

# DIFC week

## DIFC Forum 2008

### Emerging markets in and after the financial crisis



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Global economic turbulence has spilled into emerging markets, which only last year were expected to decouple from their developed counterparts. Although “financial contagion” has spread to the BRIC countries – Brazil, Russia, India and China – panellists generally agreed that today’s short-term pain will be followed by a relatively speedy recovery.

Panellists agreed that we should not underestimate the economic resilience

of the US and other developed countries. Nor should the power of the middle class in emerging markets as a driver of economic recovery and growth be underestimated. At the same time, there will be “rising stars” in the emerging market firmament, but one country – particularly China – will not dominate the global economy. Rather, there will be more sharing of the economic benefits of globalisation and more resilience to the diseases that

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caused the financial contagion in the first place.

Moderator Tim Sebastian set the stage for debate by noting that the “punch of the financial crisis” feels different in different regions. “Many thought the emerging market countries could sail past the crisis, but how badly have they really been hit?” he asked. “Will the stars of the emerging markets – Brazil, Russia, India and China – end up weathering the storm better than the US and Europe?”

## **A relatively speedy recovery**

An audience poll showed an overwhelming 72% had a lot of confidence that they would weather the storm, but not all panellists agreed. Kevin W. Lu said he was feeling “bullish” about emerging markets as they are generally less exposed than their developed counterparts. “There is a real case to be made that there are drivers to get their economies going. In the US, how much further growth is possible?” he said.

Lu noted that the financial crisis has ushered in opportunity for some. The Chinese government’s recent stimulus package of \$ 586 billion in an attempt to reverse the country’s rapid economic slowdown – is a two-year plan that will focus on infrastructure projects and social spending aimed at boosting domestic demand. This package is being boosted by provincial authorities. “China’s problem is the world’s problem. If they can solve their problems, they will become a driver for the global economy,” he said. Over the short-term, the economic recovery will be painful as many factories are closing down and people are losing their jobs. However, this is a way for the Chinese

government to make the country’s industrial chain more efficient.

“This crisis created an environment where the weaker companies will go bust and the government can have an opportunity to restart the process and beef up industries,” Lu said. “This afforded the government the opportunity to do this without having fingers of blame pointed at it.”

In India, the “fundamentals” of the economy have not changed in the wake of the financial crisis, commented Brij Raj Singh. “The market may have slowed down and be interrupted, but it hasn’t stopped. India will weather the storm and it will come back.”

When the first rumblings of the crisis were heard in Brazil, the government predicted it would be “a small wave that would not affect us,” explained Roberto Teixeira da Costa. “Right now there is more concern that it is more than a small wave, but it certainly isn’t a tsunami. We have a strong economy that is growing at the outstanding rate of 6% per year.” At the same time, against the backdrop of a 50% plunge in the Brazilian stock market, “difficult times are an opportunity to separate good management from bad,” he reminded participants.

Panellists agreed that the economic resilience of developed countries should not be underestimated. Lu pointed out that the underlying resilience in developed countries’ political systems – and different forms of democracy – means they have a strong backbone. Teixeira da Costa added that people are generally underestimating the energy and the capacity of the US to react to crisis. “People are doing a post-mortem on the US,” he said. “Under the

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leadership of [president-elect] Obama, the country will revamp. I am confident that the US has all of the instruments and energy it needs to recoup its position in the world.”

The weak links in the global chain in terms of a speedy recovery for the real economy include some of the smaller Asian countries, Argentina and Ecuador in Latin America, and some of the emerging European countries such as Hungary and the Ukraine. But the Gulf countries were given a positive prognosis for recovery due to the region’s inherent strengths.

## **The power of the middle class**

The buying power of the middle class is a strong driver of prosperity during good times, but in bad times, it can jumpstart economic growth. In most emerging market economies, GDP growth is largely internally driven and not overly dependent on external factors. Middle class influence drives their economies and their populations are relatively young.

In China, there is a lot of excitement among the middle class, according to Lu. People own cars and real estate for the first time. “There is huge room for the middle class to grow,” he said. “The key is that there are incentives for the political leadership to grow the middle class and maintain their happiness because it is their basis of power. And there are incentives for the middle class to work within the system to grow themselves.” The underlying conflicts in China’s complex society are secondary compared to these aligned interests.

In India, the potential for the middle class to galvanise economic growth is huge. For example, companies engaged

in outsourcing activities are moving from major centres such as Mumbai to smaller cities. By doing so, such companies are able to cut costs and create job opportunities. According to Singh, this has a real multiplier effect.

“The growth opportunity [for businesses] is in the middle class,” he said. The savings rate among individuals has not declined and prices have plummeted, which is having a positive effect. Consider that in 1997, there were two mobile telephony companies in the country. Today, there are 13. Phone calls that used to cost 40 cents now cost two cents. But because of the huge population, profits have still gone up.

“You have to cut costs and prices to allow the middle class to drive this change,” Singh added.

Teixeira da Costa reminded participants that in many countries, the majority is poor. In Brazil, the government has launched a programme to address such poverty. “If you protect the poor, you also protect the middle class,” he said. “You need this equilibrium or you will be an unfair country.” Teixeira da Costa also pointed out that inflation hits the poor the hardest and is the “most unfair taxation of all.”

## **A more equal sharing of the global economy**

The prospect of one emerging market economy rising above the others in the wake of the financial crisis is unlikely, panellists agreed. But the audience was less convinced – in the electronic vote, 66% believed that the 21<sup>st</sup> century economy will be dominated by emerging markets, particularly China and India.

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Lu disagreed and pointed out that it will be a “much bigger world” for China and India, but that the world will be one in which economic growth is more widely shared rather than dominated by these two countries.

Singh agreed that emerging market countries will play a larger role. He pointed to the growing opportunities in China and India with what he called the emerging “creative class.” Intellectual capital will drive the expanding role of emerging market countries. “Vision attracts capital,” he said. “It doesn’t work the other way around.”

Teixeira da Costa predicted that the Middle East and the Gulf will occupy a “very important space” in the 21<sup>st</sup> century economy. “This region is changing rapidly. You have all of the ingredients here for success.”

Panellists and participants were divided over whether the G-20 summit in Washington to address the global economy will promote financial stability or lay the groundwork for a new global financial architecture. Lu pointed out that broadening the table from the stronghold of the G-7 was a good development, while Singh dismissed the summit as “a waste of time” because nothing substantive resulted. Teixeira da Costa pointed to the fact that the summit was “a recognition that the world has changed” and praised the talk of a new architecture for international financial institutions.

“Let’s wait for the dust to settle down. We need to land and see what went wrong,” he said. “But now is not the time to create new institutions. We will come out of this situation better than we were before with stronger institutions. I

think we will have a better world that is less artificial.”

Lu pointed out that the underlying reasons for the financial crisis differ from country to country and that there is no one-size-fits all solution for recovery. But once the G-20 countries have solved their problems, “we can talk about a whole new system of multilateral financial institutions.”