weaknesses in Vietnam’s social and economic infrastructure carry a high cost. Weaknesses in transportation infrastructure undermine Vietnam’s international competitiveness.¹⁶ Weaknesses in the health care system lower labor productivity. Weaknesses in the education system also contribute lower labor productivity and discourage investment in industries other than the least skill-intensive.¹⁷

Weaknesses in the economic foundation threatened the sustainability of growth before the global crisis erupted and will continue to do so after the crisis has ended. Since the availability of resources to address these problems will likely be more constrained in the wake of the crisis, it is all the more important that the authorities take immediate steps to improve the efficiency of public goods provision by rooting out waste and corruption and relying more on economic cost-benefit analysis and less on politics in making public investment decisions.¹⁸

¹⁶ A World Bank study (Doing Business, 2007) reported that the cost to ship a 20-foot container from Vietnam is twice what it costs to ship from China.

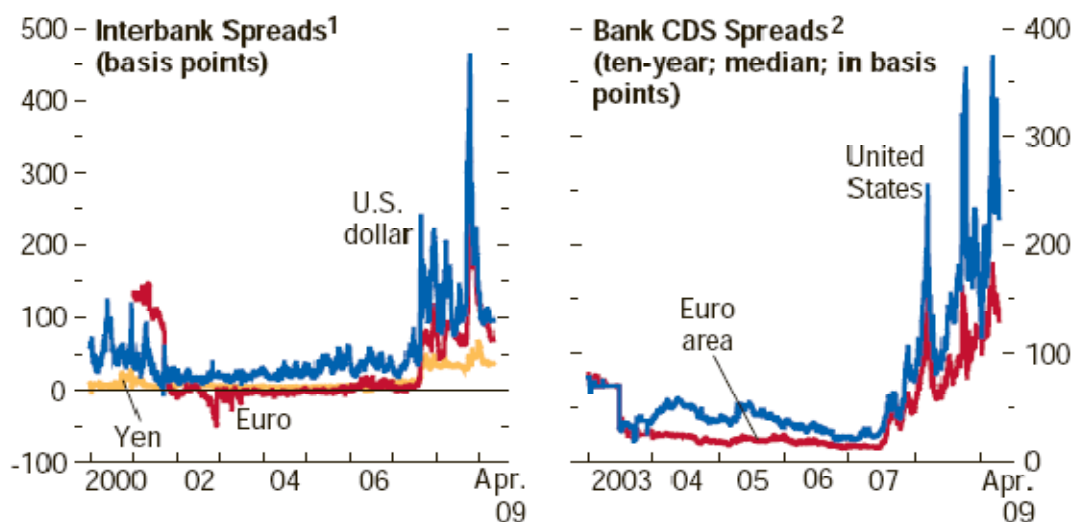
¹⁷ A recent study notes that “Both foreign and domestic firms report that recent university graduates have virtually no economically relevant skills.” David Dapice, et.al., 2008. p.22.

¹⁸ This is also the principal recommendation of Dapice, et.al., op.cit.

III. The Fallout from the Crisis Worldwide and in Vietnam

The epicenter of the global crisis was the U.S. financial system. An unexpected rise in home mortgage defaults from mid 2007 onward and the failure of Lehman Brothers bank and government rescue of AIG in September 2008 sparked a panic in the so-called 'shadow banking system' (explained in detail in an appendix to this study). Panic in the wholesale banking system led to a massive loss of liquidity and a freezing up of credit in interbank and repo markets, as indicated in Figure 9.

Figure 9. Indicators of the Credit Squeeze in the U.S. and Europe



Notes: (1) Three month LIBOR minus three-month government bill rate

(2) CDS-Credit Default Swap

Source: IMF, *World Economic Outlook*, April 2009, p. 1.

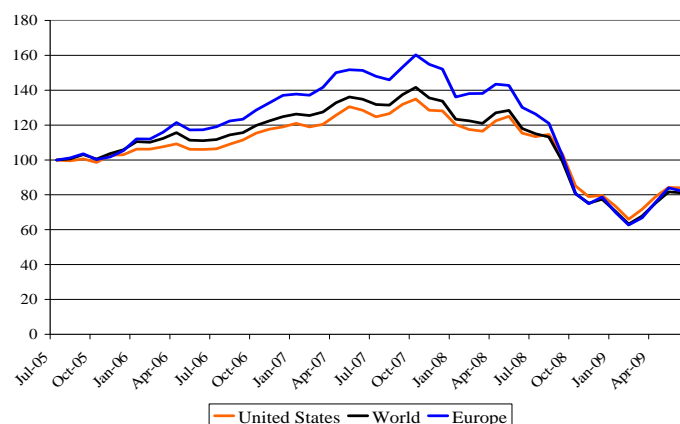
The credit crisis was, however, only the beginning. The banking system is the heart that pumps the life-blood (credit) that an economy needs to sustain life, and when a large part of it is cut off the entire economy goes into cardiac arrest—a financial crisis becomes an economy-wide crisis. Furthermore, when economies are closely integrated through international trade and capital flows, an economic crisis in one country or region of the size of the U.S. and Europe inevitably turns into a global crisis. The fallout from the banking crisis in the U.S. and Europe on the global economy and on Vietnam is examined in this part.

1. Global fallout

The initial fallout from the credit crisis was in equity markets in the U.S., Europe and around the world. As shown in Figure 10, the total return on equities in the U.S. began to decline in mid 2007 when the initial panic in the repo market broke out. Equity prices went into freefall in October 2008 when the shock of Lehman's failure and the government's rescue of AIG hit the market.¹⁹ The parallel movement of U.S. and global equity returns, also shown in Figure 1, reveals the high level of financial integration in the world economy that spread the U.S. banking crisis globally. Since mid 2007, when equity markets began to slide, somewhere on the order of \$25 trillion in the value of global equity (equivalent to about 70 percent of the annual income of the U.S. and Europe combined) was lost.

¹⁹ The total return is the return to an investor in terms of a change in the price of a stock and the dividends that stock earns. A stock price index and the total return index track each other very closely, the difference being the effect of dividend earnings on the return.

Figure 10. World Market and North America Portfolio Total Return Index (USD)



Source: MSCI Barra, MSCI Global Market Indices, online.

The collapse in stock prices in October 2008 was accompanied by a dramatic jump in the level of volatility of stock prices, indicating a high degree of market uncertainty about the future outlook for corporate profitability.²⁰ By January 2009, however, the index of market volatility had fallen back about half way to the normal range, indicating that the market outlook was more certain and, since equity prices remained depressed, the outlook for corporate profitability was bleak indeed.

Figure 11. The VIX Index of Stock Market Volatility

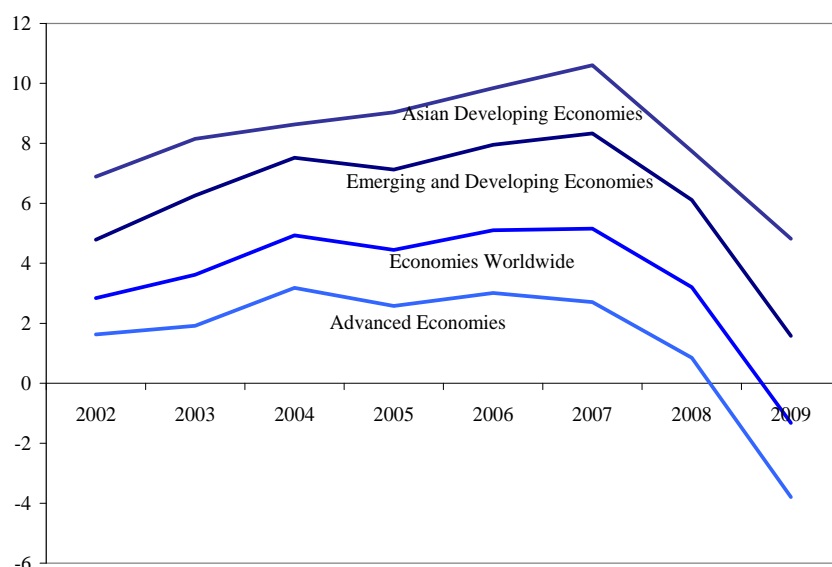


Source: Chicago Board Options Exchange, online data.

The credit freeze in the U.S. and Europe, combined with the loss of wealth resulting from the collapse in equity values, exerted strong downward pressure on aggregate demand and hence on aggregate supply (GDP), as shown in Figure 12. Real GDP growth began to decline in the U.S. and other developed countries in 2007, while in emerging and developing economies, and Asian developing economies in particular, growth continued at a robust pace until the U.S. banking crisis intensified in late 2008, when it fell steeply. The 2009 forecast is for a massive contraction, a negative growth rate of 4 percent in advanced economies and a significant slowdown in emerging and developing economies from 8 percent growth in 2007 to 2 percent in 2009.

²⁰ Sohnke M. Bartram and Gordon M. Bodnar, "No Place to Hide: The Global Crisis in Equity Markets in 2008/09," *Journal of International Money and Finance*, forthcoming.

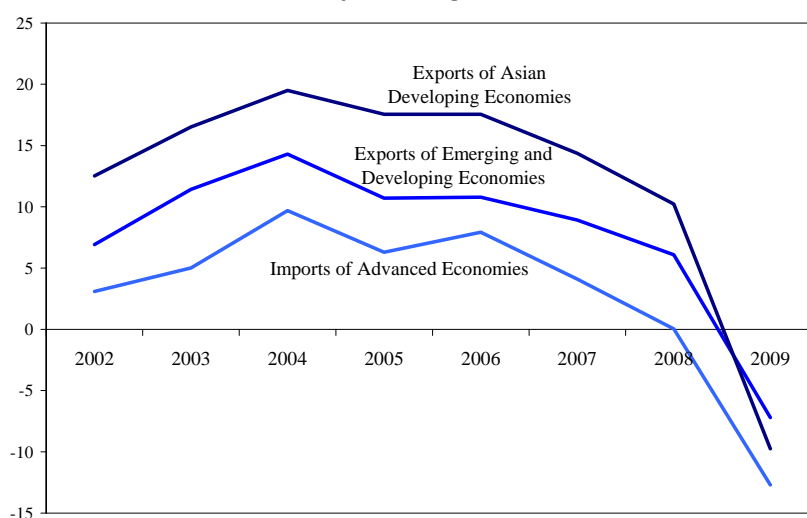
Figure 12. Rate of Growth of Real GDP (percentages)



Source: IMF, World Economic Outlook, online database.

The principal channel of transmission of the crisis from the developed to developing economies is international trade. Figure 13 reports the growth rates of developed countries' imports and developing countries' exports. As the figure shows, with the slowdown in economic activity beginning in 2007, developed countries imports declined dramatically, from 7 percent growth in 2006 to zero growth in 2008 and a negative growth rate of about 13 percent forecasted for 2009. As Figure 13 further shows, the decline in aggregate demand in developed countries has had a devastating impact of export growth in developing countries, which in turn exerted strong negative effect on developing countries' GDP growth, as shown above in Figure 12.

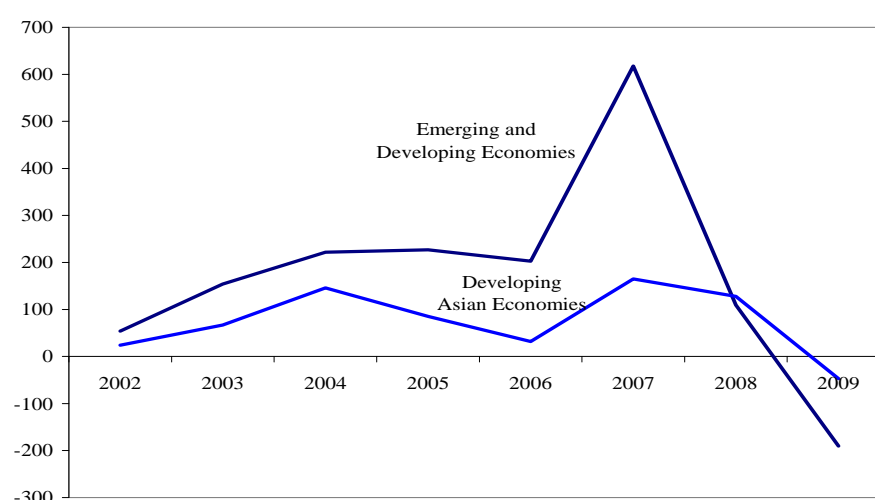
Figure 13. Rates of Growth of Developed Economies Exports and Developing Economies Imports (percentages)



Source: IMF, World Economic Outlook, online database.

The other principal economic transmission channel from developed to developing countries is capital flows. Figure 14 reveals a dramatic drop in the level net inflows of private capital in emerging and developing economies and Asian developing economies in 2008, the flow even reversing direction in 2009.

Figure 14. Net Private Capital Flows to Developing Countries (USD billions)



Source: IMF, World Economic Outlook, online database.

2. Impact on Vietnam

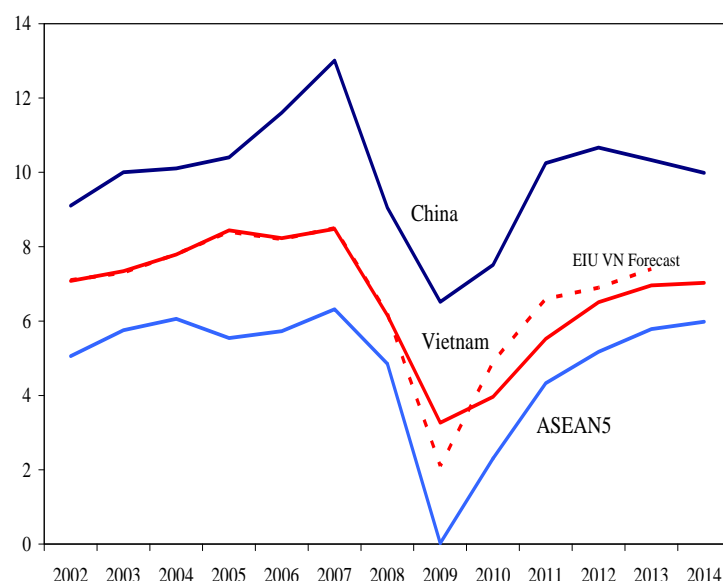
Since the fallout from the crisis only began to hit Vietnam and other developing countries less than a year ago, we still do not have hard data on its impact. The picture we have of the immediate impact and path the economy will take over the next few years is based mainly on estimates and forecasts. Forecasts are broadly based on assumptions about developed countries' recovery from the crisis over the next few years, which is a matter of great uncertainty and debate (discussed in part IV). Here we take the forecasts of economic activity provided by the IMF and others crystal ball gazers at face value, but with a healthy measure of skepticism, recognizing the old adage that "he who lives by the crystal ball learns to eat glass."²¹

a. Impact on GDP growth

The broadest measure of the impact of the crisis is the rate of real GDP growth, for which we rely mainly on IMF World Economic Outlook forecasts. As Figure 15 indicates, the global crisis is expected to have a massive negative impact on Vietnam and neighboring countries. The decline in the forecasted real GDP growth rate from 2006 to 2009 is a uniform five percentage points for China, Vietnam and the ASEAN 5, but in each case the starting point for the decline and the forecasted speed of recovery is different. China is expected to fare better than Vietnam, which in turn is expected to fare better than its neighbors in Southeast Asia (the ASEAN 5). China went into the crisis with a significantly higher growth rate and so the decline is less devastating than in Vietnam and the ASEAN 5, where in the latter case the forecast is for growth to come to a complete halt in 2009. China is also expected to recover faster, returning to a 10 percent growth rate after only two years (2011), while Vietnam and the ASEAN 5 get close to their 2002-07 average only after four or five years.

²¹ The equivalent in Vietnamese is "Fortune-tellers create ghosts, just as cleaning the house creates rubbish."

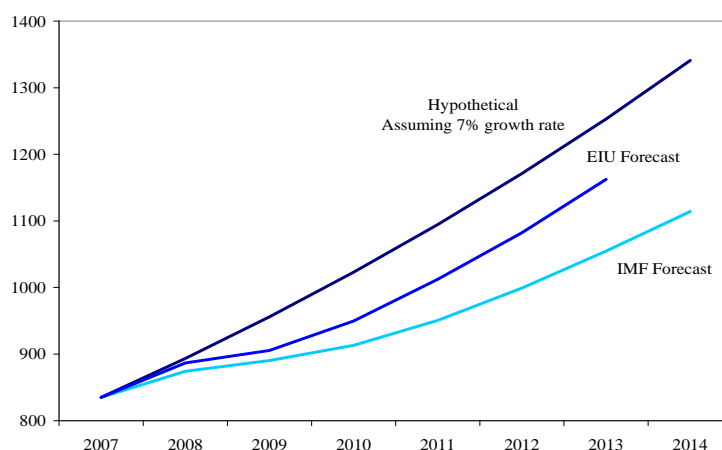
Figure 15. Actual (2002-08) and Forecasted (2009-2014) Real GDP Growth Rates: China, Vietnam and the ASEAN 5 (percentages)



Source: IMF, *World Economic Outlook*, April 2009 (online database) and Economist Intelligence Unit (EIU), *Country Forecast: Vietnam*, June 2009.

The IMF and EIU forecasts clearly do not support to the notion, widely bandied about, that “the world will never be the same again.” Vietnam and its neighbors, according to these forecasts, will hit bottom this year and within five years or less will be back growing at the Olympic gold medal rates they achieved in the past. Even if that occurs, however, the growth slowdown from the crisis will have long-lasting negative consequences. As Figure 16 indicates, the level Vietnam’s per capita income when the growth rate returns to “normal” in 2013 or 2014 will be about 20 percent lower than what it would have been if the average growth of per capita income over recent years (about 7 percent) had been maintained. At average annual rate of 5 percent, which is the average rate that the IMF forecasts for the period from 2009 to 2014, it takes about 14 years to double per capita income; at an annual average rate of 7 percent it takes only about 10 years to double per capita income. The global crisis is not, therefore, expected to produce a “lost decade,” as in the case of the Latin American debt crisis in the 1980s, but there will be a significant permanent loss of per capita income nonetheless.

Figure 16. Hypothetical and Forecasted Per Capita Income in Vietnam: 2009-2014 (US dollars)



Source: IMF, *World Economic Outlook*, April 2009 (online database) and Economist Intelligence Unit (EIU), *Country Forecast: Vietnam*, June 2009.

b. Impact on expenditure by sector

Forecasting aggregate output (GDP) is difficult enough, forecasting its components even more so. The IMF's World Economic Outlook does not forecast the growth of expenditure components, but EIU's does (see Table 4). Again, we will take these forecasts at face value, but with an even greater measure of caution.

Often the growth rates of the expenditure components of GDP (Y)—private consumption (C), government consumption (G), gross investment (I), and net exports (X-M)—are used to identify the sources of growth, e.g. external versus domestic demand, consumption versus investment.²² This common exercise does not, however, have any logical foundation in economics because the relationship $Y=C+G+I+X-M$ is an accounting identity, stating nothing more than the tautology that, *ex post*, supply equals demand—what was sold was bought. It does not explain what caused what. Economic theory tells us that long-run growth (expansion of the production capacity of an economy) depends on investment, not on domestic consumption or exports. In the short-run, however, if an economy operates at less than full capacity, then aggregate demand can have an impact on short-term growth up to the point where capacity is fully utilized, after which growth can only be achieved by making investments to expand capacity or raise the productivity of existing capacity.

The forecasts of the growth of GDP expenditure components, while of little use for understanding what will drive growth in the future do, nonetheless, offer some insights as how forecasters expect the economy to evolve over the next five years. The forecasts presented in Table 4 indicates that prior to the crisis (2006-08), investment was by far and away the fastest growing component of domestic spending, while after the crisis government consumption is forecasted to be the fastest growing component. This forecast suggests, therefore, that in the wake of the crisis there will be a significant reallocation of resources from the private to the public sector, indeed one that is likely greater than these numbers indicate because public sector (government and SOE) investment is included (together with private investment) in gross fixed investment. If this forecast is correct, then it is likely, for reasons explained in part II, that overall economic efficiency will decline, dragging GDP growth even lower than is forecasted and perhaps beyond the forecast period. The ICOR computed in Table 4 hints at this, but the numbers are not reliable since they do not differentiate the effects of changes in efficiency and changes in capacity utilization.

Another equally important structural shift predicted by these forecasts is a significant decline in the role of exports. As was noted in Chapter 2, exports have grown over the past decade at about 20 percent per year, almost three times faster than GDP. The EIU's forecast for export growth, even after the economy has fully recovered in 2013, is a rate only slightly higher than the forecasted GDP growth rate. Since the growing export-orientation of the economy has been a major contributor to structural change favoring industries in which Vietnam has a strong comparative advantage, raising economic efficiency providing for higher growth than would otherwise have been possible, this prediction also does not bode well for Vietnam's long-term growth prospects.

Table 4. Actual (2006-07) and Forecasted (2008-13) Rates of Growth of Real GDP by Expenditure Component (percentages)

	2006	2007	2008	2009	2010	2011	2012	2013
GDP (Y)	8.2	8.5	6.2	2.1	4.9	6.6	6.9	7.4
Private consumption (C _p)	8.3	9.6	4.9	-0.5	2.3	5	6	6.4
Gov't consumption (C _G)	8.8	8.9	8	8.2	8	7.8	7.8	7.7

²² See, for example, almost any international investment bank country report.

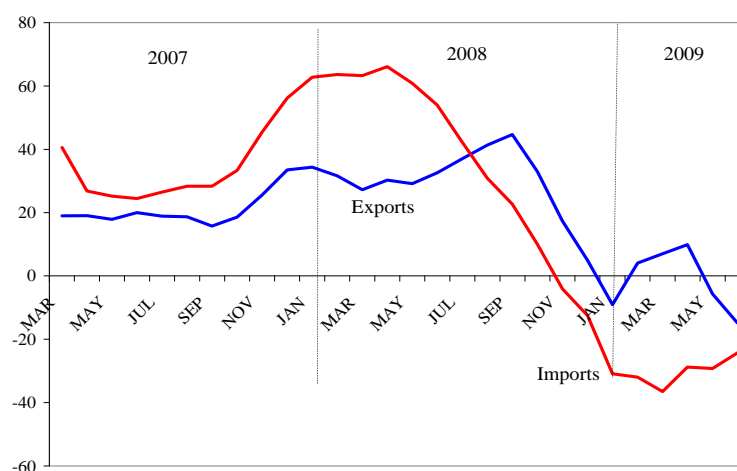
	2006	2007	2008	2009	2010	2011	2012	2013
Gross fixed investment (I)	9.9	23	14	-2.5	2	4.5	6	7.5
Exports of G&S (X)	17.1	15.2	14.9	-5.4	4.4	7.2	7.9	8.9
Imports of G&S (M)	18.4	25.6	14.4	-8.1	1.1	5.7	6.5	8.3
Domestic demand	9.6	14.6	7.2	-1.6	2.7	5.2	6.1	6.9
I/Y	33.4	37.1	41.9	34.9	34.4	33.6	33	33.2
ICOR = $I_{t-1}/\Delta Y_t$	4.01	3.93	5.98	19.95	7.12	5.21	4.87	4.46

Source: Economist Intelligence Unit (EIU), Country Forecast: Vietnam, June 2009.

c. Impact on exports

Because of the importance of trade for Vietnam's past success and future prospects, it is useful to look more closely at the data. Figure 17 reports the three-month moving average year-on-year (YOY) growth rates of exports and imports from March 2007 to June 2009 using GSO data. The bubble in import growth from mid 2007 to mid 2008 reflects the surge in consumption and investment spending that commenced at Vietnam's accession to the WTO. The import growth bubble burst with the onset of Vietnam's mini crisis in the late spring of 2008. Export growth, as Figure 17 indicates, was strong right up to the outbreak of the global economic crisis in the fall of 2008.

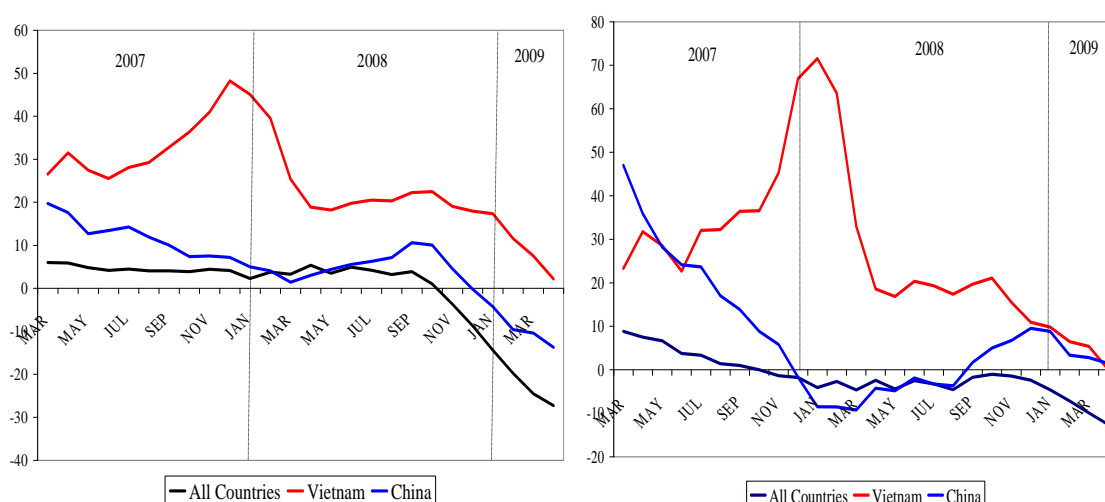
Figure 17. YOY Monthly Export and Import Growth Rates (percentages)



Source: Vietnam General Statistical Office (GSO), online database.

Vietnam's published trade data, indeed most of its published data, are problematic. A more reliable picture can be obtained by using U.S. import data, which provide comparable data for different countries and allow for commodity disaggregation. Figure 18 reports three-month moving averages of year-on-year growth rates of U.S. imports of manufactured products and clothing from all countries, China and Vietnam. These data tell a somewhat different story from what is suggested in Figure 17. The U.S. import data show that the global crisis has had significantly negative impact on Vietnam's exports to the U.S., but one that was not as severe as indicated by the data on aggregate exports to all destinations. This might appear surprising because the U.S., ground-zero of the global crisis, has seen a greater decline in aggregate demand than most of the other countries to which Vietnam exports.

Figure 18. Three-month moving average growth rates of U.S. imports of manufactured goods (left) and clothing (right) from all countries, China and Vietnam (percentages)



Source: U.S. International Trade Commission, online database.

Another interesting observation from the U.S. import data is that Vietnam's exports of manufactured goods and clothing to the U.S. have held up better than those of other countries, including China. This could reflect differences with other countries in regard to the composition of Vietnam's exports and its market share. Vietnam's exports of clothing and manufactures products generally are concentrated in product categories that mainly compete at the low-end of the market, which is the part that has held up better in the U.S., as households struggled to make ends meet during the crisis. In addition, Vietnam should be less vulnerable to the slowdown in external demand because its share in the U.S. market is exceedingly small compared to that of China and most other countries. As a small country (in terms of its world market share) Vietnam has the potential to maintain export growth by protecting and enhancing its international price competitiveness.

d. Impact on capital flows

The Government of Vietnam chooses not to publish balance of payments statistics, but gives the data to the IMF which does publish them. Table 5 contains the actual figures for 2006 and 2007, an estimate for 2008 and a forecast for 2009. The numbers describe the rollercoaster ride that capital inflows have taken the past three years, rising more than five-fold in 2007, falling by half in 2008 and by half again (according to the IMF forecast) in 2009.

Table 5. Vietnam's Balance of Payments: 2006-2009
(USD billions)

	2006	2007	2008*	2009**
Current account balance	-0.2	-7.0	-9.2	-7.3
Trade balance	-2.8	-10.4	-12.3	-7.1
Exports, f.o.b.	39.8	48.6	62.9	53.2
Imports, f.o.b.	42.6	58.9	75.2	60.2
Non-factor services (net)	0.0	-0.9	-2.3	-1.9
Investment income (net)	-1.4	-2.2	-2.0	-2.5

	2006	2007	2008*	2009**
Transfers (net)	4.0	6.4	7.3	4.1
Capital Account	3.1	17.5	9.2	5.0
Net foreign direct investment (FDI)	2.3	6.6	7.8	4.0
Medium- and long-term loans (net)	1.0	2.0	0.9	1.3
Portfolio investment	1.3	6.2	-0.4	0.0
Short-term capital (net)	-1.6	2.7	0.9	-0.3
Errors and omissions	1.4	-0.3	-0.1	0.0
Δ Reserves (negative = increase)	-4.3	-10.2	0.2	2.3

Note: * estimates; ** forecasts

Source: IMF, Vietnam: Article IV Consultation-Staff Report, April 2009.

Particularly volatile have been portfolio and other short-term flows, which flooded Vietnam's banking system with foreign exchange in 2007 and then virtually disappeared in 2008 and 2009. FDI flows are more stable, but are also expected to fall by half in 2009, reflecting the expected decline in export demand and a diminished appetite for risk among foreign investors. The international investment banks generally forecast an increase in capital inflows in 2010, with levels forecasted to be as high as \$10 billion (HSBC).²³

In spite of the expected decline in levels of remittances and all forms of capital inflow, neither the IMF nor the international investment banks foresee a serious shortfall in foreign exchange that could spark a run on the currency and/or require the central bank to drain official reserves. The IMF has stated that "the dong is somewhat overvalued from a medium-term perspective" (whatever that means), but in its public pronouncements seems reasonably content with the government's policy of widening the band and adjusting the official rate on an ad hoc basis. As shown in Figure 5 (part II), the dong is currently trading in the "free market" at about a 4 percent discount below the lower bound of the official rate, which may suggest that the market is less sanguine about the strength of the exchange rate and official reserves than the IMF or the government.

e. Impact on the fiscal balance

IMF projections for 2009 fiscal operations of the central government are presented in Table 6. Since 2007 and 2008 were exceptional years—an episode of binge spending in the former and the recuperation from the hangover in the latter—it is preferable to use 2006 as a benchmark in assessing the impact of the global crisis on Vietnam's fiscal balance. In Vietnam, as in most countries, the crisis has led to a significant increase in the government's budget deficit, the overall deficit rising from one percent in 2006 to eight percent of GDP in 2009. Five of the seven percentage point increase in the deficit is due to declining revenue, which as Table 6 indicates is attributable entirely to falling oil tax revenue. Indeed, non-oil tax revenues are, surprisingly, projected to rise 2 percentage points of GDP in spite of a 4 percentage point projected decline the real GDP growth rate in 2009. The other two of the five percentage point increase in the deficit is due to increased off-budget spending. Total central government expenditures projected for 2009 are expected to remain at the same level (relative to GDP) that they were in 2006 (28 percent). However, the 2009 projections indicate a two percentage point

²³ HSBC, Vietnam Monitor, Issue 24, 8 July 2009

shift from capital expenditure to current expenditure, which amounts to a 22 percent reduction in capital expenditure as a percent of GDP. Given the weakness of Vietnam's economic and social infrastructure (discussed in Part II), any decline in public capital spending must be seen as a threat to the country's long-run growth prospects.

**Table 6. Vietnam Central Government Budget: 2005-09
(as percent of GDP)**

	2005	2006	2007*	2008*	2009**
Official fiscal balance	0	1	-2	-2	-4
Total revenue	27	29	28	27	24
Oil tax revenue	8	9	7	6	3
Non-oil tax revenue	15	16	17	18	17
Non-tax revenue	4	4	4	4	4
Total expenditure	27	28	30	29	28
Current expenditure	18	19	20	21	21
Capital expenditure	9	9	10	8	7
Overall fiscal balance	-5	-1	-5	-5	-8
Official fiscal balance	0	1	-2	-2	-4
Off-budget expenditure	4	2	3	3	4
Financing	5	1	3	5	8
Domestic (net)	3	0	2	4	7
Foreign (net)	3	1	2	1	2
Discrepancy	-1	0	2	0	0

Note: * estimates; ** forecasts

Source: IMF, Vietnam: Article IV Consultation-Staff Report, April 2009.

The increase in the government's fiscal deficit to 8 percentage points of GDP is not a matter of much concern to the IMF, according to its April 2009 report, even though the IMF acknowledges that the deficit might turn out to be higher than 8 percent once the various stimulus measures the government has announced are factored into the budget. Even at 8 percent of GDP, the government borrowing requirement (something on the order of VND 150 trillion or USD 8.5 billion) is substantial enough to have the effect of raising real interest rates and dampening private economic activity. There is, however, too little hard information and too much uncertainty about the near-term prospects for the world economy to reach any firm conclusions about the impact of the crisis on fiscal sustainability in Vietnam.²⁴

²⁴ For example, it is reported that the government has dispersed only 27 percent of the funds raised in previous bond issues and holds a VND 80 trillion fiscal reserve. Dragon Capital, "Vietnam Financial Market Daily Report, July 21, 2009.

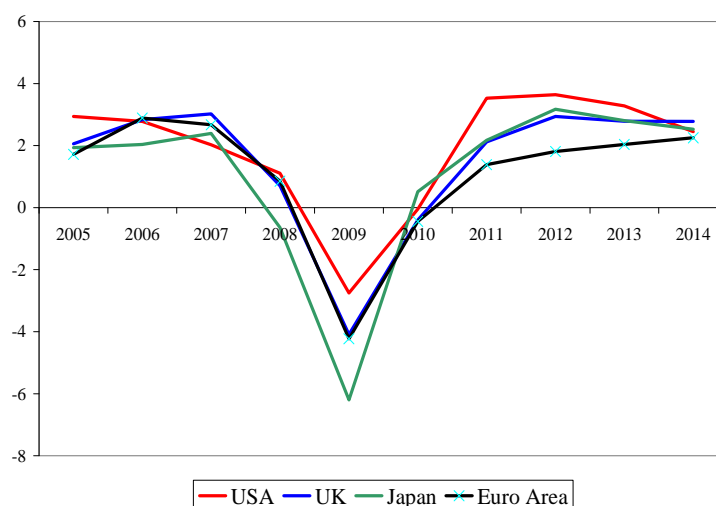
IV. Prospects for Recovery and Long-Run Implications for Vietnam

What are the implications of the ongoing crisis for Vietnam's long-term economic prospects and growth strategy? The definitive answer is: it all depends. It depends on the shape of recovery in the U.S. and other developed countries. Will they bounce back quickly (a V-shaped recovery), pulling developing countries out of recession, or will the recession drag on (an L-shaped recovery)? It also depends on the how successful the financial regulatory reforms currently being proposed in the U.S. and other developed countries will be in restoring confidence and stability in the financial system. Ultimately, however, the long-term strategic implications for Vietnam depend on whether there are viable alternatives to the outward-oriented strategy it has successfully pursued the past 15 years.

i. The Shape of Recovery

Will the recovery be V-shaped or L-shaped? As was shown in part III, the IMF is predicting a V-shaped recovery for Vietnam. This is presumably based on the prediction of a V-shaped recovery in the U.S. and other developed countries, since recovery in the core developed countries is required to pull the developing countries out of the crisis that their economic collapse put them in. Indeed, as Figure 19 indicates, the V-shape describes well the path that real GDP growth rates are forecasted to take in the developed countries.

Figure 19: IMF Forecasts for Real GDP Growth in Developed Countries to 2014 (percentages)



Source: IMF, *World Economic Outlook*, April 2009, online database.

How can the IMF and other international organizations be so sanguine about the shape of recovery in developed countries, given that the only hard evidence available so far (as of September 2009) is that their economies appear to have hit bottom? Is it preordained that, having hit bottom, the developed countries will bounce back in a year or two to their pre-crisis trend growth rates? Perhaps not, but evidence from previous post-war U.S. recessions indicates that this is what usually happens, indeed has happened in virtually every U.S. post-war recession. Michael Mussa, former chief economist at the IMF, finds that the current recession is similar to previous U.S. recessions; indeed the peak-to-trough decline in growth (3.2 percentage points) is slightly less than in the two previous deep recessions (1959Q1-1959Q3 and 1975Q1-1976Q3).²⁵ In those two cases, the decline and recovery lasted 6 quarters and the recovery to the trend growth rate from the bottom of the cycle involved a cumulative rise of real GDP of 10 percent and 11.5 percent, respectively. Mussa argues that "It is reasonable, therefore, to expect that

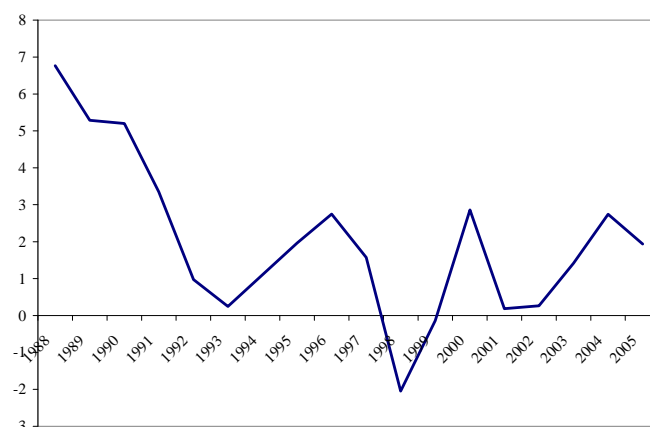
²⁵ Michael Mussa, "World Recession and Recovery: A V or an L?," Peterson Institute for International Economics, unpublished, April 7, 2009.

the recovery from the present recession would look broadly similar to the recoveries from those earlier recessions—a V-shaped pattern of recession and recovery.”²⁶

The V-shaped forecasts of the IMF and other international organizations are consistent with the mean reversion hypothesis—the greater the deviation of a stochastic variable from its mean (e.g. long-run average growth rate) the greater the probability it will revert to its mean. This hypothesis normally is a good guide, but in the current circumstances it may be misleading because in some important respects the current recession is unprecedented.²⁷ One aspect that is unprecedented is its global scope, which may make solutions that worked in past recessions that were less global in scope less effective this time. In past recessions, export expansion played an important role in pulling countries out of recession, but that cannot work (or work as well) when every country is trying to export its way out of recession.

Another aspect of the current recession that is unprecedented, especially in the U.S., is the size of the fiscal policy response to the crisis. Never before has the U.S. government responded to a recession with fiscal stimulus packages and an array of corporate bailouts on a scale comparable to the current ones. An unavoidable consequence of the U.S. policy response is going to be a significant increase in the role of government in the economy.²⁸ For the past half-century, U.S. federal spending has averaged 20 percent of GDP, with tax revenues at 18 percent, and an average budget deficit of 2 percent. However, the impact of the recovery measures already adopted, according to the U.S. Congressional Budget Office (CBO), after ten years (by 2020), will be an increase in the level of government spending to 26 percent of GDP and a deficit of 8 percent of GDP, unless taxes are increased about 50 percent, from 18 to 26 percent of GDP.²⁹ Tax increases and government borrowing on the scale projected by the CBO cannot but crowd out a significant amount of private investment and reduce the long-term average growth rate in the U.S. For these reasons, we cannot be quite as sanguine as the IMF about the prospects for V-shaped recovery. There is a distinct possibility that the U.S. economy, and by extension a good part of the world economy, could get mired in an L-shaped (non) recovery, as Japan did after its real estate and equity bubbles burst in 1989. What an L-shaped recovery looks like is shown in Figure 20.

Figure 20. Real GDP Growth Rates in Japan 1988-2005 (percentages)



Source: IMF, *World Economic Outlook*, online database.

²⁶ Ibid. p. 11.

²⁷ Simon Johnson and Peter Boone and James Kwak, “Baseline Scenario: Post G-20 Edition,” unpublished, Peterson Institute for International Economics, April 7, 2009.

²⁸ Robert J. Samuelson, “The Consequences of Big Government,” *Washington Post*, July 13, 2009. Even these numbers may be optimistic, according to Samuelson, because they make unrealistic assumptions about defense and non-defense discretionary spending.

²⁹ U.S. Congressional Budget Office, *The Long-term Budget Outlook*, June 2009.

Japan's failure to bounce back from its 1989 financial crisis has been attributed in large part to the very policies the Japanese government took to restore growth, including "fiscal stimulus focused heavily on public-works projects meant to benefit politically-connected companies...and heavy deficit spending that left little room for recovery of private investment,"³⁰ the very same concerns that are raised by critics of the Obama administration's recovery policies.

ii. Long-term Implications for Vietnam

Vietnam has made impressive gains over the past decade and a half in terms of growth and stability, but the ongoing global economic crisis has put a dent in those gains and cast a shadow over prospects for sustaining growth at the same high rate in the future. Vietnam's integration into the world economy, as indicated by the growing importance of trade and foreign investment in the economy, was a major contributor to Vietnam's past success, but these are the very sources of growth that have deteriorated as a result of the global crisis. The question naturally arises as to whether Vietnam should take measures to reduce its reliance on global sources of growth.

There has in fact been much discussion recently about decoupling in East Asia: "the idea that East Asian economies can unshackle their economic performance from that of the rich countries and achieve sustainable growth independently."³¹ There are two mechanisms by which decoupling may occur, one through greater reliance on trade among the Asian economies, and the other through greater reliance on domestic consumption, as opposed to exports, as a source of aggregate demand. It is worthwhile considering to what extent each of two ways of decoupling offers an alternative growth strategy that may reduce the extent to which Asian economies generally and Vietnam in particular are "at the mercy of world forces."

East Asia has seen a significant increase over the past decade in intra-regional trade, which on its face might suggest that decoupling from developed countries' markets is well underway already. A recent study by the Asian Development Bank debunks this notion, however, arguing that the growth of intra-Asian trade is more the result of the internationalization of supply chains than increasing consumer demand in East Asia.³² Although 40 percent of Asia's exports are shipped to countries within the region, final demand within the regional absorbs only 22 percent of Asia's exports, with 78 percent of final products going to the U.S., Europe and Japan.³³ Since much of the intra-regional trade in Asia is in intermediate goods, a large proportion of which will ultimately be re-exported as final products destined for the U.S. and Europe, the collapse in demand in developed countries will likely depress intra-regional trade about as much as it will depress exports to the developed countries directly. The reality is that the greatest demand for the products in which developing countries like Vietnam have a comparative advantage is in the developed countries, at least in the foreseeable future.

The other potential mechanism for decoupling is by producing more for domestic consumption and less for export. In fact, this is a normal, market-driven outcome of industrialization that has occurred in every country that has enjoyed a period sustained rapid growth. As per capita income rises with growing productivity in the industrial sector, spending patterns shift in favor of non-tradable goods (health, education, government services, massages, etc.), raising the relative prices of non-tradable goods and services and pulling a growing share of labor and capital from the production of tradable to non-tradables. The rise in the relative price of non-tradables causes a secular real exchange rate appreciation (the Balassa-Samuelson effect) and leads to lower growth rates, higher domestic

³⁰ Stratfor Global Intelligence, "The Recession in Japan, Part 1: Lost Decade Revisited," June 23, 2009

³¹ Tom Holland, "You can't have decoupling in an age of globalization," South China Morning Post, June 26, 2009.

³² Juthathip Jongwanich, William E. James, Peter Minor and Alexander Greenbaum, "Trade Structure and the Transmission of Economic Distress in High Income OECD Countries to Developing Asia," Working Paper No. 161, May 2009.

³³ Holland, 2009, op.cit.

consumption rates, lower saving and investment rates, and less reliance on exports as a source of aggregate demand.³⁴ In other words, gradual decoupling.

The long-run process of shifting the structure of production from tradable to non-tradables is one that China has just begun, but it is not one that is appropriate for Vietnam at its earlier stage of development. In terms of per capita income, China is about 15 years ahead of Vietnam.³⁵ China is far more industrialized and its industrial base is more diversified than Vietnam's. China is far less dependent on trade, with an export-GDP ratio half that of Vietnam. Household and corporate saving rates in China are almost double those in Vietnam, which implies that a rebalancing between consumption and saving is more compelling and likely to have more favorable outcomes in China than in Vietnam. The "middle class" plays a larger role in China's economy and its real income is growing more rapidly than in Vietnam, which suggests that resources released from the tradable goods sector as a result of a real appreciation can be more readily absorbed in the non-tradable sector at a lower adjustment cost than would likely be the case in Vietnam.

For Vietnam, at its current stage of development, there is no viable alternative to the strategy it has ostensibly followed the past 15 years, though certainly there is any number of measures that could be taken to make the strategy work better. In part II, we highlighted two key areas of weakness—the underdevelopment of a private corporate sector and the lagging development of the social and economic infrastructure—that mitigated past achievements and stood as obstacles to sustainable growth well before the outbreak of the global economic crisis. The crisis adds yet another challenge the government must contend with, namely the prospect of relatively weak external demand for Vietnam's exports over the next few years, if not longer. These challenges do not provide a reason to seek a new strategy, but instead to pursue more vigorously the one that worked in every other successful Asian economy and was working reasonably well in Vietnam.

The global economic crisis requires that Vietnam redouble its efforts to (1) protect the price competitiveness of its tradable goods sector, (2) further structural changes in industrial output and ownership that are required to raise the efficiency of investment, and (3) strengthen the economic infrastructure, including the physical infrastructure, legal institutions, the financial system, and the health and education systems. All of these were critically important requirements for Vietnam's long-run success before the crisis, and now that the country has been dragged into a global economic crisis they are even more important. Some good can come from the current crisis if it motivates the authorities to deal more effectively with these challenges than it has in the past.³⁶ If that happens then the sustainability of growth in Vietnam may be stronger coming out of the current crisis than it was going into it.

³⁴ Empirical evidence is provided in William D. Nordhaus, "Baumol's Diseases: A Macroeconomic Perspective," *The B.E. Journal of Macroeconomics*, Vol. 6, Issue. 1, Article 9, 2008. (www.bepress.com/bejm/vol8/iss1/art9)

³⁵ At a 7 percent per annum rate of growth of per capita income, it will take Vietnam 15 years to reach China's current per capita income (\$2200). ADB, Key Indicators 2007 (<http://www.adb.org/statistics>)

³⁶ Here we appeal to the Vietnam saying "cái khó bó cái khôn" (adversity makes for intelligence).

Appendix: The Causes of the Global Crisis and Proposals for Reform

The global economic crisis erupted less than a year ago, but already it has spawned a large literature attempting to explain its causes. Here we consider two strands in the literature, one arguing that the crisis was the result of a panic in the U.S. shadow banking system, the other focusing on all the things that went wrong in the U.S. subprime mortgage market, which sparked the crisis. These two approaches to explaining the crisis have been offered as competing hypotheses, but in our view they are more properly understood as complements, one focused on the systemic weaknesses that made the system vulnerable to a panic and the other on the particular failures in the one part of the financial system that sparked the systemic crisis. The two approaches do, however, have different implications for the reforms that are needed to lessen the likelihood of a repeat of the crisis in the future.

1. Panic in the Shadow Banking System

What happened, beginning in August 2007 and continuing still today, is a banking panic reminiscent of banking panics that were common in the United States in the 19th and early 20th centuries.³⁷ The panic was not in the conventional banking system, but in what is known as the “shadow banking system,” which performs on a wholesale basis the same function for large firms and financial institutions that the conventional banking system performs on a retail basis for households and small businesses. What was not understood before August 2007 was that the shadow banking system was vulnerable to a panic in the same way that the retail banking system was before deposit insurance and stricter banking regulations were introduced in the U.S. in 1934.

To understand the shadow banking system and its vulnerability to panic it is useful to compare and contrast it to the conventional, retail banking system. In the retail banking system, banks issue short-term debt redeemable on demand to depositors in exchange for cash, which they then lend to others, acquiring thereby a stock of assets. In doing this, banks provide a valuable social service, mobilizing and allocating the financial resources that fuel economic activity. For this they are rewarded by earning fees for their services and revenue from the interest differential between what they pay on deposits and earn on loans. This valuable social function is curtailed when depositors acquire information that leads them to suspect that banks’ assets have gone bad and are no longer sufficient to cover their deposit liabilities, prompting them to run to the bank to withdraw their deposits. If depositors are unsure which banks in the system are in trouble, they panic (run on all banks) and the system becomes insolvent and collapses.³⁸ In 1934, in the aftermath of a banking panic, the U.S. government undertook to insure bank debt (deposits), limit competition by restricting entry into banking and subjected banks to stricter regulation. These measures made panics a matter of history in the retail banking system.

In the meantime, however, there developed a shadow banking system that has become even larger than the retail banking system.³⁹ The shadow banking system is where large firms “deposit” their cash and fund their investments.⁴⁰ An important difference with the retail banking system is that depositors and investors are individually matched, each depositor (lender) getting collateral from his counterparty investor (borrower). Transactions in the shadow banking system are primarily conducted in the repo market, where the lender provides cash in exchange for a collateralized asset, which the borrower agrees to repurchase at a fixed date (usually overnight); although in practice repo contracts are commonly rolled over.

³⁷ This is the thesis of Gary Gorton, “The Panic of 2007,” Yale University, unpublished, August 25, 2008; Gary Gorton, “Slapped in the Face by the Invisible Hand: Banking and the Panic of 2007,” Yale University, unpublished, May 9, 2009.

³⁸ In a panic, the system is insolvent because nobody has the money with which to buy the assets of all banks in the system.

³⁹ Because it is in the shadow, there are no official statistics on the shadow banking system, but its assets are estimated to be about \$12 trillion. The assets of the retail banking system, by comparison, are about \$10 trillion.

⁴⁰ Note, the retail banking system is of no use to large financial institutions which have hundreds of millions in cash because deposit insurance is limited to deposits of about \$100,000.

The key to understanding why the shadow banking system was vulnerable to a banking panic lies in the nature of collateral in the repo market. A growing proportion of collateral in the repo market has been created through the process of securitization.⁴¹ Securitization involves the pooling and repackaging of cash-flow-producing financial assets (e.g. residential mortgages, credit card receivables, auto loans) that are taken off the balance sheets of the banks that originated the loans and sold to investors as asset backed securities (ABS), which they in turn use as collateral in the repo market.⁴² As Gorton contends, “repo is essentially depository banking,” but built on asset backed securities as collateral rather than on insured deposits as in the retail system.⁴³ In the repo market, collateral pledged may involve a “haircut,” the percentage difference between the market value of the collateral pledged and the amount of funds lent. The haircut is a measure of the perceived riskiness of pledged collateral, which under normal circumstances is minimal because the world’s largest and most reputable banks stand behind the collateralized debt pledged in the market.

What sparked the panic in the U.S. shadow banking system was an unexpected rise in the default rate on subprime mortgages after the decade-long rise in house prices came to a halt in early 2007.⁴⁴ Turmoil in the subprime market was not the cause of the crisis, *per se*, since the share of defaulting subprime mortgages in the stock of outstanding asset-backed securities was small and should have been easily absorbed without putting the system at risk. The problem was that information about where the “toxic” subprime assets resided in the system was lost in the process of securitization. Depositors in the repo market, not knowing the whereabouts of the deteriorating subprime assets and uncertain about the liquidity of their counterparty’s collateral, panicked in August 2007, leading to an abrupt deterioration in the value of all securitized assets, the bulk of which were unrelated to the subprime mortgage market and unaffected by the decline in house prices. As a result, liquidity in the repo market immediately contracted, as illustrated in Figure 6 by the jump in the spread between the London Interbank Offer Rate (LIBOR) and the three-month U.S. Treasury interest rate in August 2007.⁴⁵ An even more dramatic jump in the spread occurred in October 2008 when fear spread through the repo market after Lehman Brothers failed and AIG had to be rescued from bankruptcy by the U.S. government.

The spread between the U.S. Treasury rate and LIBOR reflects a flight to quality. When all firms want to hold cash, the price of collateral must fall to attract buyers, hence the haircuts on structured debt must increase which, as Figure 7 shows, they have done since August 2007. An increase in repo haircuts is equivalent to a withdrawal of deposits in the retail banking system, requiring banks, in lieu of borrowing or capital injections, to sell collateral, pushing their prices down and rendering the system insolvent.

⁴¹ As Gorton, 2009, op.cit. p. 29 notes, “The repo market traditionally was confined to U.S. Treasury securities, but in the last 25 years has grown to accept a broad range of securitized bonds as collateral.”

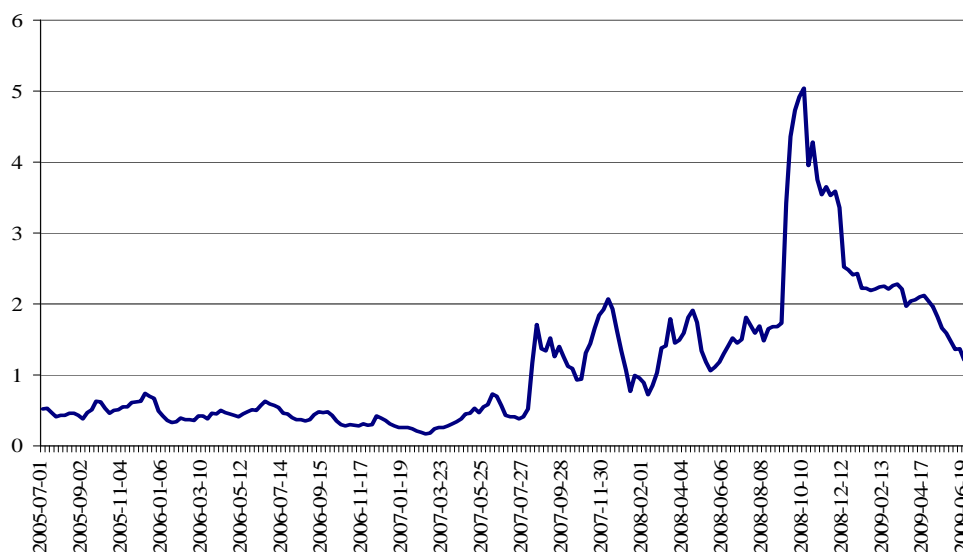
⁴² In recent years as much as half cash-flow-producing bank loans were securitized and hence taken off the banks’ balance sheets. Off-balance-sheet banking is the essence of the shadow banking system.

⁴³ Ibid. p. 33.

⁴⁴ Nothing about subprime mortgages made sense, either from the borrowers’ or the lenders’ points of view unless house prices could be expected to rise.

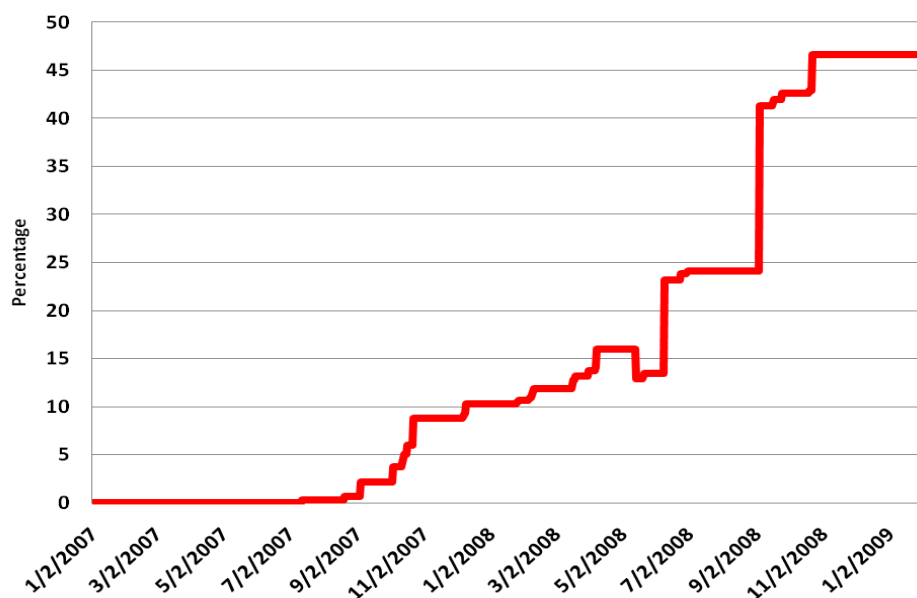
⁴⁵ Under normal circumstances, repo collateral (collateralized bonds of the world’s largest banks) is considered almost as risk-free as short-term U.S. Treasury securities, which are the most risk-free assets in the system. The so called TED-spread indicates, therefore, the deterioration in the perceived liquidity of repo collateral.

Figure 6. The percentage spread between the 3-month U.S. Treasury rate and LIBOR



Source: Federal Reserve Board, online data.

Figure 7. The Repo Haircut (percentage discount) on Structured Debt



Source: Gary Gorton, 2009, *op.cit.* p. 33.

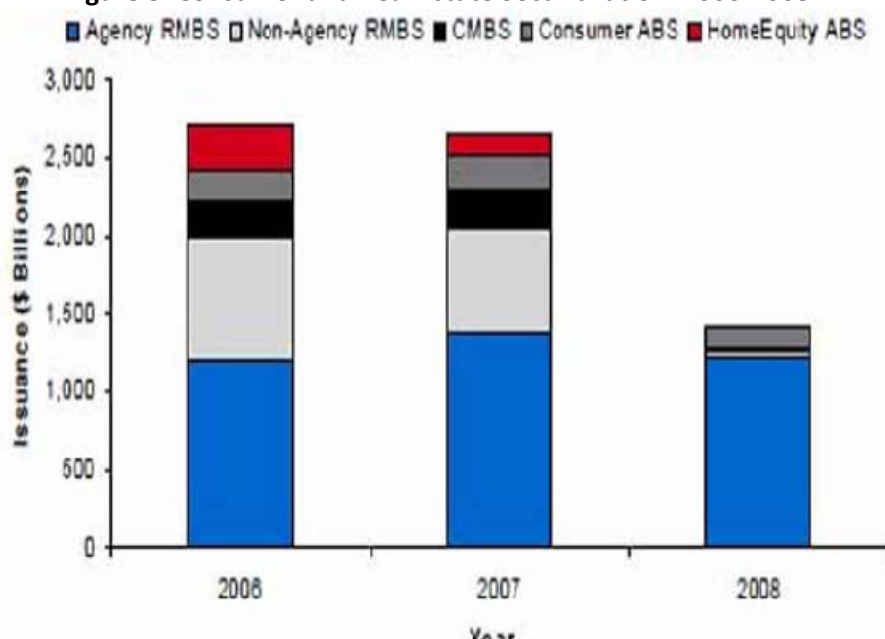
The extent of damage to financial system in the United States caused by the panic is shown in Figure 8. The upper part of the bar graph disappears in 2008, indicating that funding for residential mortgage-backed securities (RMBS), commercial mortgage-backed securities, consumer asset-backed securities (e.g. student loans, credit cards and auto loans) and home equity loans dried up in 2008. The only thing left in the wholesale credit market was the agency mortgage-backed securities sold through U.S. government sponsored enterprises (Fannie Mae and Freddie Mac) with government funding.⁴⁶ What this meant, according to one financial observer, is that “Wall Street’s credit-generating mechanism has disintegrated cutting off 40 percent of the blood flow to the economy.”⁴⁷ The retail banking sector is largely in tact, but the wholesale banking sector was, and still is, frozen by investor fear.⁴⁸

⁴⁶ Mike Whitney, “Disintegrating Financing System: Haircut Time for Bond Holders,” The Market Oracle, March 12, 2009, www.marketoracle.co.uk.

⁴⁷ Ibid.

⁴⁸ See, Olivier Blanchard, “(Nearly) nothing to fear but fear itself,” The Economist, January 29, 2009.

Figure 8. Consumer and Real Estate Securitization: 2006-2008



Source: Mike Whitney, "Disintegrating Financial System: Haircut Time for Bond Holders," *The Market Oracle*, March 12, 2009.

Before examining what caused turmoil in the U.S. subprime mortgage market, sparking a panic in the shadow banking system, it is useful briefly to consider the role of the much-maligned credit default swap (CDS) in the shadow banking system.⁴⁹ A CDS is a means whereby a lender can reduce his exposure to a borrower by paying a premium to a CDS dealer in exchange for insurance against a default by the borrower (backed up by pledged collateral). The CDS dealer can, in turn, shift the exposure he assumes by insuring the lender by paying a premium to some other market participant to insure against a default by the original borrower. In principle, the shifting of the risk of default by the original borrower from one party to another can continue almost indefinitely, indeed the gross notional value of CDSs is about \$50 trillion.⁵⁰ The key point, however, is that the level risk in the system derives from the original loan, not from the successive CDSs that shift the risk from one party to another. The reason that CDSs have been implicated in the shadow banking crisis is because much of the risk inherent in the MBSs and other CDOs that were used as collateral in the repo market was shifted around the system by means of CDSs. CDSs no doubt contributed to the loss of information about who was on the hook for the subprime defaults, but they did not create the risks that ultimately plunged the system into crisis.⁵¹

According to Professor Gary Gorton, the leading proponent of the banking panic hypothesis, the crisis was sparked by turmoil in the subprime mortgage market because "the design of subprime mortgages and subprime securitizations are unique in that they are particularly sensitive to declines in house prices, leading to an information problem for investors when the house price bubble burst."⁵² He argues that no similar problem exists with securitizations generally, since "other securitizations are not so sensitive to the prices of the underlying assets and so they are not so susceptible to bubbles."⁵³

⁴⁹ This all explained extraordinarily well by Peter J. Wallison, "Everything You Wanted to Know about Credit Default Swaps—but Were Never Told," *AEI Financial Services Outlook*, December 2008.

⁵⁰ If account is take for double-counting, the amount of gross notional CDSs is about \$25 trillion. But, as Wallison (*ibid.*, p. 7) notes, "This amount is many times the actual potential loss on all CDSs outstanding at any time because the protection sold must be reduced by the protection bought. Wallison estimates the net notional value of outstanding CDSs is 'only' about \$2.5 trillion.

⁵¹ As Wallison, *ibid.*, argues that the benefits from CDSs, by providing an important tool for risk management and generating invaluable information (revealed by CDS premiums) about the level of risk in the system, far outweigh their costs.

⁵² Gorton, 2009, *op.cit.* p. 67.

⁵³ *Ibid.* p. 68.

According to this view, the subprime turmoil sparked the crisis, but the main problem and its solution lay elsewhere.

2. Turmoil in the subprime market

The second strand in the literature on the causes of the financial crisis focuses on a set of interrelated failures in the U.S. subprime mortgage market—macro policy failure, political/government failure, regulatory failure and market failure.⁵⁴ There is wide agreement in the literature that many factors played a role in causing the crisis, but there is disagreement as to the relative importance to be ascribed to each and so there is debate about what should be the priorities in reforming the system to prevent a similar crisis in the future.

a. Macro policy failure

The subprime crisis followed a boom in the U.S. the housing market from 2002 to 2006, during which average real (inflation adjusted) price of houses prices rose at a rate of 8.8 percent per annum and the volume of mortgage lending increased 10 percent per annum. During the housing bubble, the proportion of loans made to borrowers who were unqualified under normal lending criteria (i.e., subprime and Alt-A loans) increased from 9 to 34 percent.⁵⁵ The demand for houses and mortgages to pay for them was driven by easy credit and low real interest rates, combined with unreasonable expectations on the part of buyers that house prices would continue to rise indefinitely. Interest rates at levels below historic norms were the result of an overly accommodative monetary policy by the U.S. central bank⁵⁶ and “global imbalances” that contributed to lower interest rates through large purchases of U.S. Treasury securities by foreign central banks (China and Japan in particular) as they recycled their current account surpluses to finance a large and growing current account deficit of the United States.⁵⁷

With real interest rates at historic lows and house prices on the rise to unprecedented highs, it is easy to understand the motive of home buyers to leverage up in the mortgage market. But, why were banks willing to lend to borrowers who did not meet normal lending standards and were becoming increasingly over-leveraged? One answer that has been given is that low interest rates drove banks to make riskier loans in order to maintain revenue from loan fees and to get higher yields on riskier assets. This explanation has been advanced to shift the blame for the crisis to China and its policy of recycling (rather than correcting) its large current account surpluses.⁵⁸ It fails, however to explain why banks chose to use the cheap funds made available by foreign central banks to lend recklessly to over-leveraged and unqualified home buyers. Putting the blame on global imbalances, in general, and China’s macro policy, in particular, is similar to the excuse a naughty child might try on his mother—“the devil made me do it.”

b. Political failure

A more persuasive explanation is that it was the U.S. government (not the devil) that encouraged, promoted and even compelled banks to make subprime loans. Under the Community Reinvestment Act (1977), bank examiners were required to determine whether banks engaged in racial discrimination in their mortgage lending. In the mid 1990s, however, the rules were changed to require banks to show that they had made a requisite number of loans to low- and moderate-income borrowers and further

⁵⁴ A fifth category of failure could be added, namely, ‘moral failure.’ At the outset of the crisis, public outrage and political grandstanding focused blame on “greed and corruption” on Wall Street, and while politicians continue to exploit this theme, economists and other analysts have found more compelling explanations elsewhere. In fact, there is little evidence that corruption played a significant role, and greed is as much an explanation of success as it is of failure in the economic system.

⁵⁵ Charles W. Calomiris, “The Subprime Turmoil: What’s Old, What’s New, and What’s Next,” Unpublished mimeo, October 3, 2008.

⁵⁶ According to the IMF, World Economic Outlook, October 2008, “...in the United States and to a lesser extent in the euro area and Japan, policy [interest] rates were set well below what would be implied by the Taylor rule.” p. 22.

⁵⁷ A leading proponent of the global imbalance thesis is Martin Wolf, *Fixing Global Finance*, Johns Hopkins University Press, 2008, who predicted that the global imbalances would eventually lead to a run on the dollar and a global crisis. As it turned out, however, when the banking crisis erupted, there was a run to (not away from) the dollar.

⁵⁸ See Wolf, op.cit.

mandated that they use “innovative or flexible” lending practices to achieve implicit lending quotas.⁵⁹ Banks also received direct subsidies from several federal agencies (FHLB and FHA) to make subprime loans. It was, however, the government sponsored enterprises, Fannie Mae and Freddie Mac, that took the lead in promoting subprime lending. Pressured by Congress to promote “affordable housing,” Fannie and Freddie bought up about \$1.5 trillion (half the outstanding stock) of “toxic” mortgages. It has been argued that “...absent the involvement of Fannie and Freddie in aggressive subprime buying beginning in 2004, the total magnitude of toxic mortgages originated could have been less than half its actual amount, since Fannie and Freddie crowded in market participation more than they crowded it out.”⁶⁰

c. Regulatory failure

Aside from the political failures that contributed to crisis, there is clear evidence of regulatory failures.⁶¹ Banks were permitted by regulations on capital requirements to engage in “regulatory arbitrage.” By securitizing mortgages, banks were able to move “toxic” assets off their balance sheets, where they were subject to lower capital requirements than had they been kept on their balance sheet.⁶² Regulators also proved deficient in assessing risk and enforcing discipline on banks. Lacking information other than that available to the banks themselves, regulators relied almost entirely on internal bank risk assessments and the opinions of rating agencies that were paid by the very banks whose assets they rated.⁶³

Regulators were hindered in their duty to enforce discipline on bank risk-taking by the “too-big-to-fail” problem. If banks are too-big-to-fail then there is an inherent moral hazard problem—banks expect to be bailed out on the downside of the excessive risks they take, which leaves the regulator unable to enforce discipline. The point was vividly illustrated when “After Bear Sterns was rescued by the Treasury-Fed bailout in March (2008), Lehman, Merrill Lynch, Morgan-Stanley and Goldman Sachs sat on their hands for six months awaiting further developments (i.e., either an improvement in the market or a handout from Uncle Sam).”⁶⁴

d. Market failure

The market failure that is most frequently cited as a cause of the subprime crisis is what economists call the ‘principal-agent problem’ or what others would call the problem of getting your employees to act in your interest rather than their own—the problem that bank stockholders have controlling the boards of directors that represent them, that boards have controlling bank CEOs and top management, and that management has controlling asset managers and lending officers. As a result of these problems, an incentive system was created whereby bank employees’ compensation was tied to short-term revenue and asset growth, which gave them an incentive to take risks that were not in the long-term interests of stockholders.

These incentive problems were created in large part, but not exclusively, by a banking innovation known as the “originate-to-distribute” model (as opposed to the old-fashioned originate-to-hold model). Through the process of securitization, banks could move the loans they had “originated” off their balance sheets and get funds to make still more loans. As Mishkin argues, “Originators had every

⁵⁹ Peter J. Wallison, “The True Origins of This Financial Crisis,” AEI Online, February 19, 2009.

⁶⁰ Charles W. Calomiris, “Financial Innovation, Regulation, and Reform,” *Cato Journal* (forthcoming), February 2009, p.6.

⁶¹ Note, the distinction between ‘political/government failure’ and ‘regulatory failure’ is somewhat arbitrary since regulations are set through the political process in the legislature and implemented by the government. By political failure what is referred to (following Tarr) are political actions “that sacrifice the greater social good to satisfy narrow constituencies.” David Tarr, “The Political, Regulatory and Market Failures that Caused the U.S. Financial Crisis: What are the Lessons,” unpublished mimeo, December 24, 2008.

⁶² Charles W. Calomiris, “The Subprime Turmoil: What’s Old, What’s New, and What’s Next,” unpublished mimeo, October 2, 2008.

⁶³ Calomiris, op.cit. 2009, p.11

⁶⁴ *ibid.*

incentive to maintain origination volume, because that would allow them to earn substantial fees, but they had weak incentives to maintain loan quality.”⁶⁵

The principal-agent problem is considered a market failure because, in economic theory, it is ascribed to incomplete and asymmetric information. In practice, however, politics and regulation also contributed to the problem. Calomiris points out that “the various laws and regulations that govern the market for corporate control in commercial banking make it virtually impossible for stockholders to discipline commercial bank CEOs.”⁶⁶ Furthermore, regulators, by allowing banks to assess the risk of subprime mortgages using unrealistic risk models supported by rating agencies that they in effect owned, provided lenders with the “plausible deniability” they would need when stockholders would eventually hold them to account for the losses on their on risky loans.⁶⁷

3. Implications for reform

If it is recognized that the shadow banking system is a genuine banking system, with social value comparable to the conventional banking, then the reforms that ushered in the “quiet period” in retail banking (seven decades panic free) may provide a model for reforming the shadow banking system. According to Gorton, this would mean three things:⁶⁸

1. “Senior tranches of securitization of approved asset classes should be insured by the government.”
2. “The government must supervise and examine “banks,” i.e., securitizations, rather than rely on rating agencies. That is, the choices of asset class, portfolio, and tranching must be overseen by examiners.”
3. “Entry into securitization should be limited, and any firm that enter is deemed a “bank” and subject to supervision.”

The first two reforms would give repo collateral a status equivalent to insured deposits in the retail banking system. The third reform, by restricting entry, would create “charter value” comparable to what retail banks enjoyed before it was undermined by regulatory changes in the 1990s. Charter value, according to Gorton, provides an incentive for banks to self-regulate.⁶⁹

The reform implications of the competing hypothesis are debatable. Calamities argues that “if there were no governmental safety nets, no government manipulation of credit markets, no leverage subsidies, and no limitations on the market for corporate control, one could reasonably argue against the need for prudential regulation.”⁷⁰ He recognizes, however, that this argument is “far beyond the feasible bounds of the current political environment”⁷¹ and suggests several areas for regulatory reform, including reforms to:

1. improve prudential capital regulation by improving the measurement of the value and riskiness of different asset classes;
2. fix the “too-big-to-fail” problem by limiting regulatory discretion about intervention in cases of bank failure;
3. eliminate the distortions in housing finance induced by government policies;
4. improve stockholder discipline of banks; and
5. to encourage greater transparency in derivatives transactions.

In part V, we consider to what extent reforms currently on the table are likely to succeed in making the world a safer place for international financial innovation.

⁶⁵ Frederic Mishkin, “Losses from the Leveraged Meltdown: Lessons from the Mortgage Meltdown,” February 29, 2008.

⁶⁶ Charles W. Calomiris, “A Spiritual Response to the Financial Crisis? Making Decisions for the Really Long Run,” unpublished mimeo, March 2009, p. 5.

⁶⁷ Calomiris, op.cit., 2008, p. 25.

⁶⁸ Gorton, 2009, op.cit. pp. 13-32.

⁶⁹ Gorton, op.cit. 2009

⁷⁰ Calomiris, 2009, op.cit., p. 13.

⁷¹ Ibid. p. 14.

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