Investing in Emerging Markets: A Central Bank View *

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First, let me thank the organizer, HSBC Investment, for the invitation. Before we begin our panel discussion on investing in emerging markets, I want to use this opening remark to comment on two issues.

First, I want to highlight some of the key changes that have brought emerging markets to where they are today. And second, I want to share with you my views on the challenges from the perspective of policy in ensuring that this renewed interest in emerging markets as an asset class does not lead to risks in terms of financial distress or economic disruptions as was the case of the past, but to a more durable and sustainable investment that brings lasting benefits to emerging markets.

The growing importance of emerging market economies in the world economy, as well as improved fundamentals, have been

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highlighted by a number of speakers in the earlier sessions of this conference. But one important point that we must take note is that, as a group, the improvements in economic fundamentals and resilience in emerging markets is quite remarkable, especially considering that they were the economies that were hit by a series of financial crises less than ten years ago. Such strength clearly indicates that important changes have taken place in emerging markets, and as a group, they have made a successful recovery from those difficult years.

On this issue, two observations can be made. The first is that recovery made by emerging markets is by no means a cyclical phenomenon, but a product of a careful process of restructuring and reform that has taken place. This process of reform includes improvements in the macroeconomic policy framework and institutions, centering on stability-focused monetary policy, disciplined fiscal policy, greater flexibility in the exchange rate system, and more liberal policy on capital flows. All these have worked to lower the volatilities in output and prices, strengthen the balance of payments and external positions, and regain the confidence of investors and markets.

Another common element of reform is the consolidation and the strengthening of the banking sector that have led to better risk management and disclosure by banks, and a more thorough approach to bank regulation based on risk-based supervision and adherence to international standards. Market opening and liberalization of the domestic economy is another common reform element that have led to a more competitive business environment in emerging markets that helped spur the growth of new companies. And last but not least is the self-insurance, in the forms of reserve accumulation and closer cooperation among emerging markets in policy and market surveillance aimed at reducing susceptibility to external shocks. This process of reform, in my view, is the really important change in the nature of emerging markets that have transformed emerging markets, as a group, to what we are seeing today.

Another observation I want to make is the benefits from change that we are now seeing in emerging markets, both at the macro and the micro levels. At the macro level, we are familiar with data that point to high GDP growth rates, high savings rates, large current account surpluses, and strong balance of payment positions and international reserves.

But what is more impressive is the evidence of change and dynamism at the micro level, of which three developments stand out. The <u>first</u> is the strength of companies in emerging markets.

Companies in emerging markets are making an impact at the global level and some are on their way to become new global multinationals. In 2006, the Boston Consulting Group listed one hundred of these companies in countries like China, India, Brazil, Mexico, Russia, Turkey, Malaysia and Thailand. The <u>second</u> is the positive attitude and belief of the new generation of the working population in emerging markets who are more confident now about their abilities and the future. This, in my view, is the most important foundation for future growth. And the <u>third</u> is the growth of intra-regional trade and investment driven by the dynamism of the private sector. All these are key dynamism that will help sustain the current process of change and growth in emerging markets well into the future.

The second issue I want to bring up in this opening remark is the challenge for policy.

In view of the ongoing uncertainty in the global economy, interest in emerging markets as an asset class has increased. In the short-term, emerging markets are seen as being better positioned to weather the externally-induced volatility. In the longer-term, outlook for continued growth in emerging markets driven by strong fundamentals and supportive demographic structure is a prospect that is widely shared in financial markets. Such outlook offers many good investment themes that can accommodate a wide range of investors. These themes include infrastructure financing, development of new enterprises and companies, and the growth of intra-regional trade.

As an asset class, at this time, emerging markets offer a compelling investment opportunity in terms of diversification, yield enhancement, favourable valuations, with growing set of investment and risk-management products ranging from fixed income to sovereign, equity, credit and structured products, financial derivatives and distressed assets. This range of products is a big departure from the market situation of ten years ago, and on account of this, investment opportunity in emerging markets is now being looked at by a wider set of investors, including sovereign wealth funds.

Emerging markets, in general, welcome this opportunity. The increased flows of capital will allow emerging economies to tackle the remaining issues and raise long-term growth potentials. The key challenge, instead, is to ensure that these flows of capital are put into best use that will benefit emerging markets in the long-term, while any risk to stability in terms of financial distress from such flows is kept to a minimum.

On this, one of the key differences between emerging markets and developed economies is the extent to which macroeconomic shocks, when propagated through the economy, give rise to higher output and consumption volatility in emerging markets than in developed economies. A good example is the capital flow shocks. For example, rapid movements of capital flows into and out of Asia in the period leading up to 1997 and immediately thereafter, when interacted with financial system underdevelopment, led to a boom-bust cycle with significant costs to both short-run and long-run output growth.

But for developed economies, the experience is more of the case where large shocks typically result in substantial asset price volatility and substantial financial losses that are not accompanied by major disruptions to economic growth. And a substantial part of these observed differences is attributable to the disparate level of financial sector development in these two groups of countries.

This conclusion, I think, is powerful and is key for emerging markets in managing an efficient allocation of capital, as well as in managing risks to financial stability. For many emerging markets in Asia including Thailand, although the strengthening of macroeconomic stability and the banking sector has been achieved, a lot remains to be done in financial sector development so as to improve the ability of the economy to absorb shocks by itself in a way that minimizes the impact on the real economy and avoids risk to financial stability.

In this context, an important focus of further reform in emerging markets must be on enhancing the risk management ability of economic agents via strengthening the efficiency and the robustness of the financial system. This includes developing a well-balanced financial structure, especially the bond market, so that fixed-rate, long-term security in local currency can be offered to avoid mismatch which was a major problem of the past crisis. Development of good financial infrastructure is another important agenda in the areas of credit and pricing information, supportive legal structure, human resource development, risk-transfer mechanism, and a good system of data disclosure and accounting standards.

These changes will further strengthen the financial sector, and make it more likely that the process towards greater global financial integration will bring substantial benefits to emerging markets in terms of higher growth and fewer risks, so that in the long-term, financial stability becomes more embedded in the underlying economic structure of emerging markets, as is the case of developed economies.

Thank you.