



WHARTON *on...* Global Finance



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Global Finance: Looking Back, and Ahead

The world is undergoing the worst financial crisis in decades. Although the global credit crunch was sparked by the bursting U.S. housing bubble, one of the most important causes was more basic: For too long, spending in the United States has outpaced incomes. This fundamental mismatch was supported temporarily by an extremely lax U.S. monetary policy that led to easy credit, and by foreign producers who supplied cheap goods to America in part by managing their currencies. The resulting, unsustainable imbalance led to financial collapse and a worldwide economic downturn, even in rapidly developing countries such as Brazil, Russia, India and China—the BRIC countries. The following articles from *Knowledge@Wharton* look at these and other developments in global finance. They also examine how similar crises have been managed successfully—or not—on a national basis in the past, and what lessons they may offer.

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Bad debt. Frozen credit. Stock market panic. Popular outrage. Political paralysis. The financial crisis that has dominated headlines may seem unprecedented to many Americans. But it feels altogether familiar to scholars who have examined the economies of at least 15 other nations around the world that have undergone banking crises in the past three decades. What can the United States learn from the past tribulations of markets as diverse as Japan, Mexico, and Turkey?

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As the financial crisis continues to roil credit and stock markets around the globe, it seems that no country or continent is being spared the consequences. Brazil, Russia, India, and China—the BRIC countries—are no exception. In an interview with *Knowledge@Wharton*, Shiv Khemka, vice chairman of SUN Group, based in London, New Delhi, and Moscow; Silas K.F. Chou, president and CEO of Novel Holdings, based in Hong Kong; and Odemiro Fonseca, founder of Viena Rio Restaurantes in Rio de Janeiro, discuss their countries' responses to the crisis, its impact on specific sectors, the decoupling hypothesis, and the dangers of protectionism, among other topics.

Huge Reserves, Emerging Market ‘Challengers’, and Other Forces Are Changing Global Finance



Rapidly developing economies (RDEs) have increasingly become drivers of change—and sometimes disruption—in global financial markets. That has important implications for companies in the United States and Europe as new players emerge, including sovereign wealth funds, state-controlled entities, and acquisition-minded corporations.

As these groups bolster their foreign exchange reserves, they will increasingly look to buy assets beyond their borders,

including controlling stakes in foreign companies, according to experts at Wharton and The Boston Consulting Group (BCG). At the same time, aging populations in the United States and in Europe will be seeking to liquidate some assets to finance their retirements. This combination of trends will present both opportunities and threats for companies in the developed world. Companies that do not run a tight ship could see unsolicited takeover bids from companies in countries with merchandise- or energy-related trade surpluses. Additionally, top executives at Western companies will need to understand sovereign funds' investment criteria and even get to know decision makers personally.

Seeds for this change date in part back to the Asian financial crisis of 1997 and 1998, says Wharton finance professor Franklin Allen. Back then, “The International Monetary Fund got many countries in Asia to do drastic things in

exchange for loans,” Allen explains. Most decided they never wanted to undergo such economic austerity again, and they started building large foreign exchange (forex) reserves as buffers. Even countries relatively unaffected by the crisis—such as China and India—took the lessons to heart. Today, forex reserves for those two countries “have just become huge,” he says. China now has some \$1.5 trillion in reserves, up from a few hundred billion dollars just a few years ago. “India is building too—nothing like the same scale but it is up to about \$200 billion” and rising rapidly, Allen notes.

This build-up in forex reserves by many RDEs gathered momentum through export-led economic policies, particularly in Asia. Leveraging comparative advantages in labor costs and other inputs, many RDEs transitioned from command-and-control to more deregulated, market-oriented economies, though not always with private ownership. Their success

helped create some large trade surpluses, often with high savings and investment rates.

Asia's long-standing "model of prosperity" has concentrated on exports, says Jeremy Siegel, professor of finance at Wharton and author of *The Future for Investors*. "Many of these countries are producing more than they are consuming

their savings rate to near zero. This is the other side of what some call a global financial imbalance: The world's richest country is borrowing from poorer nations.

Shifting Capital Inflows

Borrowing to finance the twin deficits (trade and budget) has come largely through issues of relatively low-yielding

acquisitions. Strong negative public and government reaction in 2005 derailed the China National Offshore Oil Corp.'s \$18.5 billion bid to acquire Unocal, a U.S. oil company. The U.S. Congress helped torpedo that bid on strategic grounds. In 2006, similar politics blocked Dubai Ports World from gaining control of six U.S. port operations.



China now has some \$1.5 trillion in reserves, up from a few hundred billion dollars just a few years ago.

and basically the government is expropriating the difference between the two. It is a mercantilist view. It is true of China and true of India."

That model has helped to create what Ben Bernanke, the Federal Reserve chairman, has labeled a "savings glut." Regardless of what happens to world economic growth this year, these trade surpluses are expected to continue to grow strongly in the foreseeable future.

Richard Marston, Wharton finance professor and director of the George Weiss Center for International Financial Research, notes another key aspect of today's global financial imbalances. "Everyone talks about the Chinese [trade] imbalances and neglects the far larger imbalances due to increases in commodity prices," he points out. "You can see it in the Middle East, in Russia, and even in commodity producers such as Brazil. There's been a tremendous windfall due to this massive [increase] in commodity prices."

Whatever the source, the huge increase in global liquidity has helped moderate world interest rates and finance a large U.S. trade deficit and—until the current economic slowdown—a spending spree by U.S. consumers, who have reduced

U.S. Treasury securities. That exchange looks likely to be redirected. "China and others are not happy with the U.S. Treasury bond interest rates," Allen says. As these investors seek higher returns, expect attention to turn to corporations in the United States and Europe, he says. New money from the BRIC countries—Brazil, Russia, India, and China—and other RDEs increasingly is seeking outward investments through mergers and acquisitions and other strategic stakes.

The most visible examples of these shifting capital flows came late in 2007 and early in 2008. That is when some of the biggest nameplates on Wall Street and in Europe turned to offshore money, largely sovereign funds, for bailouts from the severe credit crunch sparked by the U.S. subprime mortgage crisis. Investors from China, Singapore, and Middle East oil-producing countries injected some \$60 billion to \$70 billion into Citigroup, Merrill Lynch, Morgan Stanley, Bear Stearns, UBS, and Credit Suisse. Following the moves, some Europeans questioned how much foreign investment should be permitted in their banking systems. The United States took a more laissez-faire attitude—at least initially. That contrasts sharply with the outcries over other recently proposed foreign

Unlike those oil company and port acquisition proposals, none of the recent investments in financial institutions by sovereign funds involved a controlling interest. But against the background of a credit crunch and a real need for cash injections, the deals thrust sovereign funds onto center stage. U.S. and European companies realized they were blinking more brightly on the sovereign funds' radar screens and on the screens of flush—and newly confident—RDE and energy-producing firms.

Rising Sovereign Stars

Sovereign funds in early 2008 totaled some \$2.5 trillion. That compares with some estimates for private equity firm investment pools of \$1 trillion, hedge funds of about \$5 trillion, U.S. mutual funds of \$10 trillion, and pension funds of \$60 trillion. Some projections peg sovereign funds at \$15 trillion to \$20 trillion within 10 to 15 years, possibly sooner. Morgan Stanley estimated in March 2008, that sovereign funds could soon bypass the forex reserves of central banks.

Sovereign funds investing in the United States appear to enjoy an advantage. Recent reports note that government-held investments in stocks and bonds and the like are exempt from taxation,

Siegel says. Yet private foreign investors would face withholding taxes of up to 20%. “Some think we should change our law and force the funds to pay tax on that,” Siegel adds.

“The sheer scale of funds under management tells me [sovereign funds] are the new guys on the block,” notes Wharton management professor Michael Useem. He believes they resemble the large mutual funds of 15 to 20 years ago, which went from “almost nothing” to wielding strong influence in corporate governance today. “Managements have taken note that these big institutional holders will have 1%, 2%, or sometimes 3% to 4% of a large publicly traded company,” Useem says. Shareholder activity levels vary, but their stakes have brought “a new kind of power and influence ... especially when companies falter.” Sovereign funds could follow a similar path.

A common concern in the United States and Europe is that sovereign funds—and similar capital pools tightly connected to governments—might harbor noncommercial motivations. The rise of sovereign funds, along with hedge funds and private equity, “has changed the balance of the global financial system,” states *Global Risks 2008*, a Global Risk Network Report prepared in collaboration with the Wharton Risk Management and Decision Processes Center, the World Economic Forum, and several global finance and insurance corporations. “Sovereign wealth funds, which have become particularly important as rising oil prices and global economic imbalances have massively increased the foreign reserves of certain countries, present a new set of challenges, including relative lack of transparency over investment strategies, concern over possible political intervention, and potential large-scale market moves,” the report says.

Reasons for Concern

Here is one example that causes some observers to worry: In 2006, a sovereign fund from Norway shorted bonds from banks in Iceland having financial difficulties. The fund was forced to back off after strong protests from Iceland politicians. Whatever the fund’s motivations, the incident was a reminder that other sovereign funds could one day act with strategic rather than financial purpose. “Sovereign funds don’t have to

just follow monetary goals, although many do,” notes Allen. “They can pursue other goals. And since some have gotten so big, they have a lot of power—and not just in financial markets. If they concentrate that power in a certain industry, they have the potential to distort markets, such as in commodities.”

Sovereign funds contend they are passive investors seeking the best financial return. But concerns about them already run so deep that by March the European Commission, the IMF, and other world financial organizations and nations were working on market-oriented best practices or codes of conduct for governance and transparency. In some cases this was in cooperation with the sovereign funds themselves. Early this year U.S. Sen. Charles E. Schumer of New York was considering legislation targeting similar concerns.

Apart from such codes, would limiting the stakes that sovereign funds are permitted to hold reduce the risks of non-market-oriented influence? “It would be difficult to limit stakes because the question with China, for example, is who are ‘they?’” Allen says. “The Chinese government controls many companies and investment funds. It could simply set up two entities instead of one and gain control that way.”

Others view sovereign funds as important sources of capital that offer corporations new opportunities, even if—perhaps especially if—they were to concentrate investments in one area. “Some in the media report on them as a threat, but I don’t think that is the way to look at it,” says Rajiv K. Kacholia, a global strategist at GE Commercial Finance. The funds could transform sectors for the good, he explains. “Imagine if a number of sovereign wealth funds started taking large positions in venture capital investments in companies seeking alternative energy solutions. You’d have a large potential force which is complementary to a lot of other venture capital firms.” Expect to see more partnerships involving Western companies and sovereign funds, including venture capital firms, Kacholia says. “The funds are great potential partners for large projects.”

Rapidly Emerging Companies

Companies from the BRIC countries and other RDEs pose additional challenges.

They are on the hunt for acquisitions and merger partners with motives that range from a desire for growth, profit, scale, technology, natural resources, or R&D expertise to a search to add new brands, customers and distribution channels.

In *The 2008 BCG 100 New Global Challengers: How Top Companies from Rapidly Developing Economies Are Changing the World*, The Boston Consulting Group updates its list of the 100 top challengers—as competitors, customers, candidates for partnering in mergers or acquisitions, and as potential acquirers. Eighty of the 100 top companies hail from BRIC countries. The BCG 100 grew at a compound annual growth rate (CAGR) of 29% from 2004 to 2006, “close to three times the rate of companies in the S&P 500 and Fortune 500,” bringing 2006 revenues for the select group to \$1.2 trillion, according to the report. “Still more impressive—and perhaps more worrisome for managers defending their home markets—the group’s international revenues grew even faster, achieving a CAGR of 37% from 2005 to 2006. As a result, the BCG 100 generated 34% of their revenues offshore, compared with 32% in 2004.”

Certainly, Indian companies “are becoming a lot more assertive” in making outbound mergers and acquisitions, Allen notes. Last year, in a huge M&A deal, India’s Tata Steel acquired Anglo-Dutch steelmaker Corus Group for \$13.6 billion. That made Tata Steel, a BCG 100 Global Challenger, the world’s sixth-largest steelmaker. Tata’s chief competition in the auction was Brazil’s CSN, another BCG Global Challenger.

Reasons to Sell

In the United States, companies are finally going to see “the ramifications of [the country’s] huge cumulative trade deficit” and relatively low savings rate, says John R. Percival, adjunct professor of finance at Wharton. The main destination for the huge RDE-related dollar holdings will be the United States. “They will spend here, and not in retail, but they will want to buy assets, real estate and companies, because that is what we have here in the U.S., lots of wonderful companies.”

Expect U.S. shareholders to welcome RDE participation, at least indirectly and if only at first. This all occurs as the Baby

Boom generation enters the retirement years, Percival explains. “They have lots of stock, but who is going to buy it all?” The countries with all the dollars, he points out.

Siegel agrees. As the aging of the developed world requires it to import goods from the much younger developing world, he notes, “We will get a huge shift of ownership of assets, from being Western-owned to being increasingly owned by investors from developing countries. That is the very long-run view. China is a little bit of an aging country, too, so that will be a slightly different dynamic, but it will happen with India and other developing countries.” So there is a demographic component, a government trade-policy component, and an energy and natural resources component to the shift, Siegel says.

Expect RDE companies to follow the Japanese model and build manufacturing plants in their U.S. competitors’ backyards. “When the Japanese built their auto plants here, it was not about reducing shipping costs,” Percival says. “They had revenues in dollars but expenses in yen. The only way to hedge exchange rates in the long run is to have revenues and expenses in the same currency.”

One unwelcome result could be a backlash of financial or trade protectionism, Percival notes. “Will Congress say, ‘Wait a minute, Americans don’t own anything anymore?’ What happens when the Saudis want to buy Boeing? What happens when [Venezuelan President Hugo] Chavez wants to buy up U.S. assets?” Notes Allen, “If the U.S. wants to run a trade deficit of up to 7% to 8% of GDP, then there will be a lot of consequences. [Foreign entities] can come back and buy us.”

In July, one high-profile purchase occurred when the Abu Dhabi Investment Council bought a 90% stake in the iconic Chrysler Building in New York City, investing some \$800 million. The purchase was reminiscent of a similar deal in the 1980s when some Japanese investors, flush with export-generated cash, were buying up real estate and other assets in Hawaii and elsewhere in the U.S. But when they wanted to buy famous properties such as the Pebble Beach Golf Course in California and New York City’s Rockefeller Center, the Japanese groups were met with negative public opinion (though both deals went through). Such politics could prove to be



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Russell E. Palmer Professor
of Finance, The Wharton
School

the biggest constraint to RDE investors seeking acquisitions in the U.S., says Daniel Stelter, senior partner and managing director in BCG’s Berlin office and global leader of BCG’s corporate development practice.

There has not appeared to be any major reaction to the Chrysler Building purchase, at least initially. But the fact that the sovereign fund sought out a real estate investment was interesting on its own merits. Some sovereign funds had their “fingers burnt” by getting into the U.S. banking equity market too early, only to see the value of many of those investments fall, in some cases dramatically, notes Stelter. The sovereign funds for now may look to avoid financial assets in favor of other asset classes, he says.

Marston points out that as countries become “enormously productive,” they will run trade surpluses, accumulate wealth and gain influence. He agrees that a widely held concern exists about government-owned or government-controlled funds. But he notes that “companies always have to worry about hostile takeovers by any investor, whether from Ohio or from France or China, particularly if they are underperforming.” What matters is not so much the source of capital but the acquirer’s intentions. “If they just want the brand . . . well, that sometimes happens with the takeover of one American company by another American company.”

Not a New Threat

Marston also notes that “we’ve had cross-nation M&A since World War II.” Today there are more players, but “most companies are not worried one way or the other. A GE or a Boeing would see great opportunities in the accumulation of great wealth around the world, and they would certainly reemphasize their global production and their global marketing, but it would not be a source of particular concern to the CEOs or CFOs of those companies.”

BCG’s Stelter agrees that fast-growing companies from RDEs will increasingly look for opportunities to acquire companies in the U.S. and in Europe long term. In the short term, however, a slowing world economy could impede the growing stream of external acquisitions by the up-and-coming companies from

RDEs, he says. For one thing, these companies will have less to work with in the short term. Stelter notes that equity markets in India were down some 30% during the first half of 2008, and China has seen a 20% drop following a stretch of exuberance.

While top-performing companies from RDEs will likely grow relatively faster than many of their counterparts from developed countries, RDE company stock prices can overshoot their basic value, and some have done so. The companies “can still lose some market value, and if they do, they will not feel as at ease as they otherwise would to do acquisitions,” Stelter says. Some RDE companies—such as those in China—will have support from their governments, and that will underpin some ongoing level of acquisitions, he adds.

Meanwhile, the emerging middle classes in many RDEs offer U.S. and European companies opportunities for sales and more efficient operations bases. The opportunities will vary by sector, notes Kacholia. But companies that view the rise of these economies as more of a threat will adapt more slowly. And while some smaller companies will fail to benefit, “anything that touches infrastructure, heavy engineering, construction—anyone involved in any

aspect of airports or shipping ports, bridges, tunnels, and roads—should do well. It’s great to be in the cement business, manufacturing airplanes, or an airplane parts supplier.”

For companies planning to tap RDE markets, Percival warns, “You are not the only one going. Not everyone will make money.” Companies must ask themselves, “What is my believable story about my competitive advantage?” Percival says. “If you are thinking of going into the insurance business in China, which is highly regulated, for example, then you’d better have an ‘in’ with the government.”

What Managers Should Be Thinking About

Looking ahead, Siegel advises that companies recognize the fact that their shares will increasingly be owned by foreign investors. “There is really nothing they can or indeed should do about it. Why would you want to steer away a buyer? It is a huge opportunity,” he says. “If managers don’t run their companies well, the stock price goes down and they could get unsolicited takeover bids financed from abroad.” As with any takeover bid, management may or may not be happy about it, “depending on the price. It could be their savior or it could be a hostile takeover.”

Fifteen to 20 years ago, American CEOs and CFOs had to learn how to work with big institutional holders and equity analysts, notes Useem. To be an effective top team member today takes “knowing how sovereign wealth funds work and building a relationship with their officers. It’s important for top executives to know the funds’ investment criteria, but also to get to know the people who are decision makers personally. It’s very important to become personally acquainted. Personal relationships still matter in international business.”

Either way, the playing field is shifting quickly. Recognizing this, BCG, in its *New Global Challengers* report, recommends that companies consider the following to best prepare for the changes already under way: 1) Challenge-proof your business model by speeding innovation, lowering costs, and revisiting how your company adds value. 2) Attack challengers on their home turf where economically viable. 3) Acquire fast-growing RDE-based players. 4) Convert challengers into partners and customers.

In the meantime, experts say, expect sovereign funds and RDE-based companies from the BRIC countries and the Middle East to continue to tip the scales of capital flows. 

Feeling the Pain:

How the Financial Crisis Is Affecting Brazil, Russia, India, and China



As the financial crisis continues to roil credit and stock markets around the globe, it seems that no country or continent is being spared the consequences. Brazil, Russia, India and China—the BRIC countries—are no exception. In this Knowledge@Wharton podcast, Shiv Khemka, vice chairman of SUN Group, based in London, New Delhi and Moscow; Silas K.F. Chou, president and CEO of Novel Holdings, based in Hong Kong; and Odemiro Fonseca, founder of Viena Rio Restaurantes in Rio de Janeiro, discuss their countries' response to the crisis, its impact on specific sectors, the decoupling hypothesis and the dangers of protectionism, among other topics.

An edited transcript of the conversation follows.

Knowledge@Wharton: To begin with, I would like to talk a little bit about the economic situation in each of the countries that you belong to and how it has been affected by the ongoing world economic crisis. Shiv, would you like to start us off?

Khemka: I belong to India. The situation there is that the equity markets are down considerably, more than 50%. Credit is tight in the markets. Because India is not as export-led as China, underlying growth in the economy is still reasonable. I think expectations of growth [remain] north of 5%, perhaps in the 6% to 7% range. In terms of the country I work in—Russia—again, equity markets are down. But given the strong reserve position of the economy,

and given the concerted action taken quickly by the Russian government to effectively inject liquidity into the economy through four main banks, I think there is a sense of confidence that this thunderstorm will pass, and things should be at least manageable over the coming years. Of course, individual entrepreneurs will face a lot of pain. Many oligarchs are publicly known to be in fairly difficult situations. But I think that all in all, from a broad economic point of view, Russia is reasonably well-positioned to weather the storm.

Knowledge@Wharton: How about the situation in China?

Chou: In China, this so far is not too bad a thing. On the contrary, because China's economy is growing too fast, the preoccupation of the Chinese government for the last few years [has been] how to cool down the economy. So this crisis has slowed down everything around the world, and China is affected. As far as China can, it is trying to move away from too heavily relying on the exports sector of the economy to more domestic consumption. This can be an opportunity for China to cool down its economy a little bit, to [lower] inflation and to have a smooth transition to a domestic consumption economy. Of course, as the crisis develops now in the West, [things are getting] kind of out of hand. This affects everybody. So we hope that the United States and Europe are [exercising] strong leadership to solve the crisis in a quick and sensible way.

Knowledge@Wharton: How about Brazil?

Fonseca: Brazil commodity prices were declining even before the crisis, and the stock market has declined by about 30%. [There have been] a lot of fluctuations. But there are no signs yet of economic decline. There is a lot of reserves—for the first time in our economic lifetime, we are not going to have a foreign exchange crisis, as we have had in the past, because we have a lot of reserves, and because we have a flexible exchange rate. It has already started to adjust—this has given the right sign to everybody. But of course, Brazil is going to be affected. For example, the foreign credit market was paralyzed for about 15 days [at the outset of the credit crisis]. Now, [it is] working again. And the banks that are financing cars for 60 months now are offering credit for 30 months. So the credit market's much tighter. I think some specific industries are

going to take a beating, like the car industry. But we do not forecast a recession. We are going to have less growth, maybe, on the order of 4% this year as compared to 5.3% last year.

Knowledge@Wharton: To the point that Odemiro made—are there any specific sectors in India, Russia or China that you see contracting more than others?

Khemka: From an Indian point of view, clearly export sectors will be affected. The real estate sector has taken a very severe downturn because of credit issues in the market. And naturally, demand domestically will fall. And so that's another sector that one needs to be careful about because of this heavy leverage. Any sector which has a lot of leverage would be a sector to watch carefully. In Russia, you know, the oil price being down where it is today means that the bonanza of the last few years, the boom times, are perhaps coming to an end. The savings that the Russians have wisely made over the last few years need to be now invested thoughtfully in the future. But given the strong commodity base, and the lack of adequate diversification of the Russian economy, I think all the focus will be on the commodities sector—energy and mining.

Knowledge@Wharton: What about China?

Chou: China is severely affected in the export sector. But to put it in perspective, China was exporting too much. A tremendous surplus was causing a lot of the political problems around the world, especially with the United States. So this is a good pause for China. Now, it all depends if the Chinese economy can turn itself from heavily export-dependent to domestic consumption. This is a good chance for China to test that. Of course, we cannot afford to prolong the recession or depression in the Western world. That would cut off our lifeline. So hopefully this recession in the West will be brief. Then it's really a good opportunity for China. On the other hand, the Chinese real estate market has been severely affected, but [that, too] is also welcome. The government had been trying for the last two years to cool down real estate prices, which have been out of the reach of the common people. So, we still look at it as an opportunity for us to adjust our economy . . . for future growth.

Knowledge@Wharton: Speaking of the role of the government, could you help our audience understand how the government has responded to the crisis in the countries we're talking about? And what do you think about the nature of those responses? Odemiro, do you want to start us off?

Fonseca: Well, the government—the executive—so far is doing nothing. And I am glad they are doing nothing, because the Central Bank is doing the classical stuff. It's selling dollars, it's pumping liquidity into the economy, mainly when they had this pause in the credit markets. And they're waiting. They're talking about it, but no action so far.

Chou: Everybody's scared . . . because when you see the banks go into bankruptcy, that's a real case. They have heard about the word "bankruptcy," but have never seen a bank really fail. Most of China's reserves are in the United States . . . in Treasury bills. And that has not been a bad place to be. China has made a fairly small investment in [places] like Morgan Stanley, Blackstone—they lost some money, but relatively speaking, a very, very small [amount]. And so in this case, the government just waits and watches, but truly believes the U.S. will come out with certain solutions. And so we're optimistic that this will be over.

Knowledge@Wharton: What do you think, Shiv?

Khemka: The Russian government actually acted in a very organized, focused, and coordinated manner—restoring confidence in the banking system to some extent by announcing increased liquidity into the system. By guaranteeing deposits . . . by talking about cuts in oil export taxes, which will again give a boost to the economy, and by talking about significant investments in public infrastructure. And spending, which will, again, protect the lower end of the economy in terms of jobs and so on. I think the government has really been very proactive and done an excellent job projecting a clear plan and implementing the beginnings of that plan. The beginnings of liquidity started flowing this week into the economy.

Knowledge@Wharton: There used to be a hypothesis that was very popular a while ago, called the decoupling hypothesis, which said that—especially in the BRIC economies and emerging markets more

broadly—growth could be sustained even in the absence of growth in the developed world. Given what’s going on, how realistic do you think that view was? Any comments on that?

Khemka: The world is increasingly interconnected. Of course, there are some places, perhaps—such as rural societies and local microeconomies—that are relatively unconnected. But if you really look at the big economies in the world today, they are increasingly connected through human capital, through knowledge, through information technology, capital flows and many other things. In a world where the U.S. is such a dominant part of the global economy, it is unrealistic to think of a decoupled economy. However, the comments that underlie some of the thinking on decoupling are that economies have their domestic markets that are quite large—like India and China. And those markets are starting to grow. There is increased domestic capital, consumer spending power and so on. I think there is some truth in that, and that’s the reason why economies like India, China, Brazil, and others will continue to grow. The growth rate will decline, which will have potentially a very significant impact on long-term performance of those economies. But there is growth in those economies. So to that extent, it is, to some extent, decoupled.

Knowledge@Wharton: Silas and Odemiro, any comments?

Chou: I agree with this point of view. But the thing to add is, the economies of China and India—even Brazil, but especially China and India—are on a very low base. So if the West doesn’t grow that much, China and India still will grow, because the per capita income in China is less than \$5,000. India is maybe \$3,000. So there are great prospects for growth still in China and India, despite possible recessions in the West.

Fonseca: Clearly there is no decoupling of the capital markets. The fundamentals of Brazil haven’t changed, but the stock market declines at 40%. The credit market stopped. So there is no decoupling in the capital markets, in the financial markets, even for a country as isolated as Brazil. Unfortunately, there will be decoupling for the wrong reason for Brazil, because 94% of what is consumed in Brazil is produced in Brazil. So Brazil is very isolated. I would like there to be no decoupling for Brazil.

But there will be, because Brazil is much smaller, and has much lower per capita income. And it’s going to grow less. It will look like decoupling, but for the wrong reason. I’d like to export 20% of the GDP of Brazil to the United States. [Laughter]

Knowledge@Wharton: What is the one development that you most fear occurring that would prolong the crisis in your country?

Fonseca: The wrong development is what our president is saying—that we are

“I think the [Russian] government has really been very proactive and done an excellent job projecting a clear plan and implementing the beginnings of that plan.”

Shiv Khemka,
Vice Chairman, Sun Group



Iceland—[that] we are an island. That’s the wrong development. Trying to protect Brazil against so-called speculation, or trying to start again to buy commodities to support prices—something that we don’t do any more in Brazil, but we did for 50 years, buying commodities to support prices. All this kind of thing is the wrong thing—trying to protect the commodities, trying to raise the barriers for imports. It will be dangerous.

Chou: Exactly. Protectionism. If the United States, for whatever reasons, turns inward for total isolation, protectionism, that would be bad news for the world because we are really living in a global village. Everybody is interdependent.

Khemka: I completely agree. If one raises high walls right now in the world in different countries, it will only create and exacerbate the problem. I also think in Russia, particularly, it’s very important that the government has policies that are equitable across the board. There’s a lot of inequity in the policies and sort of favoritism, and so on—I think that will also send the wrong signal.

Knowledge@Wharton: One last question for each of you. What is your most optimistic, and also your most pessimistic, scenario for the next year?

Khemka: I don’t have an optimistic scenario, I’m afraid. I think that one has to batten down the hatches and prepare for a thunderstorm. One needs to be realistic . . . and prudent in this environment. I think that what was a financial crisis is becoming an economic crisis, has perhaps become a crisis of confidence. One needs to take that very seriously, and one needs to have patience. The key right now is survival.

Chou: Optimistic is that this can be over in two quarters. Pessimistic is it can go to two years and is really bad. For two quarters, I can escape this relatively unscratched. For two years, China would be in deep trouble.

Fonseca: I’m optimistic for one new reason. The central bankers, the Treasury Department—they are working together in all countries at the same time. That’s quite new . . . If this stops the panic, I think we’re going to go through this with a mild recession in the United States. And Brazil and China are going to survive. Of course, if the panic continues and you have oil declining more and more, you’re going to see problems in Russia. You’re going to see problems in the Middle East. You’re going to see problems in Venezuela. You’re going to see much more unrest. But if they stop the panic, and this cooperation helps—I’m very optimistic.

Knowledge@Wharton: Gentlemen, thank you very much for joining us today.



Do the Answers to Our Current Financial Woes Lie in the Past?

Bad debt. Frozen credit. Stock market panic. Popular outrage. Political paralysis. The financial crisis that has dominated recent headlines may feel unprecedented to many Americans. But it feels altogether familiar to scholars who have examined the economies of at least 15 other nations around the world that have undergone banking crises in the past three decades. What can the United States learn from the past tribulations of markets as diverse as Japan, Mexico, and Turkey?

A day after the Dow Jones Industrial Average plunged a record 777 points (in fall, 2008), the subject drew a group of Wharton and University of Pennsylvania professors to a panel discussion at the School's Lauder Institute of Management & International Studies.

University of Pennsylvania political science professor Jennifer Amyx, a Japan expert who has written a book about the protracted financial crisis that began in that country in the early 1990s, argued that “financial crises are ultimately political” and recovery requires reforms in the way government oversees finance. The “lost decade” that followed the 1990 collapse of Japan’s asset bubble—stock prices didn’t actually bottom out until 2003—was abetted, she said, by a governance system consistently unable to respond to the series of shocks that accompanied the end of the country’s vast expansion of the 1980s.

“The country was in crisis on a number of different dimensions following the bursting of that bubble,” Amyx said. Asset prices fell. Stocks followed. And

banks, accustomed to a cocoon of government protections that had prevented even a single bank failure in the postwar era, trembled. But well after the first big bank failure, in 1995, the government mustered little effective response. An early dose of taxpayer money did little good. “Over the next few years, what you would see would be ad hoc measures by the government and the Ministry of Finance to try to deal with emerging, growing and increasingly severe problems in the financial sector.” By 1997, as the dominant Liberal Democratic Party lost control of the upper house of parliament, still bigger banks were teetering on the verge of failure.

Those failures ultimately prompted major changes in the way banking was run. “Ultimately... a new enacting coalition would emerge, a bipartisan group of legislators, but a different group,” Amyx said. “Solutions to financial crises have to get at the heart of confidence, market confidence, and it really required, in Japan, a new set of actors to emerge who had a new set of ideas.”

In the case of the United States, she noted, “the bipartisan wrangling over a legislative response has also involved a kind of closed group of actors that are seen as part of the problem [and] that have not brought forth really new ideas. They are proposing to throw a lot of money at the situation without changing the rules of the game first.” In Japan, she said, “the rules of the game were fundamentally changed in terms of regulator-financial institution relationships” before public funds were injected to recapitalize the banks. “It was only with [the rule changes] as a prerequisite that injecting funds into the financial system produced new confidence in the market.”

A Bank Governor's Views

Turkey's 1994 financial crisis didn't last nearly as long as Japan's. Still, the cycle of currency flight and banking doom felt about as long to Wharton finance professor Bulent Gultekin, an expert on capital controls and international financial markets, who was at the time the governor of his country's central bank. Gultekin expressed sympathy for what his American analogue, Federal Reserve Chairman Ben Bernanke, must currently be experiencing. “You live a month and it's probably like 10 years in condensed time,” he said.

Gultekin noted that since the 1970s-era oil shocks, all major economic crises have been in the financial industry—and all of them were in part the products of flawed public policy and then cleaned up in large part through taxpayer money. “There's always an accommodating public and economic policy that tries to sustain an unsustainable situation,” he said. “There's also a high correlation between inadequate or misdirected regulation and financial crises. It's a myth that financial markets regulate themselves. They simply don't. Markets, just like individuals, do respond to incentives, and if there are distorted incentives, they react in a distorted fashion. And that also results in very poor resource allocation. In hindsight, we look back and wonder how we could have dedicated so many resources to the financial sector.”

Turkey's 1994 crisis—there would be another in 2000—ultimately socked the country with a 6% drop in GDP. And though he noted that the parallels

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between an emerging economy and America's only went so far, Gultekin said his experience made him confident in one other thing: Taxpayers would eventually pony up. “The banking system is the bloodline of the economy,” he said. “Without that system, nothing can happen. You have to bail them out.” In Turkey's case, of course, that was made more politically feasible by a media—in many cases owned by banks—that agitated for a rescue, and by outside intervention from the International Monetary Fund.

As for the United States, Gultekin said Americans should be leery when financial markets love the central bank chief. Such figures should be “respected,” he said, but should also be the ones who “take the punchbowl away at the end of the party.” Likewise, Americans remain unprepared to correct some of the distortions that abetted the crisis. “You just cannot have 20% of corporate profits [coming] from the financial sector,” he said. Echoing Amyx, Gultekin was sharply critical of the first bailout bill that was defeated in Congress, saying the spare, two-and-a-half page document “had the mindset of a trader” in failing to lay out the extent of the crisis and thus encouraging Congress to take the White House's word. “We have better finance economists than that,” he said.

Wharton accounting professor Luzi Hail, an expert on international accounting and financial disclosure who was formerly with the Swiss Bank Corporation, said Switzerland's early-1990s bank crisis halved the number of banks in the country. But the fallout featured mainly private-sector solutions because none of the banks was deemed too big to fail. That would be different were a crisis to strike today. Just as the woes of America's banks have left the country with a small handful of consolidated superbanks, the Swiss troubles led to a new status quo that makes future bailouts difficult. The giant UBS, he noted, had liabilities five times greater than those of the national government. “Too big to fail” is not the appropriate point,” he said. “They are ‘too big to save.’” Today, it is the largest of the banks that are caught up in the U.S. crisis—something that demonstrated how they were beyond the reach of even the best Swiss regulations. “Not only too big to save, but too big to manage,” he quipped.

Nonetheless, Hail said bank crises are a tremendous opportunity for a country to upgrade its oversight system of regulations, capital standards and risk-management rules.

China Offers Lessons

Wharton China expert Marshall Meyer said that for those grappling with the American banking implosion, China's current economic situation is more relevant than its financial sector's experiences during the 1990s Asian financial crisis. With a stock market that recently fell 70%, a sharp rise in inflation, and billions of dollars in undeclared U.S. currency in the market, China's current woes are in the "real economy" rather than just the financial sector. With a trade- and especially export-oriented economy, China faces a serious threat when recession curbs the appetites of American or other foreign spenders. "Don't bank on China to drive the global economy," Meyer said. "Ultimately, I think the Chinese economy must and will turn inward."

Penn political scientist Heiner Schulz, an expert on bank liberalization in emerging markets who also spent time as a visiting scholar at the Bank of Korea, said the aftermath of Mexico's 1994 financial panic left him unhappily certain that America's current woes would be more expensive than predicted, longer-lasting than predicted—and would likely take a real bite out of the real economy.

Schulz, who worked as a management consultant to firms doing business in the country at the time, said the possible collapse of the Mexican banking sector had prompted a full-fledged government

response, complete with a takeover of bad loans, recapitalization of banks, and direct intervention into failing institutions. Legal changes also allowed foreigners, and their capital, into the industry—which they came to dominate in the ensuing decade. The crisis did little to hurt economic growth, which trucked along for much of the decade.

Why will the United States be different? Just as the costs to the Mexican treasury grew beyond initial forecasts, Schulz said he believes costs here will be far higher than advertised. At present, predictions about bailout costs for the current crisis amount to 6%-7% of GDP. But the \$300 billion savings and loan rescue was initially forecast to be just \$50 billion to \$60 billion, Schulz said. And in Mexico, where the banking sector was unsophisticated and smaller than that of the U.S., the 1994 rescue wound up costing 15% of GDP. It also took 10 years to clear up the bad debt, which at its peak amounted to just under 19% of loans. But those were simple, basic loans. Schulz believes that America's debt problem, which is centered around complex financial instruments, will be much harder to even calculate. "It takes a lot of work to deal with a bad debt problem," he said. "This is tough even for simple loans." According to Schulz, Mexico's nonfinancial sectors escaped much damage because the economy was far less tied to the banking industry. By contrast, he said, the U.S. has a degree of "financialization" that is 10 times higher.

Schulz fears that the possible effects of the American crisis may include a backlash against financial innovation,

something he sees as disastrous since complex mortgage-backed securities, especially in emerging economies, help lower-income people buy property. He also fears a broader backlash against Western models of development by countries wary of being lectured by Washington during their own economic troubles. "They might turn to other models"—such as China—"after watching what they have been told is the gold standard turn out to be not so strong," Schulz said.

Schulz did, however, offer a word of caution to anyone who would extrapolate too much from the recent financial crises the Wharton panelists had studied: Parallels between past and present are always tricky, especially between emerging and developed economies. "Like the generals who are always trying to fight the last war, the regulators are always trying to fight the last crisis," he said.

Schulz's own prescription for preventing a recurrence of the 2008 meltdown would focus on improving America's balkanized financial regulatory system and on reducing moral hazard and information asymmetry. The latter is especially tough since an age of innovation necessarily means bankers may be inventing things faster than regulators can figure them out. "This is, in my view, another of those rare opportunities in the U.S. to change the regulatory system that's in place," Schulz said.

"In order to be a cat, you have to have been a mouse," Meyer added. "Maybe our MBAs should have to be regulators before they are bankers." 