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| Rick Lannamann: | It is my distinct pleasure to introduce Ruchir Sharma, who is the Chief Global Strategist at Morgan Stanley Investment Management. He is a contributing opinion writer, and he's written some really interesting things over the last several months in the New York Times. And his essays and op-eds have appeared in the Wall Street Journal, The Financial Times, Foreign Affairs Time, Foreign Policy, Forbes, a lot of different publications that you read. But earlier this year, he released his latest book, an international best seller, "The Rise and Fall of Nations, Forces of Change in the Post Crisis World." Fareed Zakaria has called it, "Quite simply the best guide to the global economy today." |
|  | Ruchir has been named one of Foreign Policy Magazine's top 100 global thinkers, and in 2015, Bloomberg Market's Magazine named him one of the 50 most influential people in the world. Alongside names like Barack Obama, Janet Yellen, and Warren Buffet. So it gives me great pleasure to introduce Ruchir Sharma. Thank you. |
| Ruchir Sharma: | Thank you very much. Great to be here. Of course, my office is exactly in the next block, so rather convenient as well. But I think a great opportunity to speak to this audience. I know that the focus today is very much on China, and what I thought I would do basically is to sort of just give you a bit of a brief background about how exactly I think about the world, and where does China fit in to that world view? |
|  | So I've basically been a writer for longer than I've been an investor. I started writing way back out of high school in India in 1991. When I was too young for any wealthy people to give me their wealth. So instead I thought the next best thing to do was to write about what's happening in the world. And I continued to do that until I joined Morgan Stanley in 96, where quite simply the people who read some of my work basically made an offer to me that I couldn't refuse. I was getting ready to do my PhD here in the United States, and they told me that would you rather make money, or would you work? So I said I would work. So with that I sort of gave up my PhD ambitions, and I started working. And I've been here in New York. I came here subsequently, and I've been here in New York for the last part of that as my base. |
|  | But I still like to travel to one emerging market a month to understand what's happening in the developing world. And one discipline that I've carried on throughout that is to write about what's happening in the world. So therefore, I don't think a single month has gone by in the last 25 years when I haven't published some piece of work somewhere. Of course, as every writer has an ambition, is to write a book. Every writer thinks that he or she has a book in them. As one sort of wise crack told me, that's possibly the best place for it. But I still decided to go ahead and write a book. I wrote my first book, "Breakout Nations," in 2012, which was a survey of all the countries in the world to figure out what my views of those countries back then were. |
|  | But to me, the second book was possibly a much more academic kind of work because it looked into, what are the ten most important things we should look at to know if a nation is going to rise or fall in the foreseeable future. And what I'm going to try to do today is illustrate to you what those ten most important rules are, and where does China fit in when you look at those ten rules today? |
|  | So of course, one thing that I'm really clear about, is that I'm a practitioner. I'm an investor. As an investor, I have to put my money where my mouth is. So I can't just afford to have opinions, and then be wrong about them because I'm gonna lose a lot of money, either for me, or for my clients if I do that. And one of the very important rules that I've always kept in mind is that when talking about the future, always talk about the foreseeable future. Because often what we find with forecast is that people love to talk about what's going to happen in the world in 2030 or 2050, and all those kind of forecasts. But I tell people that the old rule of forecasting used to be that you make as many forecasts as possible, and you keep telling people when you're right. The new rule of forecasting, which has become more fashionable as of late, is that you forecast so far out into the future that neither you, or I will be here to know whether I was right or wrong. |
|  | And this is my biggest problem of at times academics and other people, that often they're talking about the world in 2030, 2050. I mean who knows. I wish I could have clients to whom I could say, hey come back and check my performance in 2050, or you had sort of business people, who you could go and say that to. Instead, if you look at forecasting, what it tells you is the fact that any forecast beyond five years, is a complete random guess. So forecasting is a very difficult thing to do, as Yogi Bear has said, especially about the future. But it is even more difficult if you're trying to do it for anything beyond five years, because it's nothing more than a random guess. |
|  | So I try to construct my ten rules keeping that in mind. Let's talk about the foreseeable future, which is the next five years or so, and anything beyond that is quite pointless. Which brings me to the ten rules and where China stands in that context. So my first rule in terms of looking at any developing country to know if it's gonna do well or not, is that, what is the commitment of the leadership of the country to carry out economic reforms. And often what I find is this. That the longer a leader stays in power, the less is the incentive for the leader to carry out economic reforms. This is based on what statistical and on what some sort of observations that we have done with countries over the years. The longer a leader stays in power, the worse it is. And one really good thing about China that we have seen, which is the fact that they have a pretty much forced change in leadership at least every once every ten years. Because often you find that when leaders come to power, they're very different from the time when leaders stay in office, let's say especially for more than ten years. And I learned this rule the very hard way by examining Russia. |
|  | So let me tell you a little anecdote about Russia. When Putin first came to power in 2000, 2001, people forget, he was a very different leader compared to the Putin you see in power today. And I learned this the hard way, because in 2000, 2001 when I heard Putin speak it was a very different language. He was speaking about integrating with the west, with Europe, about liberalizing. He cut taxes, he introduced a lot of important legislation, which is what allowed Russia then to benefit from the incredible oil boom that took place after that. |
|  | But in October 2010, I was going to go to Moscow to attend a conference, and I got a phone call a few days before I was about to go saying that then Prime Minister Putin is always going to be at the conference, and his office is requesting that in your capacity as a large investor, can you make a frank presentation about what you think about Russia. So I said okay. I'm coming anyway, I'll make a frank presentation. I'm an investor, and a writer, sort of used to speaking my mind. So I decided to take the advice very literally, and said, I'm going to make a frank presentation. I landed up in Moscow to make a frank presentation. I got up on the podium to speak just like this. It was a big room. Putin was sitting right there along with Christine Lagod who was visiting back then from France, and I began my presentation. What I did not know was this was going to be telecast live, because Putin is going to be out there. |
|  | So I start my presentation by saying that Prime Minister, you first came to office, you handed out xyz reforms, which helped Russia. Fast forward today, ten years later, and here are Russia's problems. Still too dependent on oil, commodities, massive monochromatism, no space for small and medium sized businesses to do well, oil valued exchange rate, and I went on like that. Putin was sitting there pretty stone faced, but he looked as if he was making notes. After that he came to speak. He seemed to acknowledge some of the points I had made. I thought well and good. He's sort of listening to what's being said out here. I go back to my hotel. Next morning I'm woken up pretty early in the morning by my office, saying what have you done. I ask them, I'm not sure, what have I done. They said, don't you read the press. I said, no I don't read Russian. What are they saying? So of course the press in Russia, the print is largely controlled by the Kremlin. And they decided to go after me the next day, basically saying he's coming here to spoil the party. Who needs his money? He can go home. I was sort of softly advised then that you should go home. And I left Russia, Moscow that day, and I haven't gone back ever since. |
|  | But what that really told me was about how Putin had changed over time. And this is one of the points that I make. That one thing I find about China, that because of the rule they have in place that the leadership should every ten years, and they have an age limit, which is also Putin there sort of, I think that's a very healthy thing as far as China is concerned. So now for the big party congress is coming up next month. A lot of focus on that. But one of the most important things we'll be looking at then basically is the fact that is there going to be a commitment for succession, or is there gonna be an extension of the current leadership, which possibly goes beyond even then. Because, a lot of important challenges that China faces over the next five years. |
|  | Which brings me to my second rule. Which is that the size of the state, what we typically find is the larger the state and the more meddlesome it is in an economy, the worse it is for any country. And one of the successes about China which is really underestimated, or under appreciated, is that a lot of people like to think of China as a state controlled economo's. As someone which is state directed sort of capitalism. What they don't realize is that China's success is as much about the state getting out of the way, over the years and decades. So China, when it began its reform process about 30 years ago, the entire economy was dominated by the state. The state controlled more than 90 percent of the economy. There was no private sector. |
|  | Today the role of the private sector is much larger, more than 50 percent than the role of the state. And this is something which is underestimated that China's success is as much about the state getting out of the way and reducing its role, even though in some segments it's still quite large at least from an economic sphere. Rather than doing anything to the country which is by becoming more interventionist. And that is something that China needs to do even more. Because one thing that we've seen in China in the last few years as they've tried to fight the very sharp economic slowdown which has taken place globally, and also with China, is that the state has become a bit more active in some sectors. And this is taking place at the same time when a new China is emerging. So I find it very fascinating picture about China. You have an old China which has a lot of problems in terms of the state run enterprises with lots of debt on their books, a lot of inefficiencies. |
|  | And then there's the new China, which has these amazing technology consumer and health care companies coming out of the private sector, and being these big giants. In fact, today for the first time that I can remember, that of the top ten companies in the world today by market value, two Chinese tech companies are part of the top ten now. Ten Cent and Alibaba. So this is very much the rise of Chinese tech. But it's a very two faced kind of market. You have this new China which is doing very well, and this old China with a lot of debt on their books, which is a big risk to what's happening to China today. |
|  | Which brings me to my third point, which is about debt. If there's any predictor of financial trouble and economic trouble for a country, it is when a country takes on too much debt over a short time horizon. Almost always the country gets into trouble. So look at what China has done. Until 2008, China's debt, and China's economy were growing at about the same pace, which is how it should be. But since 2008, as China has tried to keep up its growth rate in a slowing growth world, it has taken on a staggering amount of debt. So, over the past year, it has taken four dollars of debt to create one dollar of GDP growth in China. And that's been the pattern for much of this decade. As a result that no developing economy in history has taken on as much debt over such a short time horizon as China has taken on over the last five to seven years. And that for me is the single biggest risk for the Chinese economy. If you look at the United States in 2007, look at Europe in 2008 when they had their troubles. It was similarly proceeded by a massive buildup in debt. |
|  | So this big buildup in debt in one of my favorite rules cause it's got such a good predictive power. That when a country takes on too much debt over a five to seven year time horizon, the next five to seven years are almost always fraught with a lot of risk. And this is one of the big things that China needs to do. So in fact, I think any sort of advice to be given, again, maybe gratuitous to the Chinese government today, it is that the number one priority needs to be to stabilize the debt. Because today in China the level of debt as a share of its economy, is now beginning to exceed that even of much more developed economies such as the United States. That share is increasing. |
|  | So the number one priority needs to be you need to stabilize that debt because if you look at the economic miracle stories in the world which went wrong, it was when they took on too much debt over a short time horizon.Something that Japan did in the late 1980s, and Korea did in the late 1990s. It's a problem that they need to look out for. |
|  | My next rule really has to do with the fact about demographics. Which is that every single fast growing nation in the world has had good demographics. Which means a good increase in it's working age population. China too experienced such a big boom in its working age population in the 1980s and the 1990s. But now that dynamic has shifted globally. In fact we're seeing a big decline now in the world's working age population growth rates take place in a handful of countries, and in China as well. We're seeing that. For the first time last year, China's working age population, defined as people in the age group of 15 to 64, declined. For the first time. So it means that demographics is now a big challenge for China's growth, and the entire growth has to come from productivity, rather than to come from demographics. Otherwise these are the two big drivers of economic growth. So this is something that China is trying to reverse growth wise now, sort of ending its one child policy, but this takes a long time for the needle to move here. Because by the time that people start producing more babies, and you end up entering the work force, it takes a long time for that to happen. |
|  | The other rule that I focus on a lot has to do with income and equality. This is something with I focused much more and more in the last few years because it's come up as a global issue. Everywhere we're seeing and increase in income and equality. The question for us from an economic growth stand point is when does income and equality become such a factor that it begins to lead to a backlash against the elite, and the against the wealth creation process in a country. And in this regard I have formed something called the list of good and bad billionaires. |
|  | What do I mean by this? The data on income and equality tends to be quite lagging. Whereas you get data on billionaires and how many there are in the world, and what's happening to their net worth, on almost a daily basis. There are about 2000 billionaires in the world today. But what's very interesting is that in each country I try to look at how many billionaires come from so called good industries, and how many from bad industries. Why do I say that? Because I say that if you have billionaires that create their wealth because they've done it on their own in industry such as technology, manufacturing, or healthcare, consumer, which is based on their own entrepreneurial talent, those billionaires tend to be respected in general by the rest of the population. |
|  | On the other hand you have the billionaires who created their wealth predominately from industries which require government help, which means that they really aren't giving the system, or bribing, or doing whatever they have to to try and get the right contracts and creating wealth in industry such as mining, real estate, oil. Typically, in that bracket you end up getting a lot of bad billionaires that come out. Now everyone is bad in that bucket. Not everyone is good in the good bucket, but the ratio is what matters. |
|  | And again, the good news I find in China here on this rule is that a lot of the wealth creation in the last few years has been by the good billionaires, and the so called industries which are like technology, healthcare, consumer facing industries rather than the kind of billionaires we saw come up previously, which relied a lot on local government contacts. And so often we would see them and the governments would change. The billionaires would be sort of in jail, or out on bail. There would be a big shift in that. So we have seen a big shift as far as this is concerned, that a lot of the billionaire wealth in China is coming in so called good billionaire segment, and so therefore I feel more confident about the sustainability of that going forward. Whereas in countries like Russia, Mexico, a lot of billionaire wealth created in the other industries, I feel less confident about that. |
|  | So some of the other rules I'll briefly touch upon and then present, what is the net picture about China is this environment. One of my other rules I look at is how cheap or expensive is the currency? That typically when you go to a country, the currency should feel cheap. If it feels expensive, it means that this country is not that competitive. And China generally has been very good at that. And you know that it's still a sort of issue here. Even though the currency now does not feel cheap anymore, and it's possibly a bit expensive, and facing depreciation pressure at times, but a success in China was that it kept its currency very cheap and undervalued for many years. And that is a good thing to do. Of course U.S. politicians don't think that, and we have a lot to say about that. But that is something that China did well. But now I feel that the currency in fact has depreciated significantly over the last decade, and today has become a bit more expensive, and possibly faces more downward pressure going ahead. |
|  | The other rule that I look at is in terms of geography. That the spread of wealth in a country should be geographically spread out. It should not be concentrated in just a few areas. I learned this rule in Thailand. If Thailand if you go, what you notice is the population of Bangkok is ten times larger than the population of the second largest city in Thailand. And that Bangkok accounts for 40 percent of the country's GDP. That is way too high. In any normal economy, the ratio of population between the largest cities, and the second larges cities typically tends to be about three to one. If it's much more than that, it means there's a lot of geographical unevenness in the way growth has played out, and people in the hinterland are likely to be quite resentful of what's happening in the main city, or cities. And so you find in U.K., in France in the developed world, these ratios are out of whack. London is much more populous than the second largest city of Manchester. The ratio is four to one. In France, the population of Paris is six times larger than the population of the second largest city Lion in France. |
|  | Here China has been very successful. Of course it has many second tier cities, and has created a lot of new cities over the last few years as far as growths concerned. Unlike let's say in India. A favorite statistic I quote is that in India, the number of cities, number of new cities which have come up in the last few decades in India has statistically been close to zero. That all of the existing cities have scaled up, but very few new cities have come up. Whereas in China, tens of new cities have come up. And that leads to a much greater geographical spread of growth as far as China is concerned, even compared to a country like India. |
|  | The other rule that I focus a lot on before I get to my summary, is what I call the curse of the cover story. And this is one of those things that goes back to my days of writing as well. What do I mean by this? You know, when we used to work in the news rooms, we used to often hear about the curse of the cover stories, which meant that the moment a country or trend made it to the cover or a magazine, that trend seemed to get jinxed. And I decided to test this. Is this just a myth? Is this a superstition, or this grounded in any reality? So we picked on Time magazine, because Time magazine is after all a very popular magazine, very widely read. So we looked at the cover stories of Time magazine going back to 1980. And here is the finding. We found that every time Time magazine put a country on its cover in a positive way, for the next five years, the country on average did poorly. On the other hand, whenever Time magazine put a country in a negatively on the cover, then over the next five years, the country did rather well. |
|  | Why does this happen? This happens I think for two reasons. One, as I said, trends don't last for long. And by the time the editors of a magazine reach a consensus that this country is doing well, typically that country's trend has already played itself out. And secondly, there's a feedback loop that when a country makes it to the cover of a magazine in a positive way, the policy makers tend to get much more complacent, they don't carry out that much reforms. |
|  | On the other hand, when a country's being spoken about in a negative way by the popular press, it means the trend has already played itself out, and the leadership of that country is now getting prepared to carry out reforms because typically leaders carry out reforms when they have their back to the wall, from Putin in 2000 to [inaudible 00:25:10] a decade ago. It's when they have their back to the wall, to what's happening in France today with Macron and the fact that the best economic reforms in the world over the last few months and quarters have been carried out in fact, in Latin America because so many leaders in those countries sort of had their back to the wall, and were forced to carry out economic reforms. |
|  | As far as China is concerned, we have to be a bit careful about the hype out here. Because there's so much hype about when China's gonna take over the world, when it's gonna rule the world, that all of this is gonna be done out there that we have to be. But yet I think that what this ignores, sometimes I find is the fact that yes, China is growing very rapidly, but beneath that surface as I pointed out to you are some very big problems, the single biggest one being that the financial system in China is very fragile today. That the amount of debt that China has taken on is a lot, and there's one aspect in which China has made absolutely no progress, which is what I find quite staggering. Which is that even though it has been catching up rapidly in its economic size compared to the United States, today the Chinese economy is only forty percent smaller than the U.S. economy, so it's really caught up a lot with the U.S. economy, even the pace of U.S. conversions have slowed down. |
|  | But, there's one aspect in which China lags the United States incredibly, which is on the financial front. On the financial front, the U.S. dollar has never been this powerful as it is now, and the Chinese currency is just not gaining any traction or acceptance in the international sphere. And what do I mean by that? So if we look at it today, if we look at the foreign exchange reserves held by various governments in the world, nearly two thirds of those foreign exchange reserves are held in U.S. dollars. What proportion of foreign exchange reserves are held in the Chinese currency? Less than one percent. |
|  | And in fact, in the last couple of years as China has been trying to keep its financial economy from causing problems to the real economy, it has clamped down incredibly on capital controls. And you have seen that China basically, the use of the RNB in international transactions has been dropping in fact, which is not becoming of a country rising to become a big superpower. So if China wants to realize its superpower ambitions, it has to think about not just in economic growth terms, but also in the sustainability of economic growth, and also on other metrics such as financial terms. And as I said that today from a financial standpoint China is very dependent on what is happening to the U.S. Federal Reserve, when will the fed increase interest rates. That tends to move capital flows a lot partly because the world today is so dependent on just the dollar as the main reserve currency, and the China not being able to make any end roads in that regards. So much talk about one belt, one road, which is very good I think it's a great initiative, but on the financial side, this is the problem. |
|  | So this is where I really come as far as China is concerned. That it really is like never before a case of two Chinas. You have a new economy powering ahead with new billionaires in such dynamic industry such as technology, consumer, and you see that dynamics in the growth rates which these companies are seeing. How they are making it to the world stage. The amount of research and development spent in China today is beginning to get to same levels as the United States. So incredible amount of dynamism happening on the new economy in China. |
|  | And then there is the big legacy problems of the old economy, the state owned enterprises, the amount of debt they have, the amount of debt that they continue to pick up to try and grow rapidly. So in fact, I was thinking about the next piece to write about China as the party congress approaches, and my single sort of biggest concern here has to do with the old economy. That is hope the old economy does not come and damage the new economy as these two Chinas exist. And the way to prevent that from happening is to basically for China to say, hey our number one priority today has to be to prevent the control, or to stop the increase in the debt levels taking place in China. The spot where it takes four dollars of debt to create a dollar of GDP growth in China cannot continue forever. And that is something that I think they need to focus on. |
|  | And as I keep saying that the way to do that is to drop the growth target. To not have this growth target of having to grow at six percent every year, but to accept whatever growth is realistic and sustainable. As that traffic sign goes, better to arrive late than never to arrive. And I think that that's the key lesson for China. That yes, it is on a path to becoming a superpower. In many ways it already is. It's the largest contributor to global growth on an incremental basis, but for China, and especially for the leadership as it plans for the next five years when the party congress wraps up in October, that if you want to achieve these goals of China, continue to grow, and not falling into a middle income trap, then you have to pay attention to the old economy even as the new economy continues to power ahead. |
|  | Thank you. |