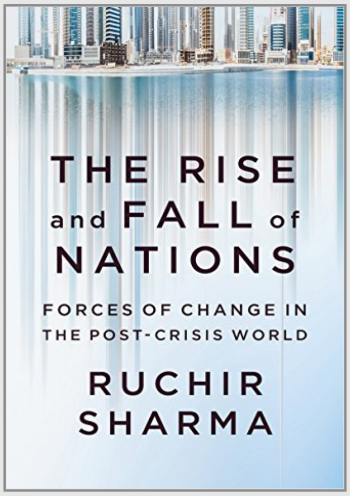

The Rise and Fall of Nations

Forces of Change in the Post-Crisis World

Ruchir Sharma
W.W. Norton & Company, Inc. © 2016
480 pages
Book: getab.li/27221

Rating

7

8 Importance
7 Innovation
7 Style

Focus

Leadership & Management
Strategy
Sales & Marketing
Finance
Human Resources
IT, Production & Logistics
Career & Self-Development
Small Business
Economics & Politics
Industries
Global Business
Concepts & Trends

Take-Aways

- Complex, interwoven series of events spur repeating economic cycles and cause national economies to boom or go bust.
- Economic peaks and valleys have been going on for centuries in cycles that run their course haphazardly and often upend conventional wisdom.
- Thus “impermanence” is a key concept for investors interpreting global markets.
- Important national economic indicators also include population growth, current account deficits, currency values and private debt.
- Population growth drives economic growth. A national economic miracle requires adding workers at a pace of 2% a year. This can gauge a nation’s growth prospects.
- Economies with relatively little manufacturing seldom weather commodity price fluctuations.
- When a nation’s current account deficit exceeds 5% of GDP, its growth is in danger.
- If a country’s private debt increases far faster than its economy, a slowdown looms.
- In his early years, Vladimir Putin was a reformer whose policies spurred growth.
- As Putin morphed into a populist and militarist, Russia’s growth cooled.

Relevance

What You Will Learn
In this book summary, you will learn: 1) Why national fortunes shift; 2) How complex, interwoven events spur repeating economic cycles; and 3) How population growth, current accounts deficits, currency values and private debt indicate the health of a country's economy.

Review
The headlines from China, Russia and elsewhere make the vagaries of global economies seem chaotic and unpredictable. How can an investor know which oft-praised economy already is in the tank or which ignored country stands poised for a rally? If you know which signs to look for, events won't surprise you, argues Ruchir Sharma, a market strategist at Morgan Stanley. In this compelling and elegantly written volume, Sharma outlines the telltale signs that often reveal where any nation is heading. Population growth, current account deficits, currency values and private debt are among the key indicators, along with the impact and "impermanence" of repeating economic cycles. While never giving investment advice, *getAbstract* recommends Sharma's insights to investors, policy makers, entrepreneurs and business students.

Summary

Volatile Global Economics
Prosperity once seemed to be a path to democracy, but the financial crisis of 2008 spread from the United States to the rest of the world, ending the rise of emerging markets. After the fiscal crisis, political freedoms declined.

"People in the world of global finance often think of themselves as big cats, predators alert to the rustlings of the economic jungle."

Brazil, Russia, India and China – the vaunted BRICs that would form a new economy – are now faltering. Their success, which economists saw as part of a new order, no longer seems assured. Russia's and Brazil's economies are shrinking. China, while not in recession, is experiencing a growth slowdown, from perhaps 14% a year to less than 5%. As the BRICs encounter rough waters, wags now say the acronym could stand for "bloody ridiculous investment concept."

Economic booms and busts have been going on for centuries. These cycles tend to run their course in a haphazard manner that upends conventional wisdom. Thus, "impermanence" is a fundamental aspect of global markets. Typically, a complex, interwoven series of events causes things to turn. For instance, political leaders can get sloppy, the price of a crucial commodity may plunge or soar, a nation's underlying demographics could change or its currency can become overpriced. Thus, investors can't rely on economic predictions that look beyond "a practical horizon of five or ten years."

"In an impermanent world, the only constant is the turning of the economic and political cycles that govern the future."

The "2% Rule"
Population trends impel economic growth. Robust population growth often drives "economic miracles." Booming economies have growing populations, but nations with shrinking populations are prone to economic slowdowns, pension fund holes and labor shortages.

In 1990, the growth rate of the world's population plunged from 2% to 1%. To put that in perspective, in the course of the past seven decades, 56 nations achieved 6% growth over a 10-year period. In those countries during those decade-long spans, the working-age populations ballooned by an average of 2.7%. Only a quarter of those countries saw sustained 6% booms when their population growth fell to less than 2%. It's exceedingly difficult for a nation to experience an economic miracle without adding workers. From 2020 to 2030, Nigeria looks to be the only nation that will top 2% in the growth of its population of adult workers.

"Even though the rapid expansion of global trade and money flows stopped after the crisis of 2008, many politicians are still quick to blame any local financial crisis on foreigners."

However, this 2% rule isn't foolproof. China, Poland and Russia, for instance, have had growth rates of less than 2% since 2003, and more recently have seen shrinking populations. China managed to sustain blistering economic growth despite low population growth, but the recent decline in its number of workers casts doubt on the sustainability of its outsized growth.

"Demographic Dividend"

The demographic dividend pays off only if political leaders set the stage for growth. Arab nations are a prime example. Despite 3% population growth from 1995 to 2005, they had no economic miracle. High youth unemployment and recent political upheaval have plagued the Arab world. Over time, nations have tried to control population growth with mixed results. Australia and France fought population declines by paying women small bonuses to have babies, but no baby boom resulted. China's famous one-child policy and the country's societal preference for boys have led to a population with too many males. In 2014, 121 boys were born for every 100 girls.

"Getting a feel for the value of currencies is an unavoidably subjective exercise; practical people are wise to be wary of the misleadingly precise numbers that abstract models can produce."

Having fewer young people means having fewer workers to pay for retirement pensions. Developed nations have tried to address this challenge. Germany has been gradually changing the retirement age from 65 to 67. In Brazil, many workers retire in their early 50s, thanks to a pension scheme that gives them 90% of their working salaries. The problem of too few workers is also a challenge for employers who need workers, so population declines encourage immigration.

"Emerging nations with the strongest records of investment growth also boast some of the world's strongest manufacturing sectors."

If you think robots will pick up workforce slack, think again. Despite predictions that computers will replace many human workers, the likelihood is that most people will adapt and find new roles, even if robots push them out of their old jobs.

Just as demography is not destiny, neither is location. The United States, with its long coastline, has many prime port locations – far more than all of Asia. Yet though much of China is land-locked, it has also emerged as a major player in global logistics. By "opening itself to the world" through trade-friendly policies, China has overcome any geographic deficits. Other, less dramatic examples include Bangladesh. Though not as conveniently located as India, Bangladesh has overcome greater travel distances by reducing the kinds of bureaucratic obstacles that hamper business in India. Meanwhile, South American governments are considering an Atlantic-to-Pacific highway that would cross the Andes and open remote areas of Brazil and Peru to trade. China supports this $60 billion project. Colombia aims to open land-locked Bogota, Cali and Medellín by building new highways.

"There is a strong tendency to believe that autocracies are better than democracies at generating long runs of growth."

Russia

Population growth is part of the overall economic picture. Consider Russia under the rule of Vladimir Putin. He took office in 2000 as a reformer and aggressively changed Russia's economy. Putin's policies included a flat tax of 13%, one of the changes that helped usher in an era of hyper-growth that sent Russian incomes soaring. Fossil fuels brought Russia $1.5 trillion over a decade. However, Putin didn't maintain the momentum he built. No longer

"Putin the pragmatist," he became "Putin the populist." He unveiled a foolishly generous pension plan. He diverted resources into military conflict and he failed to diversify from oil and gas, an industry seemingly always at risk of a cyclical downturn. As Putin's priority became holding on to power, his country's once-miraculous growth quickly disappeared.

"At the peak of the globalization boom, rising capital flows made it all too easy for countries to spend beyond their means and drift into financial crises."

Manufacturing

Manufacturing is a crucial cog in the growth of nations. China, South Korea, Malaysia and Indonesia are prime examples of countries that have produced sustained growth by using manufacturing as an important driver. In China, fully 30% of GDP comes from manufacturing. In any manufacturing economy, productivity gains matter. When a factory turns out more products with the same workers, the factory owner can give workers raises without spurring inflation.

Brazil

Poor countries can't ignore the value of smokestacks, but as nations mature, manufacturing becomes less important. Contrast the success of manufacturing-driven nations with the flops of commodity-driven economies such as Russia and Brazil. Their economies, which feature relatively little manufacturing, could not weather commodity price fluctuations.

"As the economic impact of population decline unfolds, some analysts…argue that the smart response to slower population growth is no response."

During the period that the world considered Brazil a driver of international economic growth, a curious phenomenon emerged. Brazil's currency became so strong compared to the dollar that Brazilian tourists came to New York with shipping containers full of retail goods. Some bought condos in Manhattan, a pricey real estate market that suddenly became affordable due to the robust Brazilian real. Average incomes in the US outstrip those in Brazil, but wealthy Brazilians could visit America and enjoy what seemed to be a fire sale.

However, Brazil's party was short-lived. In the early 2000s, as commodity prices soared, Brazil benefited from its production of iron ore and soybeans. But instead of spending and investing at home, Brazilians moved money overseas. It became less attractive to foreign tourists, who had to pay steep markups for hotel rooms and meals. Many emerging markets – such as South Africa and Russia – fell into the trap of letting their currencies overheat during the commodities boom.

"Even in an era when it is hard to find a successful activist state competently building competitive industries, state interventions in the economy differ hugely in quality."

To trade on currency imbalances, an investor must decide if a country "feels" cheap or dear. In the early 2000s, Brazil was expensive – as was obvious to anyone trying to buy a cup of coffee in Rio. When a currency becomes too costly, asset prices rise in the short term. But as "hot money" exacerbates the currency's situation, the tide ultimately turns. Exports become too expensive, investment slows, and the economy and currency return to earth. Economists and traders rely on metrics that endeavor to provide clarity by applying inflation rates, such as *The Economist* magazine's Big Mac index, which compares the prices of McDonald's burgers in different countries. Deutsche Bank added Levi's jeans and iPhones to the mix. These indices are useful but flawed.

"With sufficient political will and the right policies, nations can redraw the map of global trade routes to their own advantage."

The "5% Rule" Tracking the Current Account

The dollar remains the world's dominant currency, so a good assessment of money flows can begin with a currency's value against the dollar. The current account, which the IMF tracks, shows how much a nation consumes versus how much it produces. The trade balance, which compares imports against exports, forms the largest part of most nations' current accounts.

Trade balance is important, but so are other factors that don't appear in the trade balance itself. Remittances from abroad, foreign aid and interest payments going outside the country don't appear in the trade balance, but they still affect currency valuations. Red flags start waving when a nation's current account deficit exceeds 5% of GDP. On 40 occasions since 1960, nations that hit the 5% level for five years saw their economies slow. Most times the slowdown became a crash. The 5% rule applies to rich countries like Norway and South Korea, to poor ones like Poland in the 1980s, and to Turkey in more recent times.

"Brazil's economy had been thrown out of balance by its overpriced currency."

Thailand

In the early 1990s,Thailand pegged its baht to the dollar, a move that made the local currency seem strong. Thai bankers snapped up expensive wines, luxury watches and high-end golf clubs. Thai investors began borrowing in cheaper foreign currencies to buy items at home. The strong baht ultimately led to a local bubble. Thai real estate and stocks soared in value.

But when China devalued its currency in 1993 to boost exports, Thai manufacturers suddenly had an unwelcome competitor. Thailand blew way past the 5% rule. From 1990 to 1994, its current account "deficit rose as a share of GDP by an average of seven percentage points a year." The final nail in the baht's coffin came in 1995, when the dollar began to appreciate against the Japanese yen and the German mark. The baht became expensive, and foreign investors pulled out. In 1997, Thailand abandoned the dollar peg, and the baht plunged 50%. Thailand exemplifies "the kiss of debt" – the dangers of prodigious borrowing. Its private debt was 165% of GDP. Thailand's debt inflated much faster than its economic growth.

"Brazil's long record of state interference in the economy has reached a new peak."

Five-Year Growth

The five-year growth of private borrowing as a percentage of an overall economy is another indicator investors follow. From 2004 to 2009, Ireland's private credit as a share of GDP soared by 160%. Greece saw private debt as a share of GDP grow from 69% in 2003 to 114% in 2008. In the next five years, Greece's economy collapsed.

China

China has been building a "debt bomb," thanks to the state's insistence on maintaining unsustainable growth. "Shadow banks" extend credit instruments that promise investors outsized yields. In 2010 alone, people in China bought property totaling 800 million square feet [74,322,432 square meters], outpacing the entire rest of the world. Chinese apartment prices rocketed past 10 times annual incomes. Lenders issued collateralized loans often unrelated to borrowers' ability to repay but driven instead by the hope that values would grow.

"The biggest threat to growth arises when an emerging nation has already committed to heavy spending on redistribution through social welfare programs, as both Brazil and India had in recent years, and then decides to spend more."

As China's property bubble deflated in 2014, a stock bubble appeared. The people of China have $20 trillion in savings. The Chinese government urged savers to become speculators. Stocks exploded. The Shanghai market jumped more than 70% in just six months. Wise investors know four telltale symptoms of a stock bubble: Values soar at a rate disconnected from underlying economic growth. Investors borrow to buy shares. Everyday investors jump in and trade too much. "Exorbitant valuations" become common. These signs are everywhere in China today.

About the Author

Head of emerging markets and chief global strategist at Morgan Stanley Investment Management **Ruchir Sharma** spends one week every month in a different country.