# Ajith Nivard Cabraal: Harnessing sustainable growth in emerging markets

Keynote address by Mr Ajith Nivard Cabraal, Governor of the Central Bank of Sri Lanka, at the 2nd World Management Summit 2008, Karachi, Pakistan, 11 March 2008.

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As salaam Aleikum, Ayubowan, Good Morning.

Mr. Chairman, Distinguished Delegates, Ladies and Gentlemen,

At the outset, I wish to thank the organizers of this World Management Summit for inviting me to deliver the keynote address. I am also greatly touched by the wonderful hospitality accorded to me in this very interesting and historic city of Karachi.

Mr. Chairman, I consider it a privilege and honour to share my thoughts and views on a very timely topic, "**Harnessing Sustainable Growth in Emerging Markets"** at this important forum. I hope I would be able to plant a few seeds in your distinguished minds so that such seeds may be nurtured by you in your deliberations to follow.

**As a first step, let us examine the current global and regional trends in relation to World Economic Growth, so that we could deal with this topic in a wider perspective.**

As we know, over the past few years, the global economy has been experiencing one of its' strongest sustained periods of growth, since the early 1970s. This expansion is projected to be very strong even after accounting for the impact of the recent financial market turbulence. **Significantly, this growth has, as its foundation, the strong results of the emerging markets which have been leading the way.** In fact, during 2007, China's economy grew by over 11 per cent and it made the largest contribution to global growth. India grew at more than 9 per cent and Russia at almost 8 per cent. These three countries accounted for one-half of global growth over the past year, while several other developing countries also maintained their own robust expansions. In fact, the rapid growth in these countries counter-balanced the moderate growth in the United States and other advanced economies.

**The current global expansion is remarkable in several ways**. First, emerging markets and developing countries are now accounting for a high share of growth – more than two-thirds, compared with about one-half in the 1990s; Second, the successes arising from rapid growth are not being enjoyed by a few countries only – most countries and regions are doing better in comparison to their own past standards; and, third, the volatility of growth has declined substantially. For example, the Sri Lankan economy has grown at well over 6% during each of the past 3 years and in 2008 too, a growth of 7% or close to 7% is projected. Pakistan too has recorded an average growth rate above 7% during the last 4 years.

Mr. Chairman, until the last decade, there was a clear relationship between global economic growth and the growth in advanced economies. As a matter of fact, when major economies, particularly, the USA, recorded a slow down, it retarded world output significantly. So much so, it was said that when the USA got a cold, the others got pneumonia! **However, recent trends show that the world economy is no longer overwhelmingly reliant on the advanced economies only.** In fact, the weights seems to be gradually shifting with the emerging global economy recording strong growth performances during recent years, while the advanced economies are basically recording moderate growth. It may therefore be useful to "flag" this important aspect when we are discussing the issues relating to harnessing sustainable growth in emerging markets.

**Let us consider as to what extent the current expansion in emerging markets and developing countries is due to the implementation of good policies, or as to whether it**

**was just good luck that made this happen.** What is the secret behind this remarkable performance of emerging economies?

A simple assessment may probably tell us that the main driver of the recent expansion has been the fast integration of these developing nations with the global economy, and the rapid opening out of their economic activity. All three major emerging economies, China, India and Russia, were basically “closed” economies a couple of decades ago. Emergence of these three giants, who collectively account for 20% of land area on the earth and serve as home for 40% of world population, has dramatically changed the shape of world trade, direction of capital flows and the growth sources of the global economy. In fact, during the last decade, the share of advanced economies in global trade reduced gradually from around 75% to around 60%, while the direction of investment also reversed, as evidenced by the fast accumulation of foreign reserves by the emerging nations.

In the meantime, we would also observe that these and other developing countries have benefited immensely by the prudent policies that they have implemented for the rapid economic development of their emerging economies. **These improvements include more disciplined monetary and fiscal policies, more focused institutions, and more responsible financial sector developments.** In essence, the recent success of emerging economies could be explained, to a significant extent, by conventional growth theory. **Improvements in physical capital stock; improvements in human capital; and improvements in productivity.**

**We all know that according to growth theory, increased GDP growth leads to an increase in per capita incomes, which in turn leads to a significant improvement in the quality of life of people in a country**. **We also know that, right now, significant growth is taking place. But, will it continue to happen? Can we ensure sustainability of this outcome? Upto what point is it going to be tough for the countries to keep on achieving?**

Many economic experts believe that the immediate challenge that is before the developing nations is to reach a per capita income target of around US $ 2,500 as quickly as possible. It is no secret that, when a country surpasses a threshold per capita income of around US$ 2,500, it provides a new impetus to policymakers, key stakeholders and the people as a whole, to launch into a new phase of development. Thereafter, the process of development takes place more smoothly and naturally. This is due to several reasons. First, at the new levels of income, a society naturally attains certain standards, including stronger business ethics, better behavioral patterns and wider national integration. Second, at the new levels of income, people are able to plan their investments better, as they can look beyond matching their income with the cost for basics. This includes not only financial investments, but also includes investments in skill and knowledge, upgrading and investing on physical health, both of which boost factor accumulation with less effort. Third, as income levels increase, even a lower growth rate means a higher increase in income in absolute terms.

**But, moving towards that magical number is not going to be easy. In today’s trying conditions, it would be even more difficult than in the past when many of the old established advanced nations crossed the magical mark.**

As we know, many of today’s advanced nations passed that threshold under very different conditions than what the emerging economies are facing today. In fact, during those early days, some of those countries were able to freely utilize the labour and resources of the countries that were colonized by them, and benefit immensely by the fruits of the foreign lands and natural resources. They had to adhere to very few laws and regulations relating to education, training, health or labour practices, or standards on working conditions. There were no environmental laws or treaties, and the environment was often the first casualty in their quest of accumulating wealth. Capital accumulated by illegal means or criminal activity was used freely without any restriction.

But, today the situation is completely different. Today, emerging countries are acting in a much more responsible manner in driving their economies forward. In fact, the present day emerging economies are achieving their attractive levels of growth, while adhering to, and respecting international conventions on copyright, anti-money laundering and terrorist financing, environmental, labour, human rights, safety, health, etc., etc. This situation is sometimes forgotten by some of the economic and political analysts, particularly from advanced nations and therefore it may not be too inappropriate to remind the world of this state of affairs, on and off.

**All in all, from the point of view of individual developing countries, the most important economic need at present is to maintain the high economic growth momentum that they are currently achieving, in a sustainable manner.** Although it had been tough, it is heartening to note that many developing countries have, since of late, been able to do so. But the challenge is becoming more and more intense by the day, and policymakers have to be constantly alert to developments on several fronts simultaneously, in order to continue with the same momentum. Investments have to be boosted; institutions need to be strengthened; infrastructure has to be improved; regulation has to be strengthened. In addition, all this has to happen at the same time.

In the meantime, global challenges and risks loom large. **Some of the downside risks are so intense and serious that those could even threaten the very foundation of the present growth momentum, and drag the developing nations as well as the entire world economy towards recession!** There are many such dangers lurking. The current financial market turmoil could trigger a more pronounced global slowdown. The unbelievably high and volatile oil prices and the resulting inflationary pressures could lead to severe BOP problems, disrupt capital inflows and cause large global imbalances. The aging population, the intensification of resistance to globalization, the havoc that may be caused by global warming and the danger of terrorism could all lead to serious repercussions to the sustainable growth models that the economic planners are attempting to implement.

**But the good news is that there is sufficient evidence to indicate to us, that many developing countries are implementing a number of structural changes order to face upto these growing threats**. Improved monetary and fiscal policies, improved institutions, and better financial systems, etc., are clearly helping to stretch the current positive business cycle, notwithstanding the numerous threats.

**However, we must not be complacent**. We must not underestimate the recent increased financial market volatility. We must not take the oil shock or the inflation pressures lightly. We must not ignore the imbalances that are being generated by the aging population. We must not think that the resistance to globalization will just fade away. We must not conclude that terrorism is someone else's problem and therefore it will not affect us. We must not imagine that global warming will impact only a few coastal nations and therefore we will be safe from its effects. In contrast, we must anticipate the threats and prepare ourselves to face it with confidence. Needless to say, if these challenges are not adequately addressed, or faced directly, the fall out could result in serious repercussions that will greatly hamper the continued success of the current expansion.

**Mr. Chairman, another interesting phenomenon is that, while most countries seem to be growing well at the aggregate level, there are also growing concerns about the equitable distribution of these gains**. It is clear that rapid technological progress and continuing globalization of trade and finance have helped to enhance growth and reduce poverty. But the same conditions are also contributing to increasing the concentration of income and wealth, within certain selected groups. In general, owners of capital and scarce skills have been well rewarded, while, less-skilled workers and those with limited access to jobs or finance have enjoyed limited gains. While it is obvious that such an outcome poses serious political risks, even from an economic point of view, inequality raises an economic issue since it implies that human resources are not being productively used. Therefore it follows that, unless this imbalance is addressed, it would probably manifest itself in dangerous political upheavals, which could easily negate the economic gains that may have been so painstakingly built up.

In recent years, the global expansion has been supported by the ready availability of external financing at relatively reasonable interest rates. Credit has been readily available, particularly as a result of innovations in financial market instruments which were supposed to have improved liquidity and distributed risk better. But those innovative models are today facing increasing pressure, and economic planners are in the process of re-thinking these processes. **Therefore, in the near future another serious issue that we may have to face in our effort to achieve sustainability in our growth momentum would be that, over time, global savings may well become more scarce, putting upward pressure on real interest rates**.

**Mr. Chairman, twice during the first half of the last century, the prosperity of the world was severely threatened by devastating world wars.** Fortunately for us, the concerted efforts of many statesman-like leaders and other far thinking persons who served in respected international organizations, that danger was averted. Nevertheless the world paid a huge price for that terrible experience. **But, today in a different way, the world faces another destructive force of terrorism**, **which is almost as debilitating as the horrible world wars of the past century.** As a result, from the world's advanced economies to the lesser developed economies, many countries have to face some aspect of terrorism; directly or indirectly. These evil forces, if not eliminated, will soon hamper the global economic growth in many ways. It will destroy physical and human capital. It will weaken infrastructure development and institution building. It will force governments to divert more and more resources to national security and terrorism prevention. It will result in reduced resources that can be channeled to developmental efforts. In that context when we are focusing on sustainable growth, the ill-effects of terrorism must also be clearly identified and we must all take, as well as support, the necessary steps to deal with this threat, both politically and militarily; both locally and internationally; both directly and indirectly; both individually and collectively.

**The ever increasing oil and energy prices is another serious concern for all economic planners.** International prices of oil, as we all know, has increased five-fold during the last 6 years. As the world bravely adjusts daily to these unconscionable and wild increases, the oil producers enjoy the unprecedented gains. In this background, we cannot realistically expect oil prices to reduce in the near future and therefore we would have to consciously brace ourselves to deal with the harmful effects of this highly destructive attack on future growth, if we are to maintain our growth momentum.

**As if the of oil shock was not enough, the international commodity prices too, have been rising sharply during the past year or so**. This outcome possibly displays how tightly linked the prices of commodities are, to each other. As a result of these increases, which resulted in the global food price index recording a 54% increase over the past year, many countries are now facing their highest recorded inflation figures in the new millennium. China's inflation in January 2008 was at its highest in 11 years. In Singapore, it was their highest in 25 years. Australia recorded their highest figure in 16 years. We, in Sri Lanka also recorded our highest rate in 18 years while we know Pakistan too is struggling with its inflation, amidst high food prices.

**In this volatile scenario, the challenge before the emerging countries is how to maintain price stability, without hampering the growth momentum.** Unfortunately, in the backdrop of high international oil and commodity prices, there does not appear to be an easy escape route or a quick fix. Worse still, many experts are now proffering the view that the current increases in oil and commodity prices may be a "structural adjustment" rather than just another "supply shock". If that is the case, the present sky-high prices may not return to their previous low levels. If so, policymakers will have to factor that situation into their future projections. Then the billion dollar question will crop up: What do we do? If we allow domestic prices to adjust in line with the high international prices, we will immediately face high inflation. On the other hand, if we subsidize these commodities using inflationary financing, the result is again, even more high inflation in the future. Not very attractive options! But, countries have to make choices now, particularly because it is highly unlikely that this problem will go away.

Mr. Chairman, we have so far discussed at length, the current trends in economic growth, and the challenges that we have to face in our attempts to harness sustainable growth. **Now, let us get to an even more critical part of this discussion. How do we continue to harness sustainable growth in our own economies? How do we protect our growth momentum?**

Before we really get down to discussing the factors surrounding this issue, let us see as to what usually happens in the world when nations are faced with serious threats to their economic well being. In the early 1970s, when oil prices increased sharply, many countries quickly started their own oil exploration and development. When doing so, several oil reserves, which were, up to that time, believed to be uneconomical for development, were suddenly qualifying as being "economical". In other words, many countries re-positioned themselves to become "net commodity exporters" from being "net commodity importers", in the face of rising prices. They were quick to understand that such a shift was vital for their future economic development and well being. As in the 1970's, today too, there is a clear trend where countries are quickly attempting to boost their capacity to produce oil and agricultural commodities. If, as expected, this re-positioning and/or restructuring occurs, and occurs quickly, the current imbalances will be addressed sooner than later. In fact, if we look at the recent increases in bio-fuel production, it has clearly been a case of steady increases in the production of all varieties of oil substitutes, all over the world. In that sense, the current vibrant and challenging economic environment provides new and exciting opportunities to both developing and advanced countries, and many countries seem eager to seize opportunities and implement decisions quickly.

**Mr. Chairman, at the same time, we should also probably realize that in our constant search for sustainable growth, the more regular issues that confront emerging economies also need to be addressed appropriately through a series of fundamental policy actions. Let us therefore, for completeness sake, take a quick look at some of those policy actions as well.**

**One, the sound management of risk**. As the pace of globalization intensifies and massive flows of capital take place, on-going reforms in regulation and supervision, the development of domestic capital markets, improvement in corporate governance and an adequate and credible legal framework have to take place effectively.

**Two, the maintenance of sound macroeconomic policies.** Sound fiscal and monetary policies leading to low and stable inflation and an environment of exchange rate stability and sustained private sector investment is vital for sustainable development.

**Three, the implementation of policies that promote domestic savings and investment**. It is important to note that while a steady flow of foreign savings is important for emerging markets, efforts to mobilize domestic resources are equally critical for long-term growth.

**Four, the maintenance of reasonable debt levels** so that the repayment capacity of the economy is not compromised, even if some of the major risks were to materialize.

**Five, the improvement of the quality of information and statistics relating to all sectors of the economy**. This policy action ensures the widespread and timely dissemination of information, thereby encouraging robust economic activity.

**Six, the continuous expansion of trade** by lobbying for major changes within the industrialized nations, while promoting greater trade among the emerging economies and within regions.

**Seven, the rapid implementation of consistent and significant poverty reduction programmes and infrastructure development projects** so that it provides opportunity and hope to the poor and addresses regional imbalances.

**Eight, the active use of technology in economic transformation**, so that backward societies or groups could "leap-frog" rather than drift along at "snail's pace".

**At the same time, we also have to keep in mind that the sustainability for growth in developing countries will be greatly enhanced by political stability**. Therefore, care must be taken to ensure that any political crisis which threatens to undermine economic progress needs to be resolved quickly and satisfactorily, so that the growth momentum will not be hampered in the short to medium terms.

**Mr. Chairman, we should all be glad that we are today here in Karachi, deliberating on the topic of "Harnessing Sustainable Growth", because it is a topic that will touch our lives very closely, today as well as tomorrow**. In doing so, we will naturally have to closely study the worldwide conditions, trends, needs, challenges, future strategies and the many issues connected to the realization of this outcome. It is certainly a complex topic, and it will not have cut and dried answers; nor will it have an easy path, free of obstacles. At the same time there is one fact that we must all be very clear about. i.e., <u>harnessing</u> growth will only be the beginning. If so, we must all realize that while the beginning would be vital, we would need to methodically build capacity to <u>sustain the growth</u> and to keep going, amidst whatever challenges we may encounter. **Implementation of policies would therefore be the key to sustainable growth.**

People could, of course, eloquently <u>talk</u> of sound monetary policies; effective fiscal policies; well structured private/public partnerships; super regulatory institutions; vibrant markets; skilled managers; technical capabilities; clean environments; safe living conditions; developed infrastructure; speedy justice; transparent systems; stable governments; corruption – free societies; free media; lower crime; balanced development; trickle down effects; equal opportunities; equitable distribution of wealth; good living standards and a whole host of similar outcomes. But, mere talk of such conditions would not lead us to achieve those goals or achieve high sustainable growth. If we are to realize all those outcomes, the continuous implementation and close monitoring and evaluation of all our programmes and policy actions is essential. That then, is the key.

Let us remember that it is better to implement one action than write 100 reports that no one takes notice of. It is better to deliver one outcome than deliver 100 speeches that no one listens to. It is better to improve one life than organize 100 workshops that no one finds useful. It is better to light one candle than curse the darkness! This then, my dear friends, is the challenge that is before us.

Very often, we encounter prophets of gloom and doom who attempt to demoralize us by showing off the magnitude of the problem or by continuously criticizing, or by telling us that we can't. We should not fall prey to such distractions or falter in the implementation of our policy actions. **We must, with conviction and courage, move towards realizing our growth targets, while improving our macroeconomic fundamentals**. If we can achieve 8% growth on a continuous basis for 8 or 9 years, we would be in a position to double our per capita income. For a country like Sri Lanka that would mean we would reach a per capita income of around US$ 3,000 by the year 2015, from our current per capita of around US$ 1,600. That is not an impossible dream. Sri Lanka has shown that, with determination and a clear focus, it can be done. In fact, from 2005 to 2007, our per capita income shot up by nearly 30%! These successes can be maintained, but that could only be done with hard work and more hard work.

**Mr. Chairman, South Asia, the huge giant, is finally waking up from its' deep slumber**. This giant had been taking a long rest, after enjoying a glorious past. A huge giant cannot stir, without the world around noticing the rumble. All recent indications are that the world is certainly taking note of this re-awakening. It is time for all of us in this region to capitalize on this new visibility. All of us who are in this region know that our destinies are linked. We rise and fall together. Today, we see a clear light at the end of the tunnel and the tunnel is becoming wider and wider, making our journey more exciting and pleasant, but yet tough and adventurous. It is not only in cricket that we are excelling today. We are making our mark on many other areas as well.

Let us then, as a region, take our rightful place in the League of Nations by showing that we can develop economically to reasonable levels quickly and in a sustainable manner. **Our people are responding. Our people are becoming more conscious that better living standards are possible.** They are increasingly showing that they are prepared to work towards that goal. Our collective work ethic and productivity standards are improving. Let us support and intensify these efforts and amplify the trends. **Let us keep the momentum going. Let us implement, implement, and implement**!

Mr. Chairman, the Global Management Summit organized by you provides an excellent forum for all of us to learn from each other and shape our strategies. Let us use this opportunity to fine-tune our own knowledge and skills and move with confidence towards delivering sustainable growth to our economies and usher better lives for our people. That is my wish for all of us and I am certain that we would have the energy and the resilience to succeed.

Thank you.