

'What Bihar is to India, INDIA IS TO FOREIGN INVESTORS'

Ruchir Sharma, head of emerging market, equities and global macro, Morgan Stanley Investment Management, generally spends one week per month in a developing country somewhere in the world. Also, he has been a writer for as long as he has been an investor. Sharma has blended and channelled his two areas of expertise — extensive experience on emerging markets and ability to write about them — into a new book, *Breakout Nations - In Pursuit of the Next Economic Miracle*. In this free-wheeling interview with **Vivek Kaul**, Sharma assesses the planet at large and sharpens his focus on India.

How do you define a breakout nation?

Let me tell you where this idea came from. The last decade was a very exceptional decade for emerging markets in the sense that every developing economy did well. This is not consistent with the history of economic development. We have got 200 countries in the world, and only 35 are developed, everything else is emerging. So, the consistent history of economic growth is that you get bursts of growth and then it falters. Very few countries are able to sustain these bursts of growth and develop and become fully developed countries.

So, why was the last decade different?

The '80s and '90s were a very bad period and this was a catch-up happening because of that. Also, there was a lot of easy money that started to flow out of the United States (US) from 2003 onwards. And there was a boom in the global consumer. It led to this myth at the end of the decade that if you were an emerging market, it was all about time as to when you would converge with the developed world.

As I surveyed the world, I figured out that's not going to happen. That's not the history of economic development and after a decade of economic success, many countries were beginning to falter. Other thing that sort of stuck me was that people would ask me, 'listen, even if India grows at 6%, no harm done, because the US is growing at 2-3%'.

There are two things that are wrong about that argument. One we saw last year, when the Indian equity market fell 35% in dollar terms. So, if you undershoot expectations, it has a very negative fallout.

You are referring to the Indian GDP growth falling to less than 7%?

Exactly. One thing that people don't take into account is expectations. Like in China today, all expectations are of the country growing by 8-9% and if China grows below 8-9%, it leads to instant panic in markets, especially the commodity markets.

So, to come back to your first question, one of the definitions for a breakout nation is that, the expectations have to be exceeded. If your expectations are already high and if you are just about meeting them, it's not going to feel like bang for the buck for anyone.

You say one of the definitions...

The second is this per capita income argument, which is that if India grows at 4-5%, that's a real underachievement because we are only a \$1,500 per capita income country whereas if a country like Korea grows at 4%, it's a huge achievement because it's a relatively rich country with a per

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capita income of more than \$20,000. It is still classified as an emerging market, but it is fairly rich.

So, there are three things behind, which went into defining what a breakout nation is. One, that not all emerging markets are going sort of emerge, so to speak, or become developed markets. Two, that expectations are key in terms of how you define a breakout nation. And three, that you have to take into account per capita income levels. The lower the base, the easier it is theoretically to grow and the more you should grow to get out of poverty.

You also say "very few nations achieve long-term rapid growth". Why is that?

This is because most countries or most emerging markets reform only when they have their backs to the wall. They enjoy some success and then they stop reforming and begin to fritter away their gains. That's what happened to Brazil. Brazil used to be the China of the 1960s. Its growth rate was nearly in double digits and then it completely lost its way. It started to fritter it away in terms of huge government spending, subsidies and massive amount of wasteful expenditure which led to hyperinflation. If you look in the high growth list of the 1950s and 1960s, there were countries like Yemen, Iran and Iraq. The odds of long-term success like it is with companies, are very low. How many companies are there today which were there 30 years ago, or 20 years ago?

So, which are the countries that have grown consistently over the long term?

There are only two countries which have grown over 5% for five decades in a row, South Korea and Taiwan. Only six countries were able to do more than 5% for four decades in a row. The list included Hong Kong, Singapore, South Korea, Taiwan and I think there was Malta.

What is it that these countries did differently that other countries did not?

In countries like South Korea, China and Taiwan, they consistently had a plan which was about how do you keep reforming. How do you keep opening up the economy? How do you

Book excerpts... THAT AVARICIOUS POLITICIAN

Lately Indian businessmen have been regaling one another with accounts of a leading politician from Mumbai who is known to have amassed a huge wealth through property deals. At a private screening of a new Bollywood movie, this politician asked the producer to replay a particular song-and-dance number, over and over. When the producer asked if he was taken with the leading lady, the politician said no, he was eyeing the location and wondering where the producer had found such an attractive stretch of open space in Mumbai.

keep liberalising the economy in terms of how you grow and how you make use of every crisis as an opportunity.

Like Korea was really down in the dumps in the 1997-98 crisis. They really had their back to the wall. But they capitalised on the crisis to clean up their balance sheet and to emerge again as an economic powerhouse.

It is just about the fact that you need to consistently keep reforming and understand that odds are against you. In India's case, what concerns me is the attitude. 'Listen, we will grow by 7%, no matter what happens. That is a given.' Now why it is a given, I don't know. Earlier, it was 8-9%. Many businessmen also like to parrot the line that '7% growth will happen, no matter what happens'. To me I find that very disturbing. Maybe, it is changing now, but till at least a year ago, the attitude was very clear.

You have set many doubts on China becoming a breakout nation. Why?

In fact, I admire China's success and of what they have done over the past 30 years, but my point is that expectations on China have become too high. To me, that is the big thing. Even though its per capita income has reached around \$6,000, the IMF still thinks that for the next five years, the growth will be 8% per annum. Every time the growth dips below 8%, it leads to panic.

Can you elaborate on this?

Surveys are carried out where fund managers are asked, 'Will China have a hard landing?' I find two responses interesting. Only 10% say that China will have a hard landing. And how do they define a hard landing? A growth rate of 7% or less. The breakout nation concept is that you got to beat expectations. So, what I am saying is that if China records a GDP growth rate of 6% next year, trust me it will lead to a lot of panic in many circles.

There are lots of negatives that you point out about China, which we do not tend to see here in the normal scheme of things. Like, you talk about salaries going up at a very fast pace. That is to say, wage-driven inflation...

Chinese costs have been going up at the rate of 15% per year, and as I argue at the back of the book, the US, in fact, is now seeing some re-shoring (factories are moving back to America), as we call it. After all, the outsourcing and off-shoring the new trend in the US seems to be re-shoring because the wage gap is narrowing. It is still there. But the wage gap is narrowing. An anecdote that I found very useful was when one of my portfolio managers went on the ground and what the companies told him was that three years ago, we could shout at the workers, but today they can shout back at us. I think that's natural. For the first time, in China, the urbanisation ratio has gone to 50%. So, a lot of the workers have moved from rural to urban areas, and the scope of workers left for companies to tap from is diminishing.

Why do you call the \$2.5 trillion foreign exchange reserves an illusion?

If you look at the total debt of China as a share of their economy, it comes to around 200% of their GDP. The Chinese know that. And therefore, they are reluctant now to keep stimulating the economy with debt and they are trying their best to clean up the banking system by sort of being careful about off-balance sheet transactions. When you talk to the entire world, when it comes to debt statistics, they don't look at the entire picture, they just look at the narrow picture that China's central government's debt to GDP is low. But a lot of the debt sits on the local governments' balance sheets or on company balance sheets which are owned by the government, which is all the same, if you put it together.

You say that the Chinese consumer not doing well is a big myth...

This is because the Chinese consumer has been doing well. And this myth has got propagated because the

Chinese consumption as a share of their GDP is low. But my entire point is that it is low not because consumption is doing badly, but because investment and exports have done exceedingly well. My entire point is that the Chinese consumption growth cannot increase further. It can continue at this pace.

I was surprised when I read that the consumer spending in China has been growing by 9% every year over the last 30 years.

Yes. It is comparable to what Japan, China and Korea achieved.

So, it's been growing as fast as the Chinese economy...

No. Just a bit below. The Chinese econo-

my has been growing at 10% and the consumption has been growing at 9%. Because the overall economy has grown at 10% and the consumption has grown at 9%, consumption as a share of Chinese GDP has come down, which leads many people to believe that the Chinese consumer is suppressed. Yeah, maybe suppressed relative to exports and investments, but not in absolute terms.

Another thing I found quite fascinating in your book is the portion where you describe your experience of taking the maglev train in Shanghai. Can you take us through that?

It was like going to an amusement park. I had heard so much about this train which travels at 400 kilometres an hour. I never thought of taking it because typically someone is there to pick me up at the airport. In 2008, when I was driving from the airport back to my hotel, I heard this train zipping past me like zip. I was like what is this going on? It really feels like a bullet passing you by when you are going by the car. So, I decided I have got to try this thing out. When we tried it out, it was a fascinating experience, though you have to go out of the way to take the train. In the business class cabin, there was nobody else other than me and my colleague. And you have this fancy stewardess who comes and sort of buys the ticket for you. When

Q&A

Ruchir Sharma

you are on the train, because it's a levitation act, you just feel zero friction. Outside the train zips past you, but inside you don't feel as if anything is going on. It's completely still.

But what is the broader point you were trying to make through this example?

The broader point is that no other country in the world will think of experimenting like this. But they have been investing at such a huge pace that they try out these experiments as well. When I asked why has this not been replicated in other parts of China, I got all sorts of explanations. One was that now 'we get environmental protests' because it goes through very close to some of the places. This is very new to China that you have got people who are protesting and saying we don't want this to happen. The fact is, they are not extending this train to everywhere because it does not make logical sense from the economic point of view. This shows the Chinese thinking also, that, 'listen, how much can we keep spending on these things?'

You call India and Brazil very high context societies. What is that?

This is a term that the anthropologist Edward Hall came up with. It would always strike me when I went to India and Brazil about the commonalities between the two countries. Someone says you come for dinner and the dinner won't start till 9.30-10 pm. And everyone sort of came late. I go to Brazil every year and in 2008 I heard about this serial called *A Passage to India* which was a huge hit in Brazil. People were talking about it in the party circles and I was like, 'I want to see this serial'. I figured out that it is a soap opera, and people are hooked to it at nine o'clock at night. The whole thing is a love story set in Jodhpur and Agra, and the actors were all Brazilians in Indian garb, and they looked pretty much North Indian to me.

The latest item girl in Bollywood is a Brazilian...

Really? You can't make out the difference very often. And that's my entire point. There are many parallels. So all this was fun, but what was the economic point coming out of it? I hope India does not go down the Brazil way with similar cultural habits of having a welfare state where you want to protect people. At that point of time, the government spending in India was beginning to really take off and now it's clearly sort of very high.

You even hint at India going the Brazilian way of hyperinflation...

This thing of having minimum wages and having them indexed to inflation, all these are traits through which a country like Brazil went down. The fact is that we have found inflation to be more sticky than it should be. This is happening because of all these welfare schemes being put into place. My whole thing is that you just can't take this for granted. But just because it hasn't mattered in the past, does not mean that it won't matter in future.

What is your view on the S&P's change in outlook on India?

It's consistent with the fact that we need to obviously get these things under control before we begin to lose the plot.

You also say in the book that India has too many

THAILAND IS A NO-FLY ZONE

Thailand - the 1990s darling of global investors - had become a financial no fly zone. A colleague of mine described the staples of the stagnant Thai economy as "rice, tapioca, and massage," and he wasn't entirely joking.

billionaires, given its size. What is the point you are trying to make there?

Wealth needs to be celebrated. It is an integral part of a capitalistic society to have billionaires. But when I look at the number of billionaires we have in comparison to the rest of the world, it does seem a bit high. If we had new wealth being created and had new billionaires coming up, that would be a healthy sign. But if it is the same set of people holding onto their wealth, it is not a healthy sign.

In the last five years, the churn has gone down in comparison to what it used to be. And you want high churn to take place because you know then new people are coming in. Also, you want billionaires to come from industries which are celebrated because of the general entrepreneurial talent like technology, manufacturing, et cetera, and not from places where the government is issuing licences.

If you look at other countries which have a high share of billionaires compared to the size of their economies, they are all countries where cronyism is rampant. Like Russia and Malaysia. And if you look at the countries which have made economic success models in the past, the wealth of the billionaires as a share of their economy is relatively low. This is because to create an environment conducive to the opening up of the economy, to reform and to wealth generation, you have to have this perception that it is being done in a fair manner.

Can India be a breakout nation?

I think so. I give India a 50:50 chance because expectations have now become lower to 6-7% GDP growth and that at least lowers the bar from growing at the rate of 8-9%, which is a very high bar. Regarding most countries, I have a categorical stand. I don't think that Russia and Brazil are on my list of breakout nations. It is a clearly a negative take on them. There is relatively a positive take on many of the South East Asian countries and Eastern European countries. But I think in India, I am sort of caught in the middle. I see the positives taking place when I travel outside of Delhi and go to the states. The whole India chapter in the book is about the fact that as the southern states have dropped off in the growth statistics, the northern states which you never thought would do well, from Bihar to even Chhattisgarh, are doing well.

I have lived in Bihar for almost 20 years. It is growing from a very low base, and that's why

NOLLYWOOD...

There is more to the Nigerian economy than just oil. The \$300million-a-year movie industry, known predictably as Nollywood, is the second-largest producer of films in the world, just ahead of the United States and behind only India. Its rise from virtually nothing two decades ago to become the nation's second-largest employer, after the government, is a remarkable example of how new cheaper technologies like digital cameras and some entrepreneurial zeal can create a mini tech-led boom even in the heart of Africa.

the high rate of growth.

Exactly. That is my point on India to you, which is that India's biggest benefit for becoming a breakout nation is the fact that its base is so low. It is true of India. So, what you say of Bihar in an Indian context is true of India in a global context, which is what gives India a 50:50 chance even though the policy-makers keep messing it up at the top. As you know, with Bihar the base has always been low. But obviously something has happened in the last seven years that the state has started to change.

In the last section of your book, you talk about something called commodity.com. What is that?

My whole point is that the world has developed for years and centuries and commodities have followed a very predictable pattern, which is that they go up for one decade and they go down for two decades because new technology, human ingenuity always come up, and triumph over any demand burst that comes through. Yet, at this stage, all people think that commodities are in some sort of a super cycle. And one stunning statistic that stood out for me is that in 2001, the world had 29 billionaires in the energy industry, 75 in technology. By 2011, the situation had reversed, with 36 in technology and 91 in energy, mostly in oil.

What is the point you are trying to make?

All you are doing is digging dirt out of the ground, so why should you have so many billionaires out of commodities? You are not doing something that is really smart and innovative. This is complete nonsense when you have so many billionaires coming out of this sector. You can have a few. There are signs at the peak of any trend when it looks like that this trend is going to go on forever. But those lofty expectations have their own undoing. Along with all this comes my argument that China's growth is about to graduate to a lower plane. And China is the 800-pound gorilla of the commodity market.

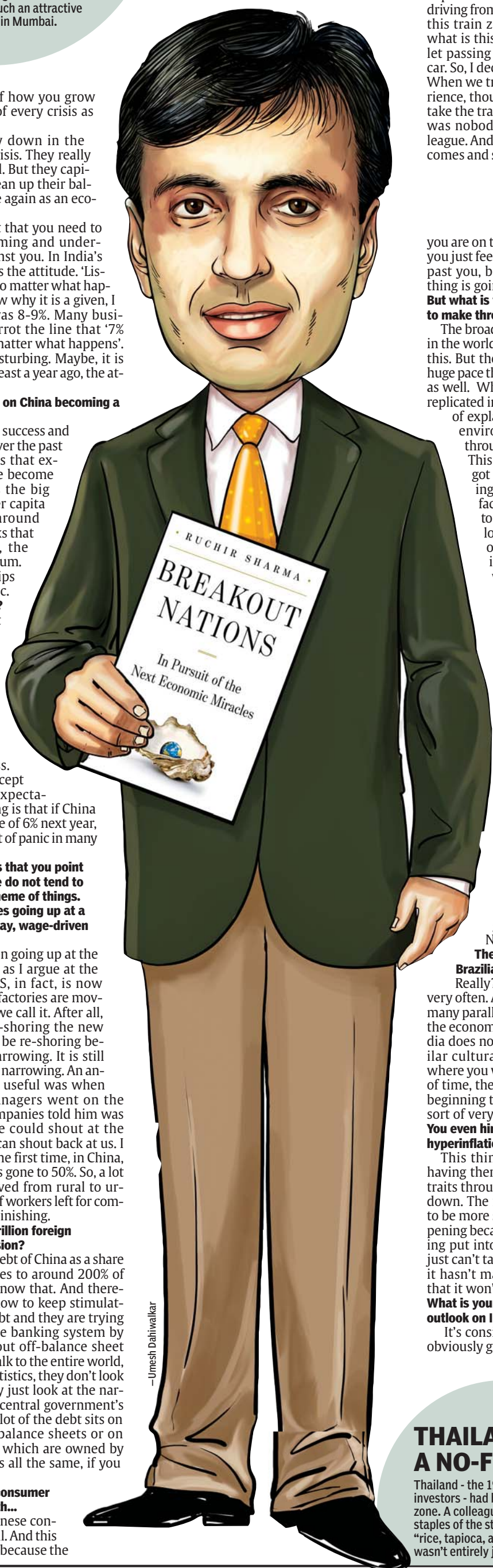
Why do you see the China-commodity connection falling apart soon?

Basically, everyone says that China has to grow, so it needs commodities. My point is again about expectations. If China's growth falls to 6-7%, as I think it may on a medium-term basis, a lot of the investments, a lot of things will appear to be excessive. So, China may grow, but the demand for commodities could come off very significantly. So steel, copper, et cetera, could all face oversupply in coming years.

One of the things you talk about in your book is that while central banks can print all the money they want, they can't dictate where it goes...

Exactly. Even in India, this sort of thing spread... and till date I get some of these questions that, 'we have all this liquidity in the world, central banks are pumping it, you know it has to come here in search of opportunities, where else is it going to go?' And my point is that it can go into all sorts of wrong places. Like, a lot of it has gone into oil, a lot of it has gone into commodities, has gone into people buying fancy wine, luxury goods, gold, et cetera. Central banks have put all that money out there because they want growth to revive. That's the reason for doing it. But you can't control it. You don't know where it ends up.

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— Umesh Dahiwalakar