BEWARE OF THE TIGERS

IGNORE DEVELOPMENTS IN EMERGING MARKETS, PARTICULARLY THE ASIA REGION, AT YOUR PERIL IS THE MESSAGE FROM **MERVYN DAVIES** OF STANDARD CHARTERED BANK.

One hundred and fifty years ago this year James Wilson founded the Standard Chartered Bank. What was the world like in the days of James Wilson? Things were obviously different in many ways, but what is interesting are the similarities to many of the issues we face today. During the later part of the 19th century one of the main global issues was deflation. From 1870 up until the outbreak of World War One, prices fell across much of the world. But it wasn't such a bad thing - in fact, there were periods of strong economic growth and high consumer spending.

Another interesting feature of that time was the big debate about which emerging market to invest in: should it be Argentina, or should it be the US? Fortunately, many people made the right decision and invested in the emerging market of the US.

To appreciate why emerging markets are attractive, consider the key global trends. There are three: modest growth, low inflation with low interest rates and, in this environment, investors are searching for higher yields or the sounder economies in which to invest.

GROWTH. First, modest growth. It is important not to be overly pessimistic. In recent years, the world economy has been remarkably resilient. It has withstood shock after shock, after shock. Just remind yourself, in 1997 we had the Asian economic crisis and in 1998 the Russian crisis and the collapse of the LTCM hedge fund. Then 1999 saw the Y2K problem. The Nasdaq peaked in April 2000. Since then, its value has halved. Next, 2001 brought the tragic events of September 11, with which nothing can compare. Last year, 2002, we saw a war in Afghanistan, the collapse of Argentina and corporate governance scandals.

It is remarkable that despite all these shocks, the world economy has been resilient. This year the same may prove true.

Recent US data has been strong. Last year's interest rate cuts and future tax cuts could help the country's economy. Outside of the US, Europe is weak but Japan is rebounding, helped by the strength in Asia. Even allowing for a stronger US this year, there are reasons to be cautious, and not just because of the war. Despite corporate rebalancing in the US in the last two years, firms are in no mood to invest, while US households are in need of rebuilding their savings. That is why we expect a modest pace of growth of about 3% in the US this year.

The Chartered Bank of India, Australia and China was one of the successful ventures of a young businessman, who originated from Scotland. James Wilson started his working career as an apprentice in his father's hat-making business. He moved to London as a young man, where he amassed an early fortune making hats. In 1837, aged 32, he estimated his wealth at £25,000, equal to £1.5m today. He promptly lost it, speculating in indigo. Undaunted, he set about paying off his creditors, as well as expanding his economic ideas. This year, Standard Chartered celebrates its 150th anniversary. Our first two branches were in Calcutta and Shanghai. We are a highly international company, with more than 85% of our revenues coming from non-OECD countries, and are a household name across Asia, Africa and the Middle East. Countries such as India and China are a vital part of our future.

LOW INFLATION WITH LOW INTEREST RATES. The second global theme is low inflation. There is deflation in manufacturing, although it is important that this is not blamed on China, as some commentators have done recently. There is much more to it than that. Economic policy has helped drive inflation down. After the inflation of the 1970s and 1980s, policy makers round the world adopted anti-inflationary policies. Central banks became more powerful, many independent. Then there was the internet, which squeezed margins, and now there is low-cost production.

Asia is producing low-cost, high-quality goods. Even Africa is benefiting, with inflation in sub-Saharan Africa expected to be in single digits for the first time ever this year.

With low inflation, interest rates are low. Although the long-term trend for interest rates is down, some of the recent emergency cuts could be reversed, which is an important risk to hedge against – but each peak in the interest rate cycle should be lower than the last.

YIELD AND RETURN. In this environment of modest growth and low inflation, the third theme is a search for higher yields and sounder economies in which to invest. But where are these yields? Where are these economies? In the emerging markets. The top performing equity market in 2002 was Pakistan. You would have more than doubled your money – a return of 112% in local currency and 118% in US dollar terms. All this was despite major regional tensions.

Thailand and Indonesia returned more than 20% last year. This is all the more impressive considering the weakness of more developed markets. The Nasdaq, a good barometer of risk appetite, fell 37% last year. Asian currencies, with big current account surpluses, are obviously benefiting. The same goes for African currencies – especially those producing 'safe haven' commodities, including gold (South Africa) and diamonds (Botswana). The strongest currencies in 2002 were African: the Rand rose 40% against the US dollar, and the Botswana Pula nearly 30%. The Rand is still the strongest currency so far this year.

The most important development in our business lifetimes will be the increasing influence of emerging Asia. This region – China, India, and the Asian tigers – should overtake the GDP of the US by 2025. It has already overtaken Japan. Already, these economies contribute a quarter of world growth last year. This is impressive for a region that still accounts for only 10% of world GDP. They are growing fast.

FIGURE 1
CHINA – GDP IN REAL TERMS.

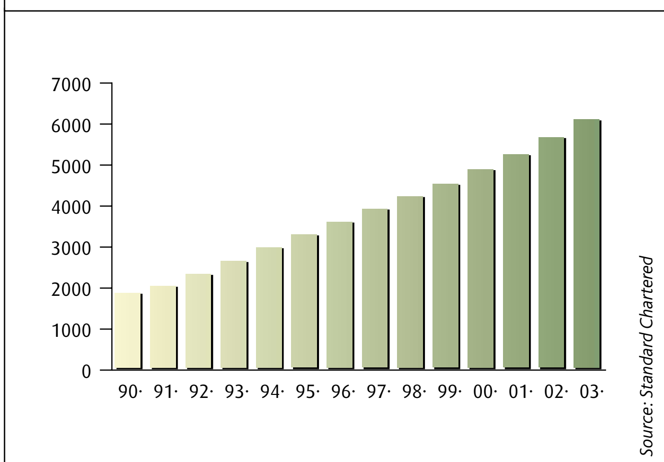
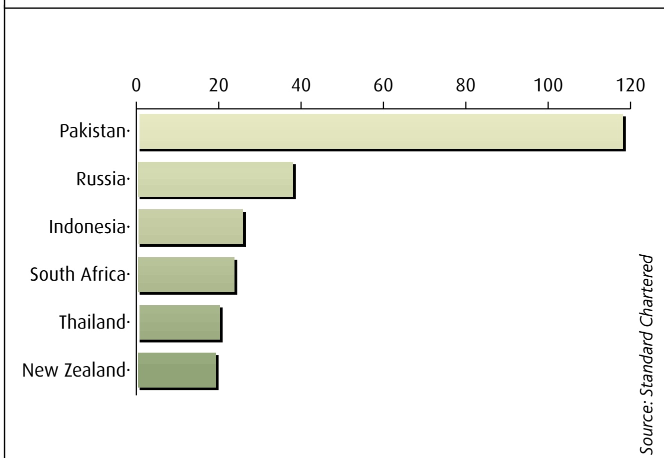


FIGURE 2
TOP PERFORMING EQUITY MARKETS IN 2002 (DOLLAR TERMS).



'ECONOMISTS CALL CHINA A 'BICYCLE ECONOMY' BECAUSE, LIKE A BICYCLE, IT HAS TO KEEP MOVING FORWARD TO AVOID FALLING DOWN'

Just as capital sought to go west 100 years ago, now capital flows are going east – and in a big way. Last year, for the first time, China was the largest net recipient of foreign direct investment. It attracted $53bn, overtaking the US.

RISKS. The biggest risks are not to do with the emerging markets but the global financial system. Last year highlighted the intense financial pressure on highly leveraged and vulnerable sectors. In the adjustment to low inflation, companies are deleveraging, by repaying debt, or lengthening the maturity of their debt. In the US, there has been a trend to share buy-backs.

Last autumn there was market concern about large commercial and investment banks. If one looks at market indicators such as credit default swap prices, the worst is over. Despite this, there are lingering concerns. Capital is not the worry, instead the concern has been earnings and profitability, with the main focus being on some of the larger US and European banks. In general, a big problem has been the way the financial sector has allocated risk.

This has become concentrated in the insurance sector and particularly the reinsurance sector in Europe. Last year insurance companies had become big sellers of credit derivatives, providing protection to banks. How will this play out? Warren Buffet's well-publicised comments have some grounding. Getting into derivatives, he said, is like entering hell – it's easy to get in but hard to leave. Buffet described derivatives as weapons of mass destruction.

In the UK, the US and parts of Europe, there is concern about household lending. Debt to income ratios are high, and there is also a pension crisis. As trustees move out of equities, you compound the problem as you are crystallising losses. Caution increases the risk. Overall, in the global economy the picture is a fragile financial sector still coming to terms with low inflation, and facing problems in Japan, the US and Europe.

BICYCLE ECONOMIES. In looking at two of the biggest opportunities, I am brought back to India and China. It is easy to see China as a giant vacuum cleaner hoovering up the world's trade. A better analogy is to see it as a magnet. It attracts inward investment to Asia. It attracts imports from the rest of Asia. Increasingly, China will be the engine for Asian growth. A new Asian trading bloc is emerging.

China's economy is already the sixth largest in the world, behind France and the UK. It has already overtaken Japan as the biggest importer from the rest of Asia. It is producing both low and high value added goods – at low cost. Half the world's shoes are made in China. It is the world's biggest market for mobile phones and, in terms of car sales, China will be bigger than Japan and Germany combined in five years, according to Ford Motors. Walmart also sources $11bn in goods from Chinese markets, mainly from the Pearl River delta region close to Hong Kong.

Yet economists call China a 'bicycle economy' because, like a bicycle, it has to keep moving forward to avoid falling down. Let's explore this theme.

If you look at four major economies in terms of bicycles, you'd have to say that in Europe the bicycle is not working – one of the wheels has fallen off, probably Germany. Japan has been pedalling hard, but for the past 10 years it has been going backwards. The US cycled hard too, but having got to the top of the hill, there was only one way to go. As for China, it sold the other three of its bicycles.

China faces many challenges. During the 1990s, the reform of state-owned enterprises led to 40 million redundancies. That is like putting the whole of Spain out of work. But so far its policy-makers have done a remarkable job. China's growth is having a significant influence on the rest of Asia. Places such as Hong Kong, Taiwan and South Korea have become two-speed economies. The parts of the economy tied to China trade are doing well, while domestic economies are in painful transition.

Hong Kong, for instance, is tied to the Pearl River delta, which is the fastest growing part of the fastest growing province of the fastest growing country in the world. Western companies are huge investors there, but there are also local companies which are developing on a big scale. Some of them will become well known names to all of us within the decade, just as the Japanese companies broke through in the 1980s.

DEREGULATION AND INDIA. The other big factor in Asia is India. Just as China is becoming the manufacturing centre of the world, India is becoming the service and software centre of the world. Companies everywhere are outsourcing to India. Like many international companies, we have set up a technology and operations hub in India, in the city of Chennai. We also have a smaller hub in Kuala Lumpur.

We employ 2,200 people in these hubs. Of these, 98% of them are graduates, 45% have post-graduate or business qualifications. It's a highly skilled, highly motivated workforce. We are doing much more than simple processing there.

Looking at the skills base and the lower costs, India is going to be a challenge for a service-led economy, like ours in the UK.

CURRENCIES. On currencies, the key issue this year is talk of a softer dollar. European investors have kept more of their money at home, strengthening the euro. Now sterling itself has started to decline against the euro. When it comes to the dollar, however, Asia holds the key. Four-fifths of the US trade deficit is with Asia. Asian central banks hold huge dollar currency reserves. Japan holds $478bn of reserves. China holds $300bn, Taiwan $160bn, Hong Kong $91bn, and Singapore $81bn. Even India now holds $71bn. Imagine what would happen to the dollar if these countries decided to change their currency policy?

In recent years, Asian central banks have not wanted strong currencies, they wanted strong growth. Along with strong growth, they will have to accept stronger currencies. A key issue will be the Chinese currency. There is pressure for the Chinese currency to appreciate. Four years ago people called for China to devalue.

Given the need for economic stability, the Chinese are most likely to keep their currency stable. But as their economy booms, the renminbi will appreciate in time.

While the world is transfixed by US policy efforts to stage an economic recovery, attempts by Asian policy-makers to gain greater independence from western capital flows have gone widely unnoticed. Thai Prime Minister Thaksin Shinawatra is at the forefront of efforts to pool Asian central bank reserves and use them to buy Asian government bonds. This plan has won vital backing from Japan and Singapore, and could leverage more than $1 trillion in Asian foreign exchange reserves.

'THE REAL RISK IS NOT UNDERSTANDING THE MARKET IN WHICH YOU ARE OPERATING. THE NEED TO KNOW THE ECONOMIES AND WHAT DRIVES THEM, THE POLITICAL ENVIRONMENT, AND THE REGULATORS, ARE ALL ESSENTIAL'

EMERGING MARKET RISKS. There are risks in operating in the emerging markets, just as there are in developed markets. The real risk is not understanding the market in which you are operating. The need to know the economies and what drives them, the need to know the political environment, and the need to know the regulators and be on top of regulatory change are all essential in this understanding. You need good partners, local knowledge and local talent.

SIX LESSONS FOR TREASURERS. What then are the lessons for corporates? There are six, explained briefly as follows:

- the ability to play a pro-active role with regulators, particularly in the emerging markets – you must worry about this;
- the need for risk management – especially in this environment in the foreign exchange market – wherever possible, raise money locally, the capital markets are gaining depth;
- as the interest rate outlook varies considerably from country to country, there are great opportunities. In the US, as rates are already low, companies may wish to fix, but in many emerging markets, where rates are still high but are set to fall further, there is the need to move funding from fixed to floating on the liability side;
- the ability to take advantage of opportunistic funding;
- the importance of liquidity in this uncertain economic climate; and
- the growing importance of the emerging markets, particularly in Asia, in which to invest.

WHERE IS THE UK FIT IN? Having worked in the UK, the US, Singapore and Hong Kong, I am in no doubt that the UK has the most sophisticated corporate treasury market. The shocks that you may now get going forward will not be necessarily interest rates but changes brought about by a fundamental restructuring of world industry.

UK companies are going to face competition from places such as China and India. There is a fundamental reallocation of labour round the world. The question to ask: is your company part of it?

The only way to compete is to take advantage of opportunities in these markets yourselves, whether sourcing from them, selling to them or investing in them.

Management teams must be challenged on whether goods could be manufactured cheaper in China, or whether the service part of the company could be done in India. The real challenge is to look beyond Europe and persuade directors to take these markets really seriously.

Mervyn Davies is Group Chief Executive at Standard Chartered Bank.
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