

INTERNATIONAL CORPORATE GOVERNANCE NETWORK 2009 ANNUAL CONFERENCE

Joint ICGN and World Economic Forum Session: The New Financial Landscape: Will a phoenix rise from the ashes? Sydney, Australia; Tuesday, July 14, 2009*

Opening Comments of Mike Lubrano, Managing Director, Cartica Capital

My co-panelists have already discussed the global financial crisis and the prospects for the financial landscape in the EU, the United States, Japan and Australia. So I guess that leaves me to cover the remaining 150 or so Emerging and Frontier Markets. I shall try to cover these comprehensively in the eight minutes I have been so generously allotted by Mr. Beatty.

Well, so maybe I won't be able to cover all these markets. Instead, I will focus my remarks mainly on the by-now formally-recognized "BRIC" countries – Brazil, Russia, India and China, or, as they are sometimes referred to, the systemically-important Emerging Markets.

Just to provide some context, the twenty-two Emerging Markets in the MSCI index amounted to 24% of global market capitalization at the end of the first half of 2009, up from 18% at year-end 2008. According to the IMP, Emerging Markets will account for all world-wide growth in 2009 and 2010, about 1.6% this year and 4.0% in 2010, versus -3.8% in 2009 and 0% next year for the US, Europe and Japan. It is worth noting that all the BRIC countries have doubled their GDP in this decade up to the current crisis, except for Russia, which tripled.

The Emerging Markets and the BRIC countries are no strangers to financial and economic shocks and downturns. There were the sovereign debt crises of the 80s, the Asian financial collapse in the late 1990s and any number of single- and multi-country catastrophes along the way. But what has occurred since last year is of a different character and magnitude. For most Emerging Markets, this is, as we say in the legal profession, a case of first impression – a global contraction and game-changing crisis not resulting from domestic policies or imbalances, but rather a set of conditions and missteps in the OECD countries.

The BRIC countries shared, to a greater of lesser extent, a number of characteristics that put them in a relatively strong initial position coming into the current crisis. As mentioned earlier, all four had experienced solid growth for a number of years. Incomes rose and the size of the domestic consuming class expanded. Domestic financial intermediaries expanded, although in distinct fashions, and the regulatory regimes generally insulated these from extensive direct exposure to the sorts of toxic assets and instruments that ultimately brought down the financial systems of the OECD countries. Indeed, even as the crisis was becoming manifest, some of the BRIC countries were a bit intoxicated by their

* The other panelist were: David R. Beatty, Rotman School of Management, University of Toronto (Moderator); Antonio Borges, Hedge Fund Working Group and European Corporate Governance Institute; Ethiopis Tafara, Securities and Exchange Commission, USA; Tatsuya Tamura, Japan Outside Directors Network; and John Trowbridge, Australian Prudential Regulation Authority.

recent successes with the idea that they were now among the new power brokers of the global financial system, along with the Gulf states, hedge funds and private equity (to cite a well-reported McKinsey series of studies).

So what happened when the initial inklings of the severity of the crisis in the US and Europe started to become apparent? Well, some policy makers and economists ascribed to the “decoupling” thesis – believing that the slow-down in the rich countries would be modest and the insulation of the BRIC countries’ financial systems from the toxic assets would limit the damage to their economies.

But as the severity of the contraction in global demand set in, the BRIC countries, and the rest of the Emerging Markets began to go through the famous stages of denial:

First – This isn’t happening!

Second – It’s happening, but it won’t affect us.

Third – It’ll affect us, but the transmission effects are weak and we’ll be ok.

Then – The transmission effects are strong, but the existing framework is adequate to get us through.

And finally – OH NOOOO!!!!

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I don’t mean to lump the BRIC countries too much together. There are key differences in their initial conditions, how they have been affected and how they have been able to respond that will be very important to how each country emerges from the crisis and what role each can play in determining the landscape of the post-crisis global financial and economic system.

One key distinction we at Cartica have found interesting to analyze is where each country fits along the spectrum from political autocracy, on one end, to “chaotic” democracy, on the other. Obviously, among the BRICs, there are two countries, Russia and China that are close to one end of the spectrum, with Brazil and India located somewhere on the opposite side. The marked differences in the political frameworks probably contribute to our being able to talk about Russia’s “decision” to become a natural resource economy and China’s “decision” to pursue a path of export manufacturing-led growth; while Brazil and India found themselves before the crisis with more diverse economies, less dependent overall on exports.

Recognizing that there are limits to how much one can talk about the BRIC countries, much less the Emerging Markets, as a collectivity, let me move on now to make some observations about how each BRIC country responded to the current crisis once the denial phase was over, and what these may mean for what sort of financial system and corporate governance regime might emerge in each country.

I will start with Brazil. Under President Lula, there was a lull in the pace of economic reform. But this administration was nonetheless a time when both the public and private sectors absorbed and exploited the reforms undertaken during the Cardoso administration. Of the BRICs, Brazil’s financial market is probably the most transparent and well-regulated. The financial sector in this decade has become broader and deeper, with expanded access to consumer credit in particular, and a “filling in” of the spectrum of instruments, tenors and services. Over the past ten years, Brazil has weathered storm after storm: the election of a leftist President, 9/11, the collapses of Argentina, etc. But with the pace of reform slowed under Lula, Brazil retains a very large and costly state-owned sector, and in the financial

realm, future development of the private long-term capital markets is complicated by the dominant position of BNDES, the “Benevolent Behemoth”.

So far, Brazil’s economy and financial sector have navigated the current storm reasonably with the benefits of: apparently well-capitalized banks; the limited role of leverage in the market; large foreign currency reserves; a growing internal market; and modest dependence on exports. Indeed, the crisis has brought benchmark interest rates down to single digits. This advantageous position allowed Brazilian policy makers to employ a more or less orthodox set of fiscal and monetary measure, tax reductions and interest rate cuts that seems to be holding up reasonably well. But what does this mean about the type of financial system we can expect to see in the post-crisis? There has been some smugness, which is not good for the prospects for reform in the short to medium-term. A lot will depend on who wins the next Presidential election. And BNDES will come out of this crisis even bigger and harder to reform.

Ping-ponging to the other side of the political structure spectrum, Russ was the worst affected of the BRIC countries by the global financial crisis. It suffered an 80% stock market decline, peak to trough. The Russian economy shrank at a 9.5% rate in the first quarter of 2009. Its economy was the least diversified among the BRICs. Russia hadn’t taken significant steps to modernize its financial system. Its banking system suffers from an overhang of poor quality assets. And Russian firms had borrowed heavily in foreign currency. The government reacted to the downturn in the global economy and the decline in petroleum prices by spending up to half a trillion US dollars so far to prop up the Ruble, keep banks afloat (there are more than one thousand Russian banks) and support Kremlin-linked firms.

What are the prospects for a Phoenix to rise from these ashes? In short, don’t look for the bird to emerge anytime soon. The prospect everywhere seems to be more direct government participation in the financial system, but in Russia this is likely to carry with it more of a centralizing political agenda than elsewhere. We at Cartica are looking to see when, or if, the Kremlin moves from political opportunism and firefighting to a vision of a financial system that can contribute to growth. Will the authorities see this crisis as an opportunity to rationalize and modernize the financial sector to support a more diverse and resilient economy?

Over to India. The impact of the downturn in India was not as sharp as in most other Asian economies. Notwithstanding impressive export growth, India still retains a fair amount of the autarkic economy advocated by the Mahatma. India’s vast rural society is to some extent insulated from globalization. The Indian authorities’ response to the collapse of global demand has been a reasonably-sized fiscal stimulus package (about 7% of GDP) followed by an election campaign, which also injected a lot of money into the economy, although these amounts are not officially reported. Benchmark interest rates were also reduced six times in seven months.

What are the prospects for the Indian financial system? Indian officials are enjoying a period of triumphalism. The Congress party was rewarded with a surprisingly large mandate. But will Congress put financial sector reform back on the agenda, now that it apparently finally has the power to do so?

Finally China. China’s financial system was predicated on making cheap credit available to its manufacturing base so the latter could export China’s way to prosperity. China’s banking system has always been particularly opaque, although government attention in recent years probably meant that there were some overall improvements in asset quality and capital adequacy up to the crisis. But bank governance and transparency are too poor to be really sure that this was the case.

The centerpiece of China's response to the huge contraction of worldwide demand for its products was fiscal stimulus. One of my partners calculates that announced programs amount to 23% of 2007 GDP!

The head of China's banking regulator recently published an op-ed piece in the Financial Times extolling his country's separation of commercial and investment banking. He characterized this separation as a demonstration of China's commitment to fundamental principles of sound financial sector regulation. But he said nothing at all about transparency, governance and the importance of competitive markets, which I would have thought are even more central to the health of a financial system. At the firm level, entrepreneurs in China, especially those of SMEs face a very underdeveloped financial system. Credit remains directed to a significant extent, with the favored enterprises being those with links to the state, SOEs the party and its leadership. Much needs to be done to broaden access to finance, or China will face serious bottlenecks to continued growth and reduction of unemployment in the post-crisis period. The issue is whether China's leadership will see modernization of the financial sector as a necessary component of its recovery program.



Russia excepted, so far the financial systems of the BRIC countries and most other Emerging Markets have survived and avoided the need for the kinds of across-the-board bailouts seen in the US < UK and some other OECD economies. So there is some smugness and complacency. The question is whether the breathing room that such countries currently enjoy will result in their putting off of reforms still necessary to make their financial systems more of a contributor to growth and to adapt to changes occurring in other parts of the global financial architecture. The political element is interesting to observe. The people of the two more democratic countries – Brazil and India – seem to have rewarded their leadership for its response to the global financial crisis, notwithstanding not insignificant declines in personal income. India's Congress Party was re-elected with a stronger mandate than it had before, permitting it to govern with fewer compromises with coalition partners. And Lula's popularity is as high as ever, with him talking about running for President when he becomes eligible again. It is, of course, harder to gauge public sentiment in the more autocratic societies of Russia and China. But anecdotal evidence would indicate that there are substantial numbers of citizens that cannot be described as happy campers.