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Asian Challenges

The Balance between Opportunities and Risk

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James J. Schiro, CEO Zurich Financial Services

Last month, the Chinese government announced a substantial revision of its earlier estimate of the total value of goods and services produced in 2004. It said that the country's gross domestic product or GDP was 1.9 trillion dollars, surpassing Italy by a healthy margin and propelling China into the ranks of the G-7, the world's seven largest economies. Assuming that the rapid growth continues, it is easy to predict by when China will have displaced the United States as the world's largest economy.

Clearly, after 25 years of unprecedented growth, the Chinese economy is a factor to be reckoned with. Its sheer size is now affecting economic variables such as global oil and commodity prices. Commentators have been quick to rephrase what used to be said about the United States: "If China sneezes, the rest of the world catches a cold."

But this cuts also the other way, because it matters not only in the West how China's central bank, for example, is investing its stock of foreign reserves. An ill considered decision could easily rock global currency markets and devalue China's newly acquired wealth. Hence, the country's economic might poses an increasing challenge also to Beijing and the question is whether Chinese policy makers have appropriate decision mechanisms and governance structures to deal with the issues typically associated with large economic powers.

It is indeed tempting to say that China is again occupying a place it held about 400 years ago. In 1600, The Middle Kingdom was one of the richest and most developed countries, accounting for roughly one quarter of the world's income. Its economic power was buttressed by a sophisticated craftsmanship. China's fleet, for example, was capable of reaching the shores of Africa, and the innovative contributions of its scientists to warfare had made it to Europe. Then, for reasons not well understood, China experienced a radical shift from an open to a closed, inward-looking society that virtually stopped growing.

Today, and despite its economic weight in absolute terms, China continues to be essentially a developing country. Valued at purchasing power parities, in other words valued at prices that compare similar baskets of goods, China's GDP per capita is currently about 1,500 dollars, roughly 15% of the GDP per capita of the United States. That is less than Japan's share in 1950, before it embarked on its 25 years of miracle growth.

Nevertheless, the trappings of new wealth, such as golf courses and gated communities are seen in the coastal zones of China. But this is just the glossy dust cover on a book that, once opened, displays a darker side of rural poverty in the inner provinces. Thus, the disparity of income is another way of stating China's continued development challenge.

I. The framework for today's talk

In some way, my talk is about development. I will focus on two of the emerging powers in Asia, China and India, and the desirability of their integration into the global economy. I will look at both countries from the practical point of business, more narrowly, from the insurance business, and I will place my remarks within the context of the broader financial sector development.

In doing so, I am mindful of the social contributions made by private enterprises. In creating values for customers, employees, and shareholders, businesses meet their social responsibility and make their contributions to the public good. This is the human face to market-based or capitalist economies, a human face that can also be seen in developing and emerging market economies.

Since the days of Adam Smith we know that a reliable way to make the self-interest of businesses serve the public interest is for economies to become open, market-oriented, and subject to competition. Open and competitive environments force firms to be innovative, to keep down costs and prices, and to be responsive to customer demand.

Of course, the success of capitalism is not only based on the self-interest of business. It also depends on a complex value system that includes reliability, trust, and honesty. In short, the success of market economies depends on good governance. In advanced economies, rules and institutions have emerged that are seen as conducive to development. By engaging in mutually beneficial transactions, multinational businesses are contributing to the spread of these values, which strengthens the framework in support of growth and prosperity.

II. The role of insurance in emerging markets

I would now like to discuss the role of insurance in society. The desire to protect one's assets and mitigate risk is universal. Households and businesses need a degree of planning certainty to engage in activities that may entail risks. Insurance allows them to manage risk better and assume more of certain risks. Since there is no reward without risk, both individuals and firms will eventually benefit from the higher income associated with risk.

This applies also to developing countries where loss prevention and loss protection assume vital importance. Last year's catastrophes in Asia painfully reminded us of the vulnerability of societies in which insurance has yet to play the role it does in advanced economies. Of course, the human toll and the economic losses caused by the recent earthquake in the Kashmir and the tsunami at the end of 2004 can never be captured by statistics alone. In the case of the tsunami, for example, insured losses of 5 billion dollars were only a fraction of the total economic loss, which does not even attempt to include the human suffering caused by the loss of an estimated 280,000 lives. But one thing is nevertheless certain: the people on the shores of the Indian Ocean were woefully underinsured.

Although the impact of underinsurance was mitigated by contributions of 13 billion dollars from private donors, aid agencies, and foreign governments, the fact is that, in the absence of charitable donations and insurance, the costs of rebuilding the area destroyed by the tsunami are crowding out resources that could have been used for the build up of critical infrastructure with stricter building codes and catastrophe shelters.

This is not to blame the people. The lack of insurance is in large part a reflection of underdevelopment. But insurance could have made a difference, and that is why it is vital that the insurance sector is developed in these regions.

Let me hasten to add that this is not an easy task. For private insurance to be offered, the conditions of insurability – such as assessibility and randomness of expected losses – have to be met. In addition, insurers have to be able to charge a premium that is large enough to cover the costs of doing business, including a competitive return on the capital invested. Finally, insurability cannot be divorced from the institutional framework that ensures the functioning of markets, and the point relevant in this context is the certainty of contracts.

This defines an agenda for development. For private insurers to play a meaningful role in emerging economies, the institutional framework to enable functioning markets must be erected, contract certainty has to be guaranteed, and the economies have to reach a stage of development that will allow for profitable pricing in a competitive environment. This will take time. Meanwhile, risk management activities and measures to mitigate catastrophic risks should become integral to any official development strategy, and I believe that there is room for private and public sector cooperation in promoting the goals of development.

This is particularly true in Asia where many if not most countries are exposed to natural catastrophes. More than half of Asia lives in well-known earthquake zones or in coastal areas where densely populated areas like Bangladesh are in flood planes. According to statistics collected by Swiss Re, between 1994 and 2003, and thus before tsunami and the earthquake in the Kashmir, China and India accounted for 25% of the global economic losses from natural catastrophes and for 31% of all fatalities. Yet, insurance compensation to the people in these two countries was minimal. It amounted to less than 1% of global insurance payments over the same period, whereas in industrialized countries, nearly half of the economic losses arising from catastrophes are covered by insurance.

III. The need for sound financial sector development

Clearly, the most important contribution to the development of the insurance sector will have to be made by the countries themselves. Their first priority must be to develop and maintain a stable financial sector. This in turn depends on stable financial markets that are also deep enough to generate the necessary capacity for the transfer of risk.

Let me illustrate this with a brief recap of recent financial crises and their impact on the insurance sector.

The Asian crisis of 1997, but also Mexico's Tequila crisis of 1995, and Argentina's default in 2001, destroyed much capacity, which is a short expression for the ability of insurers to assume risk. The primary reason is that financial crises impair the invested assets of insurers, while rising losses of policyholders drive up claims and increase the insurers' liabilities. For these reasons, the balance sheet of insurers weakens, and it is easy to see why they can become insolvent and lose their capacity to mitigate risk.

It follows that in order to make insurers in emerging markets less crisis-prone, the countries themselves have to be less crisis-prone. To do so, macroeconomic stability must go hand-in-hand with measures to improve the financial strength of insurers and the introduction of products designed to withstand financial stress. Above all, this requires technical competence, sound underwriting, prudent reserving, as well as sophisticated asset and liability management. Again, foreign insurers can make important contributions in fostering the skills necessary to introduce these activities to emerging markets. But ultimately, the skills must be developed locally on the strength of native institutions. Insurance capacity building must begin at home.

IV. Integration into the global economy

The development of a strong insurance sector in emerging markets can only be the first step toward their integration into the global economy. Indeed, the record of failure and success in developing countries shows that the integration into the open markets of the global economy is vital for sustainable growth and the reduction of poverty. Doubters should compare the radically different fates of open Thailand and closed Burma, for example, or South Korea and North Korea. That is why I would like to discuss now the importance of a market-friendly development based on openness to trade and foreign investment.

Triggered by the Latin American debt crisis in the 1980s, a consensus about the importance of a market-friendly development has emerged which, all in all, has produced good results. It is important to see that "market-friendly" does not rule out government action. On the contrary, there is a very specific role for the public sector. As the World Bank wrote in summarizing the consensus in 1991, governments should invest in people, improve the climate for business, open the economies to international trade and foreign investment, and get the macroeconomic policy-mix right.

Further refinements of the market-friendly development consensus, mainly under the influence of the Asian crisis of 1997, include also the call for strong prudential supervision and regulation. Much has been achieved since 1997 in providing for more transparency, but also in creating and strengthening the institutional framework for a sound financial sector development. At the same time, it is encouraging to see that regulatory standards developed in industrialized countries are being widely adopted in emerging markets.

Nevertheless, East Asia is still far removed from having an efficient financial market that can serve its region well. Trade financing and financial intermediation continue to rely mainly on the capital markets of the United States and Europe. But local savings should flow directly into local investments without having to make an inefficient detour through New York, London, or Zurich. This requires further progress in overcoming the region's inward-looking bias. At some time, foreign investment banks and insurers with a global perspective will push the financial sectors in East Asia toward integration. But this endeavor cannot succeed unless local institutions are prepared to do away with current barriers to trade and investment.

That is why we should welcome the progress made in the recent talks of the World Trade Organization (WTO) in Hong Kong. It is vital for the future of all developing countries that the anti-globalization movement that screamed "sink the WTO" failed to derail the Doha trade round. Major emerging market countries such as India and Brazil are now in the camp of the forces resisting protectionism. They recognize that the success of the Doha trade round is their best hope for removing trade-distorting subsidies and restrictions, and they know that market access and integration in the world trading system is their ticket to reducing poverty and raising the standard of living in a sustainable way. But speed is of the essence, because the presidential fast track authority in the United States will soon expire. It is urgent to bring in the Hong Kong harvest as quickly as possible, and we should support trade negotiators on both sides of the Atlantic as well as in the Northern and Southern hemisphere in reaching a final agreement by the end of this year.

V. Benefits accruing to advanced economies

I would like to conclude this excursion about the importance of the integration of emerging markets into the global economy with a parochial note. To state it bluntly: deep and stable financial sectors in emerging markets are also in our own countries' vital interest. I say this in light of the demographic problems in our aging societies. People in advanced economies will have to save and accumulate financial assets that can provide for their retirement – the decisive question is who will buy their assets once they are retired and ready to sell?

The short answer is that the growth of emerging markets will make saving for retirement a viable proposition. Ideally, when the baby boomers in the advanced economies are ready to sell assets, the young and increasingly more prosperous population in the emerging markets should be ready and willing to purchase those assets. This is the way it has always worked within the borders of a county where the young generation would purchase the assets of the old generation. There is no reason to assume that this intra-generational exchange within nations cannot and should not be extended to mutually beneficial exchanges across borders and between old and young countries.

This will eventually require a global financial architecture that is capable of handling a new pattern of trade and investment flows. It is easy to see that old economies will run current account deficits because retirees are selling assets to investors in young countries. On the other side, today's developing countries will be running current account surpluses in the future. Consequently, today's emerging markets will eventually hold a substantial share of real and financial assets in advanced economies. Of course, for this to work without friction requires an even closer integration of our economic systems than seen today. Whether we succeed in this endeavor or not, it remains true that the economic success of the developing world is not only good for its people but also essential for the continuing prosperity of the aging societies in the developed world.

VI. An untapped potential

Now let me return closer to my business and the role of insurance in emerging markets. In light of the underdeveloped state of insurance in these countries, it is clear that emerging markets are likely to provide an excellent business proposition for global insurers prepared to invest in them. Not only do these countries grow rapidly, demand for insurance products tends to grow even faster, outpacing growth in the markets of our advanced economies by a ratio of approximately three to one.

The reasons for this rapid demand growth are easy to see: rising incomes generate a growing demand for risk mitigation and asset protection. This is particularly true for life insurance products, which are seen as a substitute for saving and absorb parts of the high savings typically associated with emerging markets in Asia. But demand is also high for non-life products. As I pointed out earlier when talking about natural catastrophes in Asia, there are still many unmet needs in this disaster-prone region.

In addition to the natural demand pull arising from population and income growth, deregulation, liberalization, and privatization will also contribute to the growth of Asian markets. In privatizing former state-owned insurers and opening up domestic markets for foreign competitors, developing countries are implementing the market-friendly agenda I talked about earlier. Allowing for the transfer of industry-specific knowledge and capital will in turn speed up the development of a strong insurance sector. Latin America and the markets recently liberalized in Central Europe have already traveled a long distance on this route, and I trust that East Asia will soon follow.

The growth potential in emerging markets is bound to complement the more subdued prospects in the highly saturated markets of the industrialized countries. Global insurers share this experience with their corporate customers who either already have or are about to set foot in emerging markets. However, the desire to offer seamless service to our global customers is not the only reason for an expansion in emerging markets. Increasing our presence in these markets, which by and large offer risk and loss profiles that differ from our traditional markets, is one way to improve the quality of our portfolio and better diversify our risks. Clearly, the promise of emerging markets is high, and our industry must be ready to develop their potential.

VII. India and China

This brings me to China and India. Rather than recite a familiar litany of strengths and weaknesses in the two countries, I would like to make a few general observations.

There is no doubt that the factor behind the rapid growth common to both countries is a commitment to the essentials of the market-friendly development described earlier. It is remarkable, and speaks for a certain pragmatism, that in China elements of open markets co-exist with the authoritarian rule of the communist party. Obviously, Deng Xiaoping's famous quip still applies: it is not important whether the cat is black or white, important is that it catches mice. India too is now embarked on market opening. Although slower than in China, the seeds of liberalization are spreading across the Indian subcontinent.

Indeed, the commitment to open trade is a salient feature of the development seen in East Asia. Countries like South Korea or Taiwan prospered by exposing their industries to the competition of global markets. To be sure, their competitiveness was enhanced at times by an undervalued exchange rate, a point we can also make in the case of China. But there is a limit to the harmless accumulation of currency reserves, and capital markets will eventually force an adjustment.

Common to the development in East Asia is also an investment in human capital and social services, predominantly health care. In these areas, China has taken an early lead, virtually wiping out illiteracy and making a significant effort to provide limited health care for the population well before the onset of market reforms. It is perhaps an irony of history that the measures were implemented under Chairman Mao. Thus, the anti-capitalist and idol of the Red Guards laid the foundation for the market-friendly development and rapid growth seen in the last 25 years.

In contrast, India's illiteracy rate still hovers around 50%, and access to public health care continues to be limited. These deficiencies go some way in explaining why India has yet to see stronger benefits from the deregulation and market opening implemented beginning in 1992.

But the commitment to transparent markets continues to be limited in China and India. Corporate governance is underdeveloped to say the least; both countries rank toward the bottom in a governance index prepared by the World Bank. In fact, according to the World Bank, China has lost ground in the last five years, while India appears to have gained ground.

In China, the virtual absence of corporate governance and the peculiar mix of markets and authoritarian rule have led to severe inefficiencies. The four largest state-owned banks are insolvent by Western standards, and the Chinese banking system is burdened with a high share of non-performing loans. Depending on who is collecting the data, this share ranges from 20% to 40%. More important, however, is that this banking system has generated an inefficient allocation of capital. If we take Beijing's statistics at face value, the Chinese have channeled between 40% and 50% of their national income into fixed investments. This is an extraordinary share. In fact, it is about double the share of business investments seen in India. Yet, at 9%, China's GDP growth is not substantially higher than the 7% to 8% growth achieved by India. Clearly, India appears to enjoy a more efficient capital allocation. This raises the question whether India's future growth will eventually be more sustainable than China's.

VIII. Development and freedom

There are good reasons to assume that different expectations about the sustainability of the growth performance in India and China are related to differences in their political systems. Amartya Sen, the Indian-born winner of the 1998 Nobel Prize in Economics, once famously remarked that there are no famines in democracies. He pointed out that India has not seen a famine since its independence in 1947. In contrast, about 30 million Chinese died in the late 1950's in the wake of the horribly ill-conceived "Great Leap Forward."

Sen's point goes deeper. His argument is that democracies are more resilient in the face of adverse developments because their economic policies can be more flexible and their public policy more responsive to social needs. Indeed, political leadership has always been contingent on innovations that make countries more resilient. This democratic resilience appears to be lacking in China.

In contrast, India has a record of stability in democracy. The Swiss in particular should appreciate that the Indian subcontinent with more than 30 languages, 1,500 dialects, and six major religions has been capable of holding together since its independence more than 50 years ago while implementing economic reforms.

In this situation, businesses may find themselves between a rock and a hard place. They can choose to invest in India, where they will find a fairly recognizable business environment with a well established rule of law, but where decisions tend to be stifled by bureaucracy. Or they can go to China, where there may be less red tape and more economic dynamism, but where they will be confronted with deficiencies in corporate governance and a lack of contract certainty.

Clearly, India and China must continue to travel on their long road toward sustainable development. In the end, what counts is the freedom that successful development will entail. As Amartya Sen wrote:

> "Development requires the removal of major sources of unfreedom: poverty as well as tyranny, poor economic opportunities as well as systematic social deprivation, neglect of public facilities as well as intolerance or overactivity of repressive states."

This agenda deserves our support. It describes the human face of development. The post-war growth in East Asia demonstrates that a market-friendly development in partnership with global corporations can be successful. I trust that our industry will continue to make its contribution to the fundamental humanity of prospering market economies.