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<u>Plenary 2</u>

The Rapidly Developing Economies

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THE CHALLENGES IN RAPIDLY DEVELOPING ECONOMIES

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Chairman Dr. Jayasuriya, Distinguished Panel Members, Ladies and Gentlemen:

Introduction

- It is indeed an honor and a privilege for me to be on this panel. The subject i.e, “Challenges in Rapidly Developing Economies” is couched in very familiar, euphemistic World Bank language! I refer to the use of the word “challenges” instead of “problems” or “issues” and then “rapidly developing” instead of “fast growing.” I think, put in straightforward, direct terms, this panel discussion is really all about the “problems in fast growing economies.”

- I have carefully listened to my friend, Ali Qadir, and there is much wisdom in what he has said. There is nothing I really disagree with but let me share my “take” on the subject which will mostly either supplement or reinforce Ali's remarks.

Relevant Global Phenomena

- Let me begin by drawing attention to three.major global phenomena that.have had a positive Impact on the flow of investment in. several developing countries and enhance their rate of growth. These are, of course, in addition to the primary reasons for rapid growth that are specific to each country:

  - First ageing demographics of the developed world have meant that, in order to finance retirement, pension funds in developed countries are looking for lucrative, long-term investments in promising emerging markets, particularly in view of the low interest rate environment and relatively less attractive investment opportunities at home. There seems to be --- and I do not have empirical evidence on hand --- some paucity of available investments. It is interesting that the US Federal Reserve has raised interest rates six or seven times in less than two years but with little or no impact on long-term rates! In fact, for a while, long-term rates fell despite the Fed rate enhancements!

  - Second, in most countries, there appears to be a veritable glut of capital and excessive liquidity sloshing around. A variety of circumstances may have given rise to this abundance of capital. Perhaps, central banks in many developed jurisdictions overreacted to the bunting of the technology bubble by cutting interest rates too much and for much too long. The large inflows of capital into emerging markets prompted by low interest rates in the US and Western Europe, as well as the extraordinary export performance of a large number of developing countries, particularly those in East Asia, have had the eventual impact of greatly increased liquidity.

- o <u>Third,</u> in the aftermath of the magic events of September 11, 2001, there has been substantial repatriation of capital from, the US and Western Europe to some emerging markets.

<u>The Challenges</u>

- These developments have obviously accentuated the situation in rapidly growing economies which are experiencing, in the words of Charles Dickens, "the best of times and the worst of tunes." While there is no denying the benefits that rapid growth and prosperity can bring, including greatly reduced poverty if the growth is managed well, there are certain disconcerting features that often creep in, which could be quite damaging for the economy, if not actually cause a major set-back; and it is not difficult to observe this happening today in jurisdictions that are growing at a fast pace. It is somewhat similar to the "resource curse" faced by countries with extraordinary natural resources!

- Essentially, it is the optimism and complacency that fast growth induces which is the basic problem. Financial intermediaries start lowering credit and investment standards, prudence is discounted, and one can see all kinds of dubious clients and deals being chased. Allocation of capital gets less efficient, asset valuations rise sharply --- especially real estate, greatly reduced returns become acceptable, collateral requirements become lax, and overall the system becomes considerably riskier.

- Also, credit specialists and risk specialists in financial intermediaries are increasingly looked upon as having lost touch with reality and as if they were impediments to be circumvented. The financial system's ability to impose proper discipline on the real sector gets eroded and some bad, perhaps spectacularly bad, investments are made.

- Furthermore, in many instances, regulators are under considerable pressure from their political masters not to do anything that might derail the boom, like steps to tighten risk management and prudential requirements or even to strictly enforce compliance with already existing risk management arrangements although such measures are obviously needed.

<u>Achieving a Sound Financial System</u>

- Periods of buoyancy and boom clearly have in-built vulnerabilities and thus such periods have been known to precede the precipitation of financial instability or a full-blown financial crisis. While the boom is on-going, a crisis is farthest from everyone's mind. The risk of instability or a crisis in the financial system is, however, very much on the cards and the question is how to avoid it. I believe the answer simply lies in going back to basics and in ensuring, whether or not the economy is growing fast, that the fundamentals ordinarily necessary to achieve a sound financial system are firmly in place. In my view, there are four fundamentals, namely:

- <u>FIRST</u>, *it is critical to maintain macro-economic stability, including fiscal health, and sound management of exchange rate, reserves, and public debt.* It is worth mentioning, that in recent years, several emerging market jurisdictions have made significant improvements in macro-economic management which augurs well for financial stability

- <u>SECOND</u>, *the regulatory agencies must be competent, they must be duly empowered, and be independent as well as fully coordinated with each other.* This is, perhaps, the most significant aspect of financial stability and cannot be emphasized enough. If an emerging market is able to put in place an edifice of regulation that is effective and clearly independent, more than half the battle to achieve financial stability is won.

- <u>THIRD,</u> *it is essential to have strong and capably managed financial institutions operating within an incentive framework that promotes efficiency, prudential risk taking, and profitability.* Here, by financial institutions, I not only mean banks and lending institutions but also institutions providing non-lending financial services or those that are closely inter twined with the financial system like investment banks., securities companies, asset management companies, collective investment institutions, insurance companies, leasing companies, factoring companies and also institutions such as stock exchanges, credit rating agencies, credit bureaus, depositories, clearing and settlement agencies etc.

- There is a clear need for financial systems with depth --- that offer a wide-range of products and instrumentalities to not only prudently address varying risk preferences and engage in risk-adjusted resource allocation but also have the versatility to cushion the ill-effects arising from a disturbance in any part of the system.

- <u>FOURTH</u>, *another significant element that has a marked bearing on financial stability is the adequacy of governance.* It is important for financial institutions to adhere to the principles of sound governance and have systems that are transparent, that call for due process, that enhance accountability, that provide for adequate parameters to resolve conflict, and that provide a fair return to all stakeholders. Of course, good governance also means the application of acceptable accounting standards and sound processes that ensure reliable audits or else the necessary degree of disclosure and transparency will be missing.

- We have seen that the absence of adherence to norms of sound corporate governance results in cronyism, unwarranted political interventions, conflicted situations, a culture of favors, poor credit or investment decisions, and perhaps corrupt practices. All this undermines the health of financial institutions and renders them less capable of providing the services they are mandated to provide as well as much more vulnerable to external shocks.

<u>**Conclusion**</u>

- I believe that for emerging market economies --- whether rapidly developing or not --- the key to preventing financial crises or instability is to institute sound domestic economic policies, to build robust financial institutions, to put in place capable, fully empowered, and independent regulators, and to ensure compliance with acceptable governance norms. No improvement in the international financial architecture can make up for deficiencies in these crucial areas that had, in the case of East Asia during 1997-98, led to speculative excesses in asset markets and poor risk management.

- I would, of course, be very happy to respond to any questions or comments.