



The Ascent of the Pacific Region

Consequences for the Atlantic Business Community

Speech at the 36th St. Gallen Symposium, St. Gallen, May 19, 2006

James J. Schiro, CEO Zurich Financial Services

Less than ten years ago, East Asia was mired in a financial crisis. Loss of investor confidence had led to capital outflows, currency depreciation, and high interest rates. An “economic miracle” laid in shatters. The situation was made worse by the fact that Japan, Asia’s then dominant economy, was trapped in stagnation. The outlook for the region was bleak.

Today, we are looking at the world’s most dynamic region. Japan is back, and Asia has become the global work bench. It is also host to service centers for IT and process outsourcing from the United States and Europe. So, it is not surprising that the topic of Asia’s economic ascent appears on sessions like these, and I am happy to tackle it as CEO of a large global insurer.

When discussing Asia, China is obviously on everybody’s mind. Over the last years, it has acquired a decisive impact on the world. Its contribution to global growth was bigger than America’s, and more than half of the combined impact of India, Brazil and Russia. China is now the world’s fourth-largest economy behind the United States, Japan and Germany, and the biggest holder of foreign reserves. At last count, they exceeded 875 billion dollars, and growing at the tune of 25 to 30 billion dollars a month, they will soon reach 1 trillion dollars.

Whether we like it or not, this raises questions about the functioning and stability of the global economy. China’s potential to disturb forex markets has been driven home earlier this week when Beijing allowed the Chinese currency to break the psychologically important marker of 8 yuan to the dollar. This was widely interpreted that the pace of yuan appreciation – and conversely dollar depreciation – may pick up in the future. We are reminded of a

remark attributed to Napoleon, “let China sleep, for when she awakes, the world will tremble.”

But the world doesn't need to tremble. Of course, Asia's economic ascent has implications for the world. Never before in history, and never as quickly, have more than 1 billion new workers entered the global work force, leading to an almost exact doubling of its size. This is bound to have a profound impact on the labor markets of the whole world.

Nevertheless, we should maintain a sense of proportion. Although Asia's growth and China's performance in particular are impressive, they are not unprecedented. Other countries, notably Japan in the 1950's and the United States and Germany between 1870 and 1913, have grown with similar speed. The integration of another fast growing region into the global economy will be manageable, just as other emerging giants had been integrated in the past. To be sure, it will be a challenge, but we should accept it with confidence based on our inherent strengths.

This sets the stage for my remarks. First, I would like to look at opportunities for businesses arising from Asia's ascent. In doing so, I will gloss over the vast differences in the region. My focus will primarily be on the emerging markets of Asia and their role in resetting the equations of global competitiveness. I will also address the sustainability of current trends, and I will conclude with a look at a few issues and a discussion of some challenges facing Europe.

So, what are the prospects for business?

I believe there is no need to impress on this audience why Asian markets are important for global businesses. These are young economies with the promise of high growth rates and billions of unmet needs. More than half of India's population is younger than 25, and there is a well-established middle class with a growing purchasing power. The same holds true for China where the creation of a prosperous middle class is one of Beijing's explicit goals.

Let me illustrate the pull of the Asian markets with figures relevant to my own industry. Less than 4% of the Chinese have an insurance policy, and less than 3% of the Chinese market is

supplied by foreign insurers. Throughout the region, measures for insurance density and insurance penetration are very low. Recent catastrophes in Asia have painfully reminded us of the vulnerability of societies in which insurance has yet to play the role it does in our advanced economies. Of course, the lack of insurance is in large part a reflection of underdevelopment. But insurance could have made a difference, and that's why it is vital that the insurance sector is developed in these regions.

Zurich has been active in Asia for more than 40 years. As you know, some markets have been rather difficult for foreign insurers. The Indian branch office that we had opened in 1962 was nationalized 10 years later. In other countries, financial and political instability took their toll and we have resized our activities accordingly. Now that stability has returned, we see a readiness to accept foreign know-how throughout the region. Based on our distinct global expertise in risk management, we are convinced to offer win-win solutions for all stakeholders.

Earlier this week, the China Insurance Regulatory Commission announced that Zurich was granted approval to operate out of Beijing, which will make us the first foreign insurer to do business from the Chinese capital. Since the paperwork on the license has yet to be completed, I prefer not to comment specifically on the approval. But we have been present in China since 1993, first with representative offices in Beijing and Shanghai, and then with a minority stake in New China Life, the fourth-largest life insurer. These activities underscore our interest in the world's most dynamic economy, and we are ready to do business.

But we should not put the cart before the horse. For private insurers to play a meaningful role in emerging countries, functioning markets must be established first. Contract certainty has to be guaranteed, and economies must attain a development stage that allows for profitable pricing in a competitive environment. It also requires a stable financial sector, which in turn depends on stable financial markets deep enough to generate the capacity for the transfer of risk. Macroeconomic stability must go hand in hand with measures to improve the financial strength of insurers and products designed to withstand financial stress.

This is an ambitious agenda. It requires cooperation and commitment. I believe that foreign insurers can make vital contributions to the development of a thriving insurance sector in Asia. They can transfer critical technical skills in underwriting, reserving as well as asset and liability management. However, for this to happen, the countries will have to make more meaningful steps to open their markets for investments by foreign insurers. But let us not deceive ourselves – ultimately, the insurance sector must develop on the strength of local skills and domestic institutions.

The lack of strong institutions in support of functioning markets is one of the many reasons why we continue to hear doubts about the sustainability of Asia's growth record, the point I would like to address now.

To be sure, we have seen much progress since the crisis of 1997. Transparency on cross-border transactions and the quality of prudential supervision have been improved. But corporate governance in much of Asia continues to rank in the bottom half of all countries surveyed by the World Bank. Furthermore, the quality of growth has been uneven. India, for example, is known for limiting infrastructure deficiencies, while in China rapid growth came at the price of environmental degradation. This is coupled with misallocation of capital caused by an inefficient banking system, and – a more recent trend – underinvestment in vital social services such as public health and education. These distortions are bound to create social tensions that may turn into serious challenges for the stability of the political system.

To paraphrase it differently: much of Asia has yet to complete the transition to a market-friendly framework for growth that is both inclusive and sustainable. The economist Paul Krugman once said that the Asian tigers had grown more as a “result of perspiration than inspiration.” What he meant was that they had grown through the rapid transition from an agrarian to an industrialized society. They simply brought more people to work. But the productivity-enhancing and ultimately welfare-creating benefits of market-led growth, which is based on strong institutions, sensible regulations and the rule of law has yet to fully materialize.

Despite these deficiencies it would be wrong to give up. Rather, we should take a long view. The region's dynamic growth is proof of the potential that even modest degrees of openness and market-friendly development can unleash. The genie is out of the bottle. If we trust our rhetoric, we must believe that Asia will continue to move on the path toward free markets and – ultimately – open societies.

There may and will be set backs. But in the end, “peaceful commerce”, as Adam Smith would have called it, and an even better integration of Asia into the global economy will likely be the best guarantee for the region's sustained progress. We should not underestimate the power of economic forces. A couple of weeks ago, when China's President Hu Jintao visited the United States, he stopped to see the chairmen of Microsoft and Starbucks before shaking hands with President Bush. Obviously, this was President Hu's bow to reality. We do not have to be Marxists to accept that real power resides in economic and not military might.

This is where the challenge for the industrialized countries comes in. The real or perceived threat of ultra-competitive Asian economies has weakened the political support for open trade and capital market liberalization. Acceptance of the system designed at Bretton Woods in 1944 and implemented under the umbrella of the Pax Americana is waning. Instead, we see a retreat to protectionism and economic nationalism, coupled with globalization fatigue.

This unfortunate development, which can be spotted on both sides of the Atlantic, could be detrimental to our prosperity. The argument that globalization is harmful to our economic well-being is flying in the face of facts and it is based on bad economic reasoning to boot. Let me quickly address each of these points in turn.

First, Asia's ascent is a positive trend all around. Primary beneficiaries are, of course, literally the several hundred millions in Asia who were fortunate to have escaped poverty. Is it really a threat to have more than one fifth of the world's population raise its standard of living? Would we rather see Asia poor and starving? Clearly, the answer to both questions is no.

But there is more to the benefits of globalization. Western consumers tend to forget that manufacturing prices have been kept low because of competitive imports from Asia. Also, American home buyers have benefited from affordable mortgages because Asian central banks used their foreign exchange reserves to purchase US treasury bonds. This was certainly one of the reasons why global interest rates have been exceptionally low for such a long time.

Now to my second point: the discontent with globalization is also built on bad economics. Of course, western producers of goods now manufactured in Asia are coming increasingly under pressure and there will be painful adjustments. But the allegation that Asia is more competitive than the West and will drive all manufacturers into bankruptcy is absurd. Equally absurd is the fear that Asian competition will drive down living standards in the industrialized world. However, the defense of our way of life will not be easy. We must pro-actively embrace change and not withdraw into the seemingly comfortable cocoon of protectionism.

Germany, for example, continues to be the world's export champion, despite the fact that German labor costs are the highest in the world. What determines competitiveness is relative or comparative and not absolute cost advantage. This advantage arises from having access to a well educated and highly productive labor force. We must take care of this asset. Better trained workers, but also more flexible labor relations, will go a long way in defusing the potentially adverse impacts of globalization. It would behoove the business community to make this point more forcefully. The debate about the gains and losses from globalization should not be left to the shrill voices of discontent.

Let me turn to another concern which is associated with global capital markets and that needs to be defused. A big risk for the health of the global economy arises from the large current account imbalances in Asia and the United States. In a nutshell, Asia's citizens are saving more than they invest, while Americans have a much bigger appetite for investments than for savings. This situation is not sustainable, and the longer we wait, the more unappealing the necessary adjustments will be. Many believe that a disorderly resolution of the economic imbalances could spark a global recession.

Unfortunately, the architecture of the global financial system is not geared to addressing this problem constructively. Meetings of the G-7 – or G-8 if we add Russia – exclude China, the world's biggest holder of reserves and biggest supplier of cross-border capital flows. To recall: the G-7 process was started when policy coordination and exchange rate policies were mainly of concern to industrial countries and when the only interaction with emerging markets was a matter of periodic debt crises.

These premises are no longer met. At least one country with a significant influence on the global economy is not admitted to the table. Although the pressure on Asian countries – and on China in particular – to appreciate their currencies relative to the dollar, and thereby contribute to the defusing of global imbalances, has been increasing, Asian leaders have shown little interest in participating in solutions to which they were not invited to contribute.

Multilateral institutions must be relevant for the problems they portend to address. I do not wish to belittle the issues. The inclusion of China and India into the international policy coordination poses delicate issues for the representation in relevant forums. I welcome that at its spring meeting, the International Monetary and Financial Committee has instructed the IMF to come up with new governance rules that better reflect the changing international economic weight of countries in the global economy. One consequence of this rebalancing may be that Europe will have to give up its overrepresentation in international institutions. This is a sobering thought. But I believe that it would not necessarily have to be coupled with a reduced influence of a truly integrated and economically powerful Europe. The question is whether Europe is ready for the challenge.

One often hears the argument that global imbalances are not a European problem. This may be true if we looked at current account figures only. Euroland is running a small current account surplus with the rest of the world. But complacency is unwarranted. While Europe may not be part of the problem, it will be certainly part of the solution. An abrupt adjustment of global imbalances could easily drive up the external value of the euro with a non-trivial risk of deflation and recession in all of Euroland.

It does not need to happen. But it would require the strengthening of European economies by making them more flexible and resilient in the face of shocks. Today's forum is not the place to rehash the well-known list of economic reforms in Europe. At least in principle, European leaders know what to do. The Lisbon Agenda would provide for many vital steps. Perhaps, the threat of Asia's competitiveness can concentrate the minds in the capitals of Europe and convince the politicians of the need to act. Completing the single market for goods, services, capital and labor should be a top goal, and paying more than lip service to the benefits of financial sector deregulation could bring additional impulses.

Let me add one of my pet projects to this reform list. Strengthening the insurance sector is to a large extent dependent on efficient regulation. As luck would have it, we are in the fortunate situation that work on the future of EU-wide insurance regulation has just begun, which provides an opportunity for rebuilding the regulatory structure almost from scratch. If successful, it will be a competitive advantage for European insurers that are active in global markets.

This agenda has also far-reaching consequences for countries that are not members of the EU. In Switzerland, the proposal to put the Federal Banking Commission and the Federal Office of Private Insurance under one roof has the potential to increase the effectiveness of Switzerland as a hub of the global financial services industry. Clearly, joint supervision of these two sectors recognizes that banks and insurers are often confronted by similar issues. While the proposal for a joint financial market authority – or FINMA in short – goes into the right direction, we should be mindful of two issues.

First, seemingly similar issues should not muddle the fact that banking and insurance are not the same businesses. In particular, the long-term nature of many insurance contracts defines an important difference. Hence, an integrated supervision must ensure that banks and insurers are treated differently whenever the nature of their business is different. Above all, this requires specific skills in the separate entities entrusted with bank and insurance supervision. Prudential regulation of insurance should not become the stepchild of bank supervision.

Second, FINMA must be strong. As markets grow together and regulation tends to spill over from one jurisdiction to another it is important for FINMA to be internationally recognized. Otherwise, Switzerland will be left behind and its financial services industry disadvantaged. That's why the governance structure of FINMA must be state of the art, enabling it to be recognized as competent and strong. Only an agency with these properties can mitigate the threat of regulatory spillovers and ensure a level playing field in the global marketplace.

As to the European Union, the reality is that we are not anywhere close to the completion of the single market. To the contrary, we see obstacles left and right. If events in France and Italy are taken at face value, one could believe that the core of Europe is not prepared to tackle the necessary economic reforms. However, gloom may be unwarranted. Britain under Margaret Thatcher, but also smaller countries such as the Netherlands in 1982, Ireland in 1987, and Finland in the early 1990s have shown that tough reforms to make countries more competitive and prosperous can happen. Perhaps, politicians in the larger EU countries need to make the transition from an inward-looking to a more open and self-confident policy framework that is better prepared to accept the challenges of the global economy.

Globalization is often seen as fostering a race to the bottom that needs to be avoided at all cost. But behind this fear is a misinterpretation of economic development. Moving steadily up-market is its natural feature. The biggest worry in developed countries appears to be that they have lost the capacity to create wealth. It is not the fear that China – or Asia for that matter – will become a more formidable competitor. It is rather the concern that the developed world will lose in vitality and stop being prosperous. There is no reason why that should happen, and, in fact, economic history provides solid counterfactuals. But if it should happen, we would have no one to blame but ourselves.