

Opportunities of a Lifetime

Lessons for New Zealand
from New, High-growth
Economies

STEPHEN JENNINGS

THE SIR RONALD TROTTER LECTURE

2009

NEW ZEALAND BUSINESS ROUNDTABLE

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The Sir Ronald Trotter Lecture

SIR RONALD TROTTER was the first chairman of the New Zealand Business Roundtable in its present form, a position he held from 1985 to 1990.

Among his many other roles he has been chief executive and chairman of Fletcher Challenge Limited, chairman of the Steering Committee of the 1984 Economic Summit, a director of the Reserve Bank of New Zealand, chairman of the State-owned Enterprises Advisory Committee, chairman of Telecom Corporation, chairman of the National Interim Provider Board, a chairman or director of several major New Zealand and Australian companies, and chairman of the board of the Museum of New Zealand Te Papa Tongarewa.

He was knighted in 1985 for services to business.

This lecture was instituted in 1995 by the New Zealand Business Roundtable to mark Sir Ronald Trotter's many contributions to public affairs in New Zealand. It is given annually by a distinguished international speaker on a major topic of public policy.

The fourteenth Sir Ronald Trotter lecture was given by Stephen Jennings at the Museum of New Zealand Te Papa Tongarewa on 7 April 2009.

Stephen Jennings

STEPHEN JENNINGS is chair and chief executive officer of Renaissance Group, a Moscow-based company engaged in investment and commercial banking, asset management, agriculture and forestry in Russia, the Confederation of Independent States, and several African countries.

Prior to establishing the group, he served as co-head of Credit Suisse First Boston (Moscow) from 1992 to 1995. In this role, he led the State Property Committee's pilot voucher auctions, a project that established the foundations for the creation of Russia's capital markets. Subsequently, he has worked on numerous landmark financings and merger and acquisition (M & A) transactions in Russia and throughout the ex-Soviet Union countries, many of which have won professional awards and commendations.

Before going to Russia in 1992, he was with Credit Suisse First Boston in London, working on investment banking and privatisation transactions in Central and Eastern Europe. Previously, he worked for Credit Suisse First Boston and the Treasury in New Zealand, advising the New Zealand and Australian governments on privatisation, state enterprise restructuring and a variety of private sector M & A and capital markets transactions.

He earned his Bachelor of Business Studies degree from Massey University and holds an MPhil in Economics with first-class honours from the University of Auckland.

*Welcome by
Bill Day
vice-chair
New Zealand Business
Roundtable*



OUR EXCELLENCIES, MINISTERS OF THE CROWN, members of parliament, distinguished guests, ladies and gentlemen.

I am Bill Day, vice-chair of the New Zealand Business Roundtable, and it is my pleasure to welcome you to the fourteenth Sir Ronald Trotter Lecture. I would like to extend a particularly warm welcome to our guest speaker, Stephen Jennings.

As you may know, this lecture was originally scheduled for last October, but because of the unprecedented crisis in global financial markets that erupted at that time, it had to be postponed.

We are pleased that Stephen has managed to ride out the turmoil, and his insights will be all the more interesting for that.

We are also delighted that Stephen's parents, along with other family members and friends, are here tonight.

Unfortunately Sir Ron Trotter is unable to be with us and I know others will be paying a special tribute to him this evening.

I also want to thank New Zealand Business Roundtable members for their generous support for this event. Without you it would not be such a success.

A few words about the New Zealand Business Roundtable.

It is an organisation with a proud history. Most of us remember the days of 'Fortress New Zealand' in which business competition was limited and the government solved all our problems.

Businesses were on welfare with a plethora of government subsidies and protection. Farmers enjoyed 'supplementary minimum prices', which effectively meant that even the sheep were on welfare.

It was, of course, pretty comfortable for those involved – they faced no real risk and the money kept coming in – but it was not a recipe for the more efficient and competitive New Zealand we know today.

The New Zealand Business Roundtable grew out of this era. The very people who were receiving this largesse from the taxpayer argued against it, on the grounds that it was not good for New Zealand as a whole.

It is rare to see people arguing against their own self-interest. That is the proud history I am talking about and one of the reasons why I am a member of this organisation.

Our mission is promoting policies for a better New Zealand. The goal is increased prosperity for all New Zealanders.

The common thread that runs through members is that they are successful people who care deeply for the future of this country.

We are independent from the political process. Our aim is to get sound, well-researched ideas into the public domain and debated actively.

This evening is part of our mission.

Introduction by
Roger Kerr
executive director
New Zealand Business
Roundtable

IT IS MY VERY PLEASANT DUTY to introduce our guest speaker, Stephen Jennings, to give the 2009 Sir Ronald Trotter Lecture.

The lecture was inaugurated in 1995 to recognise Sir Ron's role as the Business Roundtable's founding chairman and his many contributions to business and public affairs in New Zealand.

Sadly, Sir Ron and his wife Margaret are not able to be with us this evening. Ron's health is failing and Margaret wanted to stay close to him.

Ron is a great New Zealander. The country owes him a huge debt of gratitude for his lifetime's work. He has been an inspirational role model for many, including our guest speaker. On behalf of everyone here tonight, I would like to send a message to Ron, Margaret and their family: Thank you, Ron, for everything you have done and everything you have stood for.

The purpose of our lecture is to feature an outstanding speaker on a major topic of public policy, which is the core focus of the Business Roundtable. We have been privileged over the years to have had a roll call of very distinguished individuals. One worth noting this evening was Yegor Gaidar, Russia's first deputy prime minister and minister of finance under Boris Yeltsin, who gave the lecture in 2000. Dr Gaidar is

well known to Stephen Jennings; indeed he was formerly on the advisory board of Stephen's company.

Like Sir Ron Trotter, Stephen is a Taranaki boy. He did a bachelor's degree at Massey University and then an MPhil with first-class honours in economics at the University of Auckland.

Stephen joined the Treasury in 1984 and was soon involved with the economic reform programme of the time. His talents were quickly recognised by finance minister Roger Douglas, particularly in tax.

Stephen went on to join what became Credit Suisse First Boston NZ, where he worked with Sir Ron Trotter who was then advising the government on state-owned enterprise policies. He also did work for Ngai Tahu and another of his mentors, Sir Tipene O'Regan, is in the audience tonight.

Thereafter, his career took a markedly different turn. He joined Credit Suisse First Boston's London office and then its Moscow office when it was opened in 1992. In 1995, he and a partner left Credit Suisse First Boston to set up what became his present company, Renaissance Capital.

I will leave it to Stephen to describe the relevant parts of his experience in Russia and beyond in his lecture. It is an extraordinary journey. He was involved from the outset with the economic transformation of Russia, starting with the first sale of a factory, the Bolshevik Biscuit Company. Renaissance Capital is now engaged in investment and commercial banking, asset management, agriculture and forestry.

A Russian friend of mine described Stephen as the most successful foreign oligarch in Russia. Unlike some oligarchs, however, he and Renaissance Capital have involved themselves as little as possible with government-related activities, and never bought state assets. I suspect his early education about keeping business and politics apart stood him in good stead.

Stephen has gone on to expand his business activities, including to countries in Africa; has ridden out the present financial crisis; and

has kept learning lessons about why some countries succeed and others fail.

Throughout, he has maintained deep connections with New Zealand. Last year he took up membership of the Business Roundtable, saying in an email to me that “If I’m going to keep worrying about New Zealand’s underperformance, I’d better pitch in and help”.

Our lecture tonight is from someone who has insights that are surely unique, from his professional training and his stellar business career, into the institutions and policies that allow countries to prosper.

With New Zealand’s productivity and economic growth rates having fallen away in recent years, and the new government’s goal of reversing that trend and catching up with Australian living standards over the next 15 years, there could be no more relevant topic.

Ladies and gentlemen, please join me in welcoming Stephen Jennings and inviting him to give the 2009 Sir Ronald Trotter Lecture.

Opportunities of a Lifetime

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Stephen Jennings

IT IS AN HONOUR to be given the opportunity to deliver the 2009 Trotter Lecture. This is primarily because of the enormous mana Sir Ron has as one of the great business leaders and contributors to our society of his generation. In many ways, Sir Ron and his lifetime of achievement embody the mindset, values and energy that are critical ingredients if our country is to achieve its potential in an age I believe will be characterised by extreme levels of both opportunity and uncertainty.

From rural Taranaki roots, Sir Ron went on to run New Zealand's largest corporation and, in so doing, embraced a global vision of industrial opportunity, something that is rare in New Zealand today. I once overheard him say, "if you can't beat the Aussies it's not worth getting out of bed in the morning". I haven't heard that one for a while. His cultural and community contribution has been a lifetime endeavour. Perhaps most importantly, in the mid-1980s when Sir Ron recognised that New Zealand was overdue and ready for a shift in economic direction, he brought the full force of his energy, expertise and determination to bear in leading many critical reform and restructuring initiatives.

Sir Ron is not a man who easily gives way to obstacles, figuratively or literally. When he was chair of Telecom New Zealand I was fortunate

to be part of a team advising the company on a range of regulatory and policy matters. On one occasion we were driving out of Telecom's building en route to the Beehive for a meeting when we found our exit blocked by an empty car. While the bankers and analysts looked at each other Sir Ron jumped out and started physically moving the car from our path. Very soon we were on our way.

My address this evening is ambitiously broad but in another sense highly specific and personal; it is about the global world we live in. I will speak about the accelerating economic convergence taking place worldwide as the living standards of the 5 billion people living outside the historically rich part of the world rapidly catch up and, in some cases, even surpass income levels in the West. I will talk about why this process will be so transformational and pervasive and why, in my opinion, the essential nature of this process is often misunderstood.

In contemporary jargon, the first draft of this speech was prepared 'PL', or pre-Lehman Brothers' collapse, before it was clear that the global economy was enduring the deepest and most coordinated recession since the 1930s. The crisis is disorienting in its power and speed. A wit in Moscow recently asked me: "what is the difference between a Gulfstream business jet and Aeroflot economy class?" In my case, he said, "about three weeks!".

The crisis also makes the concept of accelerating economic convergence even more relevant now than six months ago. First, as I noted in the draft of this speech, we have been living through an age of rapid economic and structural change in the global economy with the attendant risk, as in the late nineteenth century, of heightened business cycles and economic crises. One of the primary structural imbalances underpinning the current crisis is the enormous excess of savings in the major emerging markets and oil-producing nations that has effectively financed an equally enormous excess of consumption in the rich countries of the world. This imbalance is a symptom of both the rapid economic ascendance of the emerging markets and the relative

decline of the West. I doubt this is the last crisis that will be rooted in this historic shift in economic power.

Secondly, consider whether emerging markets are likely to converge more or less rapidly after the crisis than before. Generally speaking, the rich countries went into the crisis with bigger fiscal and current account deficits, lower savings rates, bigger governments, higher taxes and less flexible labour markets than their emerging market peers. They are also experiencing much greater and more lethal impairment of their banking systems than countries with less developed financial intermediation. In terms of the collapse in financing flows, the biggest threat to emerging markets actually comes from the implosion of Western banks and Western capital markets rather than from local problems. Most major emerging market countries have levels of hard currency reserves together with fiscal and current account balances that mean they are relatively well positioned to weather a prolonged economic downturn. In recent years, emerging market gross domestic product (GDP) growth rates have exceeded those in the rich world by 5 percentage points; not surprisingly, the International Monetary Fund expects this differential to increase in 2009.

I expect in 10 years, when we look back at today's events, we will see that this crisis marked an important step in the pace of convergence of the income levels of people living in emerging markets with those in the West. As Phillip Stephens, one of the Financial Times' political commentators, wrote last month "the [current] chaos speaks to a world in which the west is surrendering centuries of economic and political hegemony ... and to an emerging multipolar system that has broken the multilateral boundaries of the old order".

Let me now move away from the crisis and focus on something far more transformational and enduring – the concept of accelerating economic convergence. To provide the backdrop and context for this it is helpful to summarise the generally accepted historical data on the origins, speed and geographic focus of global growth. What is not well understood is where the current frontiers and limits of this process lie.

Here, I will draw heavily on my own experiences, observations and lessons from living and working for the last 16 years in two of the least expected but most successful economic transformations underway today – those in the former Soviet Union and sub-Saharan Africa.

My professional life during this period has been focused on trying to build businesses and survive the periodic crises that have plagued emerging markets but that, as we are witnessing, are more likely today to emanate from the most developed economies of the world. Preparing this lecture has been a one-off opportunity to reflect on what I have experienced and learnt, and to collate my thoughts in what I hope is a moderately coherent fashion.

In doing so, I have realised just how little and how much my thinking has evolved. Working as a young Treasury officer and as a policy analyst at Jarden & Co during New Zealand's liberalisation programme from 1984, I received as rigorous a grounding in microeconomics as anyone could hope for. Those lessons regarding the importance of sound microeconomic policy and macroeconomic stability in promoting efficient resource allocation apply at all times, everywhere, as does the importance of distinguishing between political rhetoric or self-interest and impartial analysis. Everything I have witnessed or participated in since leaving New Zealand has only served to reinforce this view.

My experience in the 1980s was grounded in a particular institutional and historical context, much of which we could afford to take as given without needing to understand the specific circumstances that had created the evolution of New Zealand's institutions and system of government. There was probably even an implicit assumption that Western-type institutions were in some sense superior and more developed than in poorer parts of the world. It was certainly assumed these institutions could be lifted out of one country and transferred relatively painlessly to others, which would then enjoy the same benefits we had traditionally enjoyed in New Zealand.

My experience working in the former Soviet Union and in sub-Saharan Africa has changed my views in this regard. I have seen first hand how economic performance can be dramatically improved under a wide range of institutional arrangements and styles of government. I have learnt, often at my own expense, how difficult it is for outsiders to understand why particular arrangements have evolved in particular countries and why they 'work' in those specific circumstances. I have become strongly opposed to what I term 'missionary economics', the attempt to impose on a society or preach the unadulterated adoption of institutions and forms of government that have developed in often totally different historical, economic and social contexts.

The most dramatic lesson I have learnt, however, is that we are living in a world where most low-income countries are transforming themselves in a manner and at a pace that confounds the economic missionary view of the world. In addition, I have seen at close range how the acceleration and changed geographic focus of economic growth has resulted in the development of highly successful new business models and concepts, and how these are challenging many accepted Western-centric conventions regarding management and industrial organisation.

I will also touch on the threats and opportunities that a world of accelerated economic convergence presents for New Zealand. I am definitely not qualified to make specific policy recommendations for New Zealand. However, a world of greater structural change and faster and less predictable re-ordering of economies, industries and businesses has certain unavoidable implications, which I will discuss.

World economic growth

Before I look at the lessons that might be learned from the current period of global economic transformation, I want to go back to a time when New Zealand itself was one of the world's pre-eminent emerging markets.

In the second half of the nineteenth century, a phenomenon that began 100 years earlier in Britain was exported to Europe and, eventually, the rest of the world. Its consequences had the biggest impact in history on the productive potential of humanity and on our standard of living. In the 43 years between 1870 and 1913, annual global economic output doubled. That rate of growth, compounding at just over 2 percent per annum, was historically unique. In 43 years, the jump in production was as great as the entire increase in the previous 1000 years of human endeavour. And alongside the increase in production went an increase in population and life expectancy that was equally as unprecedented. The world population in 1000 AD was 270 million. By 1820, it had reached nearly 1 billion people. The quadrupling in 800 years was repeated again in less than 150 years. Life expectancy at birth in 1000 AD was 24 years, and had reached 26 years by 1820. By 1950, the average had doubled to 49 years.

The raw numbers for increased output and average living standards during that period are remarkable. Just as extraordinary is the increased disparity in income across countries during the same period. Not only was the jump in production temporally unique, it was also geographically unique. In 1000 AD, per capita income in the richest region in the world, Asia, was maybe 10 percent higher than in the poorest region in the world, Western Europe. In 1870, the productive capacity of somebody living in the United States, then the richest part of the world, was roughly five times higher than somebody living in either Asia or Africa. By 1973, the difference was 13 times. By 1998, the income disparity between the richest part of the world and the poorest had risen to 19 times, its highest level in history.

The world economy grew 12 times between 1000 AD and 1920. Of that, 85 percent took place from 1700, and 80 percent among the countries of Europe and their major offshoots – the part of the world commonly, if inaccurately, defined as the West. In their time, every country at one point or another has been an emerging market.

Causes of economic transformation

So what caused this extraordinary increase in the productive power of one reasonably small part of the world relative both to anything else seen in history and the world at that time? What was it about one set of reasonably similar countries that set them apart from the rest of the world and allowed them to embark on this extraordinary period of increasing economic prosperity?

The early adopters of the process of economic transformation shared a common cultural heritage. With few exceptions, they were all either European or offshoots of European countries. The temptation is therefore to draw the conclusion that it is something inherent in the socio-political traditions of European nation states that is necessary for a flourishing market-based economy to transform living standards.

But we should be careful here. There are common conditions that are crucial – the concept of transferable and enforceable private property rights is one – which I will discuss in detail later. There are others, however, that are demonstrably not. Only the United States was a democracy that we would recognise today. The rule of law was only really robust in the United Kingdom. There was no free press in Germany, Japan or Russia. Capital markets were not regulated. In the United States, the Wild West did not only involve cowboys of the bovine variety.

Many of the socio-political traditions we associate with market-based economies could just as easily be argued to have been the result of economic transformation, rather than the preconditions for it. To understand the process of economic transformation, it is important to distinguish between which institutions were important to kick-start the take off in living standards, and which developed as economic growth took hold. In other words, which were the institutions in these countries that were prior conditions for the take off, and which were the results of that period of modernisation.

It is important to be careful on this point because the confusion between cause and effect of rapid economic modernisation creates many of the misperceptions about opportunities for business and the impact of economic policy in the world today. This is particularly true for those countries that have enjoyed its benefits longest and become most used to living with both the economic success that began in the Western world and the institutional underpinnings that characterise modern western life. I should say here I use the word ‘institutions’ quite broadly. By institutions I mean the set of rules, conventions, organisations and associations that define a particular society.

The case of Russia

Because I believe it is important, I want to discuss the underpinnings of this first wave of economic transformation a little more carefully. We can begin to think about cause and effect by examining what was different about this set of countries at that time compared with others that failed to take off. Richard Pipes, Professor of History at Harvard University, has done a lot of work on this, specifically comparing Europe’s institutional and economic development with that of Russia.

Russia is especially interesting because it shares a great deal in common with Europe, yet benefited much less than the other major European powers from the economic growth of the nineteenth century. Russia’s religion, culture, language and main historical frontiers share more in common with Europe than any other major society. At one point, it looked as though Russia might even have been leading the pack towards the creation of a modern-day European state. In the fourteenth and fifteenth centuries, the principality of Novgorod was the commercial centre of Russia, bigger economically at the time than its main rival, the principality of Muscovy. Novgorod’s leaders were elected, and held in check by a legislature formed by popular assembly. Its wealth was in private hands. Compared with the feudal systems then common to much

of the rest of Europe, Novgorod's institutional framework was advanced. Yet Russia eventually came late to the economic transition that took off in the rest of Europe.

In his book, *Property and Freedom*, Professor Pipes comes at the issue of what went wrong in Russia from a different and rather illuminating angle. The question he attempts to answer is not which institutional differences explain why Russia followed a different path to modernisation than the rest of Europe, but rather what was different about Russia that explains why it followed a different path of institutional development.

The answer that Professor Pipes reached is telling. In his opinion, it was the weak and late development of private property in Russia that caused the evolution of a different set of institutions from that of the rest of Europe. So, on this view, the reason why parliamentary democracy, civil rights, freedom of speech and eventually the rule of law developed first in England, rather than Russia, was that the tradition of property and land ownership, and the freedom to trade that had existed in England since the early Middle Ages, never managed to take hold in Russia. Private ownership created the demand for institutions that protected and facilitated the transferability of private assets, including courts, property registers and written law. Similarly, the Crown was only able to tax property owners through negotiation with a House of Commons, which gradually demanded increasing rights in exchange for a portion of the income of those they represented.

In Russia, the reason why development stopped in its tracks was that Novgorod was eventually overrun by the military might of Muscovy. The Byzantine traditions of a centralised authority fusing state and church proved stronger than the trading culture developing in Novgorod. Without the first steps towards private property, Russia was to follow a different path of institutional development to that in Western Europe and that region's offshoots in the New World.

Viral growth

Viral growth occurred even when the institutional pre-conditions appeared to be unfavourable; viral growth is highly adaptive.

This point becomes stronger when we consider how the idea of modernisation spread between countries during the first period of rapid economic growth in the nineteenth century. Between 1700 and its peak in 1870, Britain's share in global GDP grew from 3 to 10 percent. The concepts underpinning that rapid economic growth took a relatively long time to spread through Western Europe and caught on in some places faster than others. Social and political resistance to the changes it implied was understandably fierce. The democratisation of wealth generation threatened the status quo. Rather than having the 'right' set of institutions in place to kick-start economic transformation, many of the institutions in place in much of Europe at the end of the eighteenth century did not appear to welcome the transformational processes taking place in England. Contemporary descriptions of German industrial workers in the first half of the nineteenth century despair of them as unreliable, slovenly and undisciplined. It appears that Germany's reputation as a society that rewarded hard work and discipline was not one that preceded its period of rapid economic development. Certainly, Germany is one nineteenth century emerging market for which the strategists and policy makers of the day would not have predicted early economic success.

What seems to have catalysed the economic transformation in the nineteenth century was not so much the particular institutional framework of certain countries at that time, but rather the demonstration effect of the power of that transformation. Any nation that hoped to preserve influence on the global stage had to adopt its basic tenets or risk irrelevance. The main driving force was essentially competition and the pressure for imitation this created. A regime needed to adapt its institutional framework to the demands of private markets in order to generate the necessary industrial base to keep up with its international

rivals. Success bred success. The greater the range of countries illustrating what was possible and the bigger the gap between the rapidly growing and the rest, the greater was the necessity and the lower the perceived costs of attempting to copy the leaders. That process, or a form of it, has been continuing until the present day. Between 1870 and now, Britain's share of global GDP has declined back to its original 3 percent, despite its absolute level growing by a factor of 33.

I do not think there is some magic button that just needs to be pressed to push a country onto a high growth path. Clearly, there were many different factors affecting individual countries as they began to play catch-up with Britain. I am in no position to define which institutional changes made the most difference in which countries.

In fact, my point is almost the opposite. Although Western countries today are relatively homogeneous when it comes to their institutions, in the nineteenth century there were profound differences between countries within Europe, and between them and their European offshoots. The important similarities were the recognition of private property, some version of a rule of law based on the notion of nationhood and the gradual acceptance of competition and the market as the best way to allocate resources.

What did not drive growth was the government. In fact, the principal impact of government was negative – to slow the process down through various forms of mercantilism. The transfer of technology and capital happened most rapidly where government was able to step out of the way and resist the temptation to meddle. In the first era of *laissez-faire* government, growth and prosperity went hand-in-hand with dismantling the economic role of the state. At the risk of jumping ahead, this interpretation of the spread of rapid growth dovetails with the message I have heard countless times across numerous African countries: “the government hasn't improved but at least it stays out of business now”.

A further case in point is, again, Russia, which held out longer than most in Europe against the forces of economic change. But even here, the demonstration effect of the rest of Europe meant that Russia finally

had to open itself up to investment and markets. Despite having one of Europe's most conservative regimes, Russia was one of the world's fastest growing economies in the 20 years between 1890 and 1910. Imperialist Russia, Europe's most dedicated autocracy, managed to treble coal, iron and steel output in a decade as it sought to catch up with the economies of its major European rivals. The driving force behind the industrialisation would not look out of place today. A combination of inward investment and increased competition was encouraged by then finance minister Sergei Witte to force the Tsarist era industry into greater efficiency. Both Witte and his reformist successor, Pyotr Stolypin, had no interest in destabilising the political status quo. The period of rapid investment and economic transformation occurred while Tsar Nicholas II remained firmly in control. Indeed, the Tsar was well placed to defend his position internationally thanks to the economic revival stimulated by the reforms of Witte and Stolypin. The resulting economic changes clearly contributed to the political upheaval of the 1917 revolution, but the growth itself happened with few changes to the form and institutions of government.

Looking back on the transformational growth in the nineteenth century from the success of the twenty-first, it is easy to conclude the economic success of the West is somehow baked into the institutions that define our own economies. After all, 200 years since growth began to catch hold in Europe, Western-style economies are still able to offer the highest standard of living globally. It is not surprising the temptation exists to believe that all other countries need to do is copy the West and they too will enjoy the benefits of a booming economy. But that type of missionary economics is something I have come to see as naive at best and often highly counterproductive.

Many of the institutions we now enjoy were clearly not preconditions to the economic success of the first wave of economic transition – they would have looked at least as alien to Western Europe in 1800 as they do to much of the world today.

The institutional preconditions for the rapid acceleration of economic growth and improvement in living standards are remarkably limited. Private property is a key requirement, as is the transferability of property rights. That itself requires stability and security, which the state has a minimal obligation to provide. Many of the other institutions that we currently in the West consider to be a fundamental part of a modern state with a modern economy have developed as a result of a rich and prosperous society.

Accelerating economic convergence in the twentieth century and today

The economic forces unleashed in the second half of the nineteenth century revolutionised the world. But, remarkably, they were actually quite muted relative to what we have seen in the period since the end of World War II. Both in size and scope, the economic change in the last four decades has dwarfed anything before. Global economic growth between 1870 and 1913 averaged 2.1 percent and increased global output during that period by 150 percent. Global economic growth between 1970 and 2013 is expected to average 3.5 percent and will increase global output by 340 percent.

Most remarkably, however, the rate of change itself continues to increase. Perhaps the most under-appreciated fact about the current period of growth is how much more inclusive it is than anything we have ever seen before. In contrast, as previously noted, one of the most remarkable aspects of the first 100 years of industrial development was the dramatic economic divergence that accompanied it.

Growth goes global and accelerates

Since the 1970s, the divergence in growth rates has been reversing. What we are living through today is not just an age of rising growth rates but, crucially, a period of accelerating economic convergence – convergence both of growth rates and living standards. More and more people living

in increasingly varied regimes are hitching themselves to the growth locomotive. The number of people involved in the economic revolution in 1900 was 300 million. By 1960, it was 2.5 billion. By the end of the last decade it was 4 billion. Today, there are 5.5 billion people living in countries with growth rates higher than the average in the G7. The great transformation of living standards that began in the second half of the nineteenth century, and marked by 100 years of increased divergence in living standards, is itself transforming. If these trends continue, simple arithmetic tells us that global growth over the next 20 to 30 years will be the highest in human history.

Because the spread of explosive growth is so remarkable, I will explore these changes further. In the aftermath of World War II, the countries that powered economic recovery were largely the same as those that benefited from the first wave of globalised economic growth. In the so-called Golden Age between 1950 and 1973, Western Europe, Japan and the former Soviet Union in particular were the powerhouses, driving global economic growth at rates that were, on average, 50 percent higher than in the late nineteenth century. Once again, the limited range of countries that enjoyed high growth rates suggested there was something inherent in the institutional framework of these countries that was conducive to economic recovery.

But then in the early 1960s, something remarkable began. Economic growth started to go truly global. The number and range of countries experiencing rapid growth began widening, and that process has been accelerating over time. It started quite slowly with Korea in the 1950s and then the South East Asian tiger economies in the 1960s, suggesting these were exceptions to the common rule.

But it did not stop there. Defining strong growth as GDP expanding by more than 3 percent on average every year for a decade or more, the new entrants to the high-growth league in the period between 1980 and 2005 comprise countries with hugely varied histories, geographies and cultural and political legacies: Botswana, Bhutan, Ireland, Singapore, Mauritius, India, Malaysia, Indonesia, Chile, Sri Lanka and Malta. If we

move the start date to 1990, the list broadens further to include Vietnam, Lebanon, Trinidad and Tobago, Laos, Mozambique, Poland, Guyana and Tunisia. Coming closer still to the present by starting from 1995, the countries of the former Soviet Union and former Yugoslavia join the growth league, together with the likes (or should I say the unlikes?) of Cambodia, Angola, Greece and Tanzania. Economic transformation is developing from something that seemed to be limited in its membership to an elite group of countries blessed by history and culture, to something much more viral in nature, spreading rapidly across many different countries with many different cultures and forms of government.

Moreover, alongside the *broadening range* of countries experiencing rapid economic growth, the *rate* of growth is itself increasing. The growth rates during the Japanese economic miracle were surpassed by the Asian tigers, which were widely interpreted as being a special case. Then China smashed the Asian growth records becoming widely interpreted as a truly unique transformation. Similarly, in a Western context, Ireland's average GDP growth of 6 percent per year for the two decades from 1988 to 2007 exceeded anything achieved by any Western nation in the so-called Golden Age of 1950 to 1973. Plus, in recent years a series of often unexpected countries have matched Chinese growth rates: Kazakhstan, Angola, Cambodia, Sierra Leone and Nigeria. There does seem to be an emerging pattern of later take off leading to faster convergence. This is certainly the pattern of development we are witnessing first hand in sub-Saharan Africa today.

Viral growth prospers in a wide range of political regimes and historical circumstances

So what is going on? Why is it that economic growth is taking hold in so many different types of political and economic regimes simultaneously? It is tempting to ascribe the success to the desire of very different countries to emulate the Western model, in order to be rewarded by economic success. This is a variation of Professor Fukuyama's seminal thesis on the end of history. It is tempting, but also demonstrably not the case.

Singapore, Malaysia, Indonesia, China, North Africa, Kazakhstan, Angola, Azerbaijan and Vietnam have all experienced more explosive growth than the Western block pioneered without choosing the Western model of society or government. Indeed, for many countries, economic success has allowed them to choose a different set of political and social institutions. China and Russia look more confident political regimes today after 10 years of explosive growth. Equally, some countries that have attempted to adopt the Western institutional framework have failed economically. Russia during the nineties is one obvious example. Ukraine today is another.

The common thread that seems to link most of the countries that have started to enjoy the benefits of rapid economic growth is that they have increased the domain of the market in allocating resources. Where Europe led the way in the nineteenth century, so East Asia took over in the 1960s, and many more countries have followed since. A combination of allowing markets to set the price of labour, capital and goods, and a commitment to opening up to trade and maintaining a degree of fiscal and financial stability, has been enough to kick-start growth. The other common factor all these countries share is their diversity.

There are of course many countries that have successfully combined the Western model with high rates of economic recovery. Much of Eastern Europe has a model that can fit into the Western mould and has enjoyed a long period of moderately high growth. It is noteworthy, though, that of all emerging market regions Eastern Europe is likely to suffer most during the current economic crisis. South America, too, has several economies that sit broadly under the Western umbrella.

Chile is probably the most successful of the Latin American economies. It has consistently enjoyed high growth rates, and has increased per capita GDP on a purchasing power parity (PPP) basis from 25 percent below that in Brazil in 1980 to 50 percent above the Brazilian level today. It is also one of the most stable, democratic, law-based countries on the continent. But the current political regime has been built on an economy that enjoyed its greatest success under a

military dictatorship. Clearly, the Western model is not a barrier to the spread of viral growth. But equally, it is neither a necessary condition nor a necessary outcome.

Moreover, it is not only the type of institutions needed for economic growth that are proving to be far more varied than the Western model might suggest. Western precedent also seems to have little to say on the speed and manner with which they are introduced. In the early 1990s, I remember many people were predicting that the apparent liberalisation of politics together with economics in Russia during the dramatic fall of the Soviet Union would put the country on a more sustainable growth path than China.

The 'big-bang' of price liberalisation and privatisation meant that Russia had taken its pain up front, whereas China, two years on from Tiananmen Square, would still have to go through it in the future. A decade later, as China boomed and Russia returned to a more authoritarian regime, the gradualism of China was touted as the superior means. Last year, after Russia had proven to be the best performing market in the world over the previous decade, I heard again that the 'big-bang' front-loaded all the pain.

As an aside, the extraordinary chaos and dislocation in Russia in the 1990s presented a steep professional learning curve for me. Obviously this was a challenging environment for building any kind of normal business. But fundamentally, this period challenged and overturned many of my assumptions about how emerging market economies and societies work or should work. With my Treasury hat firmly strapped on, it is only a slight exaggeration to say that my basic view was that if we set up the right rules and regulations 'they', the Russians, would behave more efficiently, and more like us! My initial assignment was to structure and execute the first privatisations in Russia in a pilot for what became the largest and most comprehensive privatisation programme ever. With the best possible intentions, our thinking was essentially missionary – if we could privatise the economy there would be massive and rapid improvements in productivity and efficiency.

Well, yes and no, and the yes for more complex reasons than I expected. In an environment with no modern history of private ownership, no real concept of widely dispersed share ownership, no supporting values and norms, no established market institutions and endemic corruption, the initial impact was chaos. Radical price liberalisation and hyperinflation completed the picture of pervasive dislocation, collapsing output and corporate asset stripping. But then Russia gradually began pulling out of its economic and social nosedive. There is no doubt this was facilitated by improved terms of trade following the economic crisis of 1998. But essentially, private ownership began to work and to work in an extremely powerful fashion.

As the ownership of collapsing assets began to consolidate, investment, modernisation and management upgrading gradually took off. With a sudden focus on asset values, corporate governance went from absolutely shocking to average over a four- to five-year period and the global equity capital markets locked on to Russia. In 2007, Russia had the third largest issuance market in the world for new equity. The negative sum corporate culture of theft and asset stripping has metamorphosed into a strong focus on modernisation and value creation. In fact, the country's corporate culture has changed beyond recognition. These changes have taken place in virtually all of Russia's old industries across all nine of its time zones. Of equal importance, growth and the dramatic improvement in the overall business environment have provided the ideal breeding ground for the extremely rapid development of completely new industries and businesses, primarily in the retail, consumer and banking sectors. The economy itself has increased nine times in US dollar terms in the 10 years to 2008, with the 'new' industries being the fastest growing.

Even more interesting has been the second-round effects and feedback from business to regulation and government. Russia's powerful and increasingly diverse business community is a high profile and often effective proponent of economic policies that support growth and stability. The competitive benefits of being able to access long-term

international capital have incentivised a surprisingly robust lobbying for a better business environment. For example, the most vociferous proponents for cleaning up the customs system are the major retailers: they need to show the capital markets that they are paying all of their taxes and customs duties but want to ensure their smaller privately held rivals do likewise.

While I was thinking about this speech, I re-read the Trotter lecture given in 2000 by Dr Yegor Gaidar, Russia's first post-Soviet head of government. Dr Gaidar was responsible for introducing the economic policies that have defined Russia since 1992. Two points in particular resonated most clearly with me from his excellent speech. The first was the conditions in which he introduced the initial reforms. As he said, "The government was confronted with a dangerous reality in which it needed to make markets work without all the preconditions for markets". Privatisation, liberalisation of prices, lowering of trade barriers and convertibility of the rouble were made when the Soviet-era institutions had collapsed and before any new ones could be built. The second point was that 10 years later when the communists effectively regained power under prime minister Yevgeni Primakov, they had no option but to push forward with the reform programme. Again, quoting Dr Gaidar, "... it became clear to the elites in society that the only way to deal effectively with the more negative aspects of the semi-market economy was through progressing the reforms". After the introduction of a relatively limited set of policies aimed at setting market forces free, the broad institutional development of Russia was assured.

My purpose here is not to give you a full overview of recent Russian economic history. Nor do I wish to gloss over Russia's many serious economic challenges and the unattractive authoritarian aspects of its politics. Rather I wish to highlight the critical role played by widespread private ownership both in rapidly modernising business, just as privatisation did in New Zealand, and in greatly strengthening the pressure on government to improve and modernise the legal, regulatory and institutional environment.

The Russian experience illustrates that economic transformation can take off even when the institutional underpinning to the economy is surprisingly weak and disordered. The variety of regimes that have experienced the transformation of their economies over the last 40 years suggests that viral economic growth is highly adaptive. Exceptions are the rule. Preconditions for economic convergence are more limited than those that underpin much of the missionary economics that continue to drive a surprisingly large body of opinion in the West today.

The importance of openness and information

At the same time as more and more countries are demonstrating that the institutional requirements for transformational growth are relatively limited, the world is becoming increasingly open to the spread of information and ideas. In particular, it is becoming obvious how other people in the world live, and that is proving to be a major force for the contagion of ideas. Openness is not only driving transfers of technology and flows of capital but, most importantly, is driving a pervasive desire for emulation.

This understanding that the transformation in living standards is possible does not necessarily have to seep through the whole of a society. It is often adequate only that the incumbent political elites have access to that information. The absence of widespread access to technology does not therefore have to be a barrier. In almost every country, the elites have access to information about the benefits of economic prosperity. Take Turkmenistan, probably one of the world's top 10 most broken regimes. Literacy has fallen in the 17 years since the break up of the Soviet Union, from 90 percent to less than 50 percent. Under the dictatorship of the recently deceased Turkmen Bashi, access to information was strictly limited, even to the extent of banning the internet. Yet even here, in this backwater petro-state, the new leader is beginning to open up to inward investment and economic change in order to acquire more of the benefits that he sees available elsewhere.

Similarly, in sub-Saharan Africa a significant cross section of society is fully aware of the horrific cost of bad government on the continent; that the ideology and substance of outside aid and other assistance is a double-edged sword with little if any medium-term benefit; and that rapid economic improvement is totally achievable. There is tremendous and mounting pressure for reform from these constituencies, and as the benefits of the first phase of reform and growth begin to flow those pressures are both intensifying and broadening.

Transformational growth stimulates pluralism

I need to be clear that I am *not* saying there are *no* preconditions needed to catalyse an economy on to a high growth path. Neither am I attempting to justify the awful regimes that are trying to benefit from it. Rather, I strongly believe that transformative economic growth is often the major impetus towards the development of pluralistic societies just as it was in Western nations in the nineteenth century. At a basic level, the most important step towards political enfranchisement has to be the lifting of an individual out of abject poverty.

Economic improvement generates the desire for more information and the material wherewithal to acquire it. The flow of information starts to spread beyond narrow elites and behind information follows technologies, which are often applied with explosive effect. In Russia, mobile phone penetration went from zero to over 100 percent in less than a decade. Nigeria has gone from having only 400,000 landlines to 45 million cellular subscribers in five years.

Rather than engaging in carping and paternalistic criticism of high-growth countries with forms of government that differ from those in the West, Western commentators would do better to reflect on the fact that what we are witnessing is in many cases a replay of the West's' own successful story.

Accompanying rapid economic growth, then, is the breakdown of redundant ideologies and the increasing difficulty of sustaining closed

political systems. Apart from in the Ivory Coast, I have not talked to any African leader who has anything but scorn for old-fashioned socialism or statism. Economic growth necessarily leads to a more pluralistic society – the spread of economic wellbeing ensures an increased ability to exercise choice.

But to repeat, increased pluralism does not mean a move towards a modern Western state. A country's institutions will evolve to reflect that country's unique economic, social and political challenges and opportunities. The figure who I find is most revered by African leaders today is not Nelson Mandela but Lee Kuan Yew.

To summarise, the demonstration effect of economic growth encourages other countries to adopt its basic tenets. Fundamentally, this entails considerably increased reliance on markets to allocate resources and a corresponding reduction in state intervention. However, the sequencing and emphasis of market liberalisation varies enormously from one successful country to the next. This is often achieved without massively disrupting established political or power systems. Countries can get many of the benefits of economic transformation without the institutional and political costs with which they are often assumed to be associated, particularly in the West. As this becomes increasingly obvious, an increasingly wide range of countries will choose to move in that direction. And it is that move towards economic transformation that itself begins to drive a process of institutional change and, over time, greater political pluralism.

In effect, transformational economics is becoming self-fulfilling. This is what I mean by viral economic growth. Transformational growth is now the rule rather than the exception. The exceptions occur in extreme regimes, such as North Korea, which stamp out private sector activity, or failed states like Somalia, which results in anarchy. Even, or should I say especially, in Zimbabwe where I have spent considerable time, there is enormous domestic pressure for market-based economics that will deliver the benefits being received by citizens in the great majority of

other emerging markets. These benefits are almost universally understood around the world today.

Some of the most basic reforms create benefits that broaden the constituencies supporting further reform. This virtuous cycle of reform and benefit is highly idiosyncratic, organic and dynamic. It explains why the further you are behind the faster you will catch up; it explains why the North Korea and Ivory Coasts of this world are increasingly rare – they are the freak shows of global economics. In this sense, the only precondition for commencing transformational growth is the political will to change, not any specific set of institutions or policies. Institutions and policies develop organically as transformational growth takes hold; they are the structural building blocks in a virtuous cycle involving ideas, openness, policies, institutions, economic benefits and greater pluralism.

Consequently, economic catch up will be both more rapid and more inclusive than the West currently expects. It is also likely to be sustained for longer than most commentators expect and to have a bigger impact on global growth.

There is little predictive analysis of transformational growth

Despite the overwhelming evidence of viral growth and accelerating convergence, Western analysts, business leaders and politicians still tend to see transformational economic growth in terms of special cases and exceptions. There is always plenty of rear-vision mirror analysis of why particular countries have had highly successful economic transitions. Equally, there are widely accepted theories as to why today's laggards will never make it. These theories often have a cultural or historical complexion. Unfortunately, their predictive power is virtually nil, and they are quickly modified as the view in the rear-vision mirror changes. In one decade we are told that Confucianism is a barrier to capitalism; in the next experts extol the Chinese work ethic. Lazy, slovenly Russian

workers suddenly become ambitious and creative. India's colonial past goes from being a liability to an asset. The Irish, from drunken poets, become the most enterprising people in Europe. And of course we all know why Africans are the world's perennial underperformers.

Jim Rohwer in his excellent book *Asia Rising* describes how, in 1955, the Philippines seemed destined to be South East Asia's economic success story. With relatively high income levels and a set of western-style institutions inherited from the United States, the Philippines looked set to boom. War-ravaged Korea and desperately poor Taiwan looked highly unlikely to succeed. Both were military dictatorships and neither had any reason to expect material assistance from the West. But 50 years later, the world looks rather different. The per capita income of South Korea and Taiwan is considerably greater than that of the Philippines. Moreover, South Korea and Taiwan are two of the most stable countries in South East Asia.

Perhaps an even better example is China. It is difficult now to believe, but in 1960 per capita GDP in China was less than that of Africa. Before Deng Xiaoping's Reforms and Openness programme began in 1978, there was no reason to believe that communist China was going to grow substantially more quickly than sub-Saharan Africa, and few commentators expected it would. How wrong they were. International business did not really begin to understand the scale of the opportunity until the early 1990s. It took virtually no time, however, for Chinese business to pick up on the changing attitude towards business and to kick-start economic growth. The Chinese economy grew by an average of 3 percent in the 1970s and by 10 percent in the 1980s.

Today, the same negative predictions are being made for Africa. In 2000, the *Economist* magazine had an edition with a front cover showing a map of Africa and the title, 'Africa, The Hopeless Continent'. In the intervening nine years, three out of the 10 fastest growing countries in the world have been from sub-Saharan Africa. The region as a whole has grown at an average rate of 6 percent, three times the rate in the G7. The growth is both accelerating and broadening. Five of the six fastest

years of growth that Africa has ever experienced have occurred in the last five years. According to the International Monetary Fund, in 2000, 13 out of the 51 countries of Africa were growing at 5 percent or more. This year, they expect 29 to be growing at above this pace. This includes countries most often consigned to the basket-case club. The average growth rate over the last five years in Tanzania was 7 percent, in Sudan 8 percent and in Nigeria 9 percent. To be sure, Africa is rich in natural resources, and some of the fastest growing countries have benefited. The average growth in copper-producing Congo over the last five years has been 7 percent and in oil-producing Angola, 17 percent. However, it is not only natural resource producers that are growing. Ethiopia, a country that was once synonymous with disaster and aid relief, has been growing at an average of 10 percent per annum for the last five years. I believe over the next 20 years there is no reason why Africa cannot go through the same sort of economic expansion that has so revolutionised life in Asia. Indeed, because of the tendency for convergence to happen more rapidly the later in time it commences, I personally expect Africa to grow more rapidly than Asia did at the equivalent stage of its take off. I know that sounds fanciful right now, but then so would that kind of prediction about Asia in 1970.

In business, less publicised but equally wrong-headed predictions have been made. In 1994, Goldman Sachs, perhaps the most successful investment bank of the last 20 years, pulled out of its representative office in Moscow after two difficult years. In 1997, after a 300 percent rise in the stock market, and to great fanfare, including a visit by George Bush Senior, it re-opened the office. A year later, after the market had lost 90 percent, it pulled out. Two years ago, and a 1000 percent increase in valuations later, it returned.

The roller-coaster in Russia was probably as dramatic as anything seen anywhere over the last 15 years and Western pundits have, once again, generally been wrong. When I arrived in Russia, you could buy vouchers that effectively priced the entire Russian equity market – including major shareholdings in a third of the world's gas, 10 percent of its oil,

12 percent of its nickel and the second largest electricity generation company in the world – for US\$3 billion. Few wanted to touch them. Credit Suisse First Boston's elite European bankers had a nickname for our tiny group camped out in borrowed office space in Moscow. We were called the 'smellies', a reference to sanitary conditions in Eastern Europe at the time. My principal take from this was that the incredible business opportunity we had in our hands would be greatly enhanced by others' ignorance and the consequent lack of competition. By 1997, after five years of economic collapse and less than a year before a financial crisis that wiped out over 90 percent of the value of the stock market, some stocks were trading on 95 times earnings, and there was huge demand from Western investors. By the beginning of 1999, you could not mention Russian finance in polite company, but you could buy shares in Gazprom for 5 cents. Six months ago the stock was trading at US\$10.

As in politics, western business models are not directly transferable into high-growth emerging markets

The most successful emerging market businesses have evolved in a manner that is highly adapted to their local environment. We have discussed the kinds of economic and political pressures that cause political systems to evolve. In business, evolution tends to be brutal and immediate for the simple reason that businesses that are unable to create comparative advantage face rapid extinction. Comparative advantage often evolves in a rather haphazard process of trial and error, its sources can be highly idiosyncratic, they may be extremely complex and they may not be entirely clear even to the people running the business. But one thing is certain, the sources of comparative advantage must be relevant to the specific market, legal and political system in which a business operates. The best pelmeni restaurant in Moscow will not have much of a business in Milan.

Three interrelated aspects of large high-growth markets

There are three interrelated aspects of large high-growth emerging markets that stand out and have enabled the formation of several hugely successful local businesses that have often proved, quite unexpectedly, to be competitively superior to their multinational counterparts. These three interrelated aspects of high-growth markets are: 1) their highly idiosyncratic nature; 2) their large scale; and 3) their extremely rapid pace of change.

The importance of idiosyncrasy

It goes without saying that markets like Kazakhstan, Russia and Nigeria are highly idiosyncratic. But think what this means for business. A successful business must work with existing infrastructure and labour; it must navigate specific local product market dynamics; it must manage local regulatory and legal realities. Think of the challenges this presents. How do you form a joint venture when the courts are corrupt? How do you manage risk in a consumer finance business when there's no credit bureau? How do you build a major derivatives business when there's no relevant legislation? Imagine how challenging these questions are if you are a bureaucratic multinational.

The importance of size

Market size is equally important because it creates the potential for scale. Scale creates the potential to acquire the best management and technology. If your supermarket business has two outlets you are unlikely to have the best management or technology. If you have 100 outlets it will be logical to acquire the best relevant technology and to hire truly world class management – either locally or internationally. In many such situations your technology will be state-of-the-art and will leapfrog that seen in developed markets. Our consumer finance business has the

best scoring and anti-fraud technology available globally. With 15,000 points of sale across 10 time zones prior to the crisis we could approve or decline tens of thousands of loan applications per day, each in less than five minutes without any human decision making.

The importance of rapid growth

The pace of change rounds out the story. In economies growing at 2 to 3 percent a year, industrial change is relatively gradual. In these countries, explosive change is usually associated with rapid technological change, such as with the information technology (IT) industry in the 1980s and '90s. In fast-growing emerging markets all industries are like IT. Market growth and changes in competitive dynamics are explosive. For Russian retailers or Nigerian banks, 100 percent plus growth in revenues or profits is totally normal. Small businesses can become multi-billion dollar enterprises in just a few years. Losers rapidly disappear without trace. Needless to say, with these stakes, the winners tend to be highly organised and extremely aggressive in their business style and strategies.

Now consider what this combination of idiosyncratic features, size and speed means when taken together. To be highly successful, a business has to build something very large, very quickly and of relatively high quality while contending with a complex and idiosyncratic local environment. In many industries, this combination has proved to be extremely challenging for the world's large multinationals. Their advantages in terms of know-how and capital have been neutralised by their inability or reluctance to grow explosively in complex, foreign environments. In many emerging markets and in an increasing number of industries the market leaders and fastest growing players are local or regional businesses that have local roots.

The largest metals group in the world is Indian; most of the fastest-growing companies in the sector are Russian, Brazilian or Kazakh. The largest aluminium group in the world is Russian. Until recently, there were five multi-billion dollar supermarket chains in Russia; Tesco and

Wal-Mart do not have a single outlet between them despite considerable investigation. The fastest-growing mobile businesses in the world are owned and operated in emerging markets. The fastest-growing and largest banks in China, Russia and Nigeria are all domestic. The largest investment banks in India, Russia and, until recently, Brazil are also local. Across Africa, foreign banks with many decades of local presence are being lapped by the local players. Even in a global industry like brewing, the world's two largest players have emerging market roots: South Africa in the case of SA Brewing and Brazil in the case of InBev. Similarly, the world's rich lists are increasingly dominated by entrepreneurs from the emerging markets.

Key adaptations of successful emerging market businesses

How have these and dozens of other enormously successful emerging market businesses gone from start ups to large-scale operations in the face of global competitors with seemingly vast superiority in terms of capital, management and know-how? While every successful recipe has its own ingredients there are consistent themes running through these businesses. I will discuss later why I believe these themes are relevant to entrepreneurial New Zealand businesses chasing global-scale success in a world of accelerating convergence.

Ownership

The first theme concerns ownership structure. Many, if not most, successful local firms throughout Asia, Russia, Africa and South America are majority, or entirely, owned by an individual, a small group of partners or a family. There are distinct advantages to concentrated ownership in highly dynamic, rapidly growing markets. Bold vision and execution is essential. This is achieved where an entrepreneur or small group of entrepreneurs has a concentrated economic interest and the flexibility to make major decisions rapidly. Further, with this ownership model, the agency and conflict issues that apply to Western-style

corporations are largely absent even when minority public shareholders participate in the entrepreneur's business. Responsibility for strategy is also clearly defined. In addition, in jurisdictions with weak legal systems, agreements are much easier to make on a handshake when you know you are dealing with 'the owner of the business' – an expression I hear virtually every working day. In my experience, a handshake means a great deal more today in Moscow or Lagos than it does in London.

Speed and boldness

Second, and related to the question of ownership, is the speed and boldness of decision making. Slow or hesitant business leaders are quickly weeded out in high-growth emerging markets. The survivors are typically able to think on a big canvas; to make bold decisions and have the resilience to withstand extreme volatility and market setbacks. Concentrated ownership means that emerging market business leaders are fully compensated for the risks and complexity they face. It is virtually impossible for multinationals to operate in this manner. Their key decision makers usually live in a distant part of the world; they think they fully understand the risks but cannot grasp the upside. European foreign direct investment into Russia is greater than into China but for many US corporations Russia is still the evil empire. In addition, the personal risks and returns are asymmetric; get it right and your bonus is 10 percent higher; get it wrong and you are gone. It is also difficult for multinationals to have different business models and decision-making structures in different countries. The international competitors to Renaissance Capital, our investment bank, understand many of our competitive advantages. However, I think it will be some time before they are prepared to have one ownership and management model in Germany and the United Kingdom and a radically different one in Russia and the Commonwealth of Independent States. Finally, when the going gets tough, multinationals are likely to retreat while local entrepreneurs hunker down. This is often the moment of greatest opportunity.

Deep local 'platforms'

Third, successful emerging market businesses have what I call deep local 'platforms'. They have broad trust-based relationships – with customers, suppliers, and, yes, politicians and regulators. They tend to have specialised infrastructure and ancillary capabilities and to be more vertically integrated than their Western counterparts. These platforms enable the entrepreneur to manage the vagaries, inefficiencies and infrastructure gaps of the local environment in an effective manner. They also tend to provide resilience in difficult times. Critically, these platforms are 100 percent local – you cannot deploy your Indonesian relationships and logistics capabilities in Uzbekistan.

For all but the most determined and committed multinationals, the need for such platforms represents an important comparative disadvantage. However, there is another equally important implication. With a small number of notable exceptions, Mittal Steel being one, the great majority of successful emerging market businesses are country or regional specialists. Highly specialised local knowledge and infrastructure is expensive to maintain and difficult to transfer to a new geography. Russian banks underperform in Ukraine; Nigerian banks struggle in Ghana. India's high-flying industrialists are generally yet to prove they can succeed internationally. There are many other examples. My expectation is that while the era of accelerating convergence continues, with the majority of global growth coming from fast-growing emerging markets, multinationals will play a considerably less prominent role than they have in the last 50 years. Instead, I predict the big business success stories of the next 20 years will be concentrated in or emanate from highly entrepreneurial, often private businesses that are deeply engaged in one or a small number of major emerging markets.

At Renaissance Capital we make a huge effort to ensure our businesses are owned by the entrepreneurs building them, that we continue to move boldly and build deep local platforms. Because we operate in several distinct geographies we try to function as a

confederation, with highly empowered local management and without a country or culture-specific head office. This is challenging to say the least but, when we get this model in place, the results tend to be positive; when we don't failure is virtually guaranteed.

None of this is to say that there are not incredibly valuable lessons to be learnt from Western business models and management techniques or that there are *no* practices that are transferable across borders. Clearly there are. But successful businesses in new markets tend to take what is best and adapt it to local circumstances. As those economies develop further these business concepts will continue to evolve and adapt to the requirements and opportunities of the local environment. And with the ongoing success of emerging market businesses, multinationals will eventually learn from these achievements and adapt their own business models more effectively to a world of accelerating convergence.

This conclusion is really again just a function of competition and opportunity. In the next decade, emerging market economies will become bigger than those in the West. Already the G7 economies account for only 44 percent of the global economy, down from 51 percent in 2000. By 2020, the BRIC economies (Brazil, Russia, India and China) plus Asia will be bigger than the G7. If Western companies want to maintain their global significance, they will have to compete in these new markets. To compete, they will have to adopt business models that are competitive, and those business models will reflect the business environment on the ground there, not what is currently the model in the West.

To summarise, growth rates will be higher outside of the traditional Western economies and consequently economic power will shift away from the West to the East. The basic logic of the competition inherent in a market-based economy means that the institutions and businesses developing within this part of the world will be better suited to the global economy that is currently emerging.

It is possible, I believe, to reach a stronger conclusion than simply that the catch up with the West will be quicker than currently anticipated.

The businesses and institutions underpinning the economies currently going through economic transformation will not only be catching up with the West, but eventually taking over leadership. At that point, it will be their business models and institutions that may have to be re-exported.

The threats and opportunities accelerated economic convergence presents for New Zealand

The world of accelerated economic convergence has several important implications for New Zealand over the next few decades.

First, global GDP growth is likely to be high, potentially higher in fact than at any time in history, notwithstanding the current economic crisis.

Secondly, the era of Western ascendancy economically and geopolitically will end as the combination of higher per capita incomes and large populations propel the major emerging markets into leadership positions in the global economy. The centres of economic power and wealth creation in the world will become extremely diverse. The global political architecture will gradually adjust to reflect the new economic ordering.

Thirdly, the new world middle class will be the largest new market opportunity ever seen and will present an extraordinary opportunity for the suppliers of products, services and raw materials to those customers.

Fourthly, new business models and concepts will continue to develop and evolve to meet these massive new market opportunities. The winners in this process will be highly tailored to the new markets, they will be extremely entrepreneurial and will often have a strong local market orientation and focus. Small businesses with the right DNA and strategy will have the potential to grow very quickly. Major global players will need to adapt their business models quickly if they are to compete.

Fifthly, the increased pace of economic growth and reordering will probably result in more dramatic structural adjustment, bigger movements in relative prices of all kinds, more uncertainty and, in all likelihood,

greater financial volatility and shocks than those to which the world is accustomed.

How well is New Zealand positioned today?

How well is New Zealand positioned for such an environment and what can be done to improve its positioning? Before answering these questions, I would like to repeat that I am not qualified to make specific economic policy recommendations for New Zealand. I believe, however, there are certain logical implications for this country of a world of greater structural change and faster and less predictable re-ordering of economies, industries and businesses. These include the general approach to economic policy New Zealand will need to adopt to succeed economically in such a world.

In terms of how well positioned New Zealand is today, I think the answer is straightforward: not particularly well. Please do not think this is a throwaway line from someone who has jumped ship and developed a touch of arrogance towards his country of birth. It is not. I care deeply about this country. I am engaged in a wide range of activities here, and I follow our economic and political situation closely. However, given the choice, I would much rather be constructive than diplomatic.

Basically, we are living in a world that is more competitive than in any other era; where change is faster and less predictable; and where long-established orders – whether they are economic, political or industrial – are being challenged and supplanted. In this world, the difference between ‘success’ and ‘failure’ is greatly magnified. This applies to specific labour market skills, businesses, industries and entire countries.

I do not need to give this audience chapter and verse on the dramatic decline in New Zealand’s relative economic performance over the last 50 years. Let me just remind you that, since 1956, our global ranking in GDP per capita has fallen from seventh to twenty-seventh. Moreover, apart from a decade following the Douglas/Richardson reforms when per capita income growth exceeded the Organisation

for Economic Co-operation and Development (OECD) average, New Zealand has been consistent in its trend of underperformance. It is particularly concerning that productivity growth has fallen away this decade in comparison with the 1992–2000 post-reform period.

The staggering number of young New Zealanders who have chosen to make their careers and increasingly their lives overseas is the most damning indication of our relative economic decline. We New Zealanders should stop kidding ourselves that this is because of our small size and isolation. Perth is isolated, so are Iceland and Northern Finland in their own ways, but their people are not flooding overseas.

Nor do I need to detail the choices that New Zealand society made that led to this situation. These include the incomplete nature of the liberalisation measures begun in the 1980s, particularly with regard to labour markets and social welfare; the relatively large size of government; and the inconsistent and stop/start nature of reforms over the last 20 years or so. In addition to the size of government spending is the issue of its quality; a recent OECD report observed that around 95 percent of government spending is not evaluated rigorously or systematically.

New Zealand does have areas of definite economic strength, some of which are widely recognised internationally. The World Bank's *Doing Business* survey ranks New Zealand second to Singapore out of 178 countries for "ease of doing business". Similarly, the World Economic Forum gives New Zealand high rankings in several areas including judicial independence. But this does not alter the fact of our long-term economic decline. In looking to address this decline the question is not where are we doing well but where can we do better. In my experience, top chief executive officers tend to be totally honest in identifying weaknesses and ruthless in addressing them. My personal assessment is that, as a society, we are drifting away from this type of hard-nosed common-sense reasoning; to put it politely we are becoming too inclined to believe our own myths. We are more likely to move forward if we talk about why the World Economic Forum ranks

New Zealand fifty-first for burden of government; sixty-seventh for extent and effect of taxation and ninetieth for hiring and firing practices. Nor should we be complacent about our historic strengths. I will not be at all surprised to see our strong ranking in corruption surveys deteriorate, for example.

Clearly, the New Zealand economy is not performing well at all in the early stages of the era of accelerated economic convergence. In essence, New Zealand society has been sceptical about the benefits of a free-market, highly open economy. New Zealanders have been prepared to trade off higher incomes for the perception of increased stability and reduced exposure to market-led change. I say perception, because in a world of viral economic growth any country that attempts to insulate itself from the changing global order does so at its peril; delayed adjustment will often translate into costly and painful adjustment. Put colloquially, New Zealand is not a very competitive society today. Social acceptance and openness to markets and competition is low, particularly in comparison with our nearest peer – Australia.

From my current vantage point, I would go as far as to say this is one of the defining characteristics of New Zealand today. Apart from a brief ‘cold turkey’ period of reform from 1984, the last five or six decades have been marked by an almost continuous drift to bigger government and further regulation. There is a prudish attitude to privatisation of any kind despite the overwhelming evidence on this subject. Attitudes and policy towards foreign ownership are equally archaic, with Auckland International Airport being a prime case in point. In addition to the general arguments in favour of contestable ownership, what could be better than an ownership link with Dubai, one of the most dynamic emerging market cities in the world? Of even greater concern is the blend of passivity and fear New Zealanders seem to have regarding entrenched vested interests. As George Stigler the Nobel Prize winning economist said: “all regulation is rationally devised”; it is devised to benefit specific interest groups. This is a simple fact of regulation in any democracy. Yet in New Zealand interest groups

in areas like health, education and the environment often seem able to intimidate the rest of the community out of open, rational debate.

As economic convergence broadens and accelerates, the economic costs of our current attitudes and policy settings are likely to increase. Our relative standard of living will decline further and we will drop down the global league tables as fast-growing emerging markets leapfrog us. Emigration is likely to increase, potentially dramatically, while a increased percentage of overseas New Zealanders will never return to live or work here. In this scenario, we should expect a continued slide in our relative performance in a wide range of social and economic indicators including health, education, sporting and cultural achievement. If you are thinking this is unduly pessimistic please recognise this is not a prediction; it is merely an extrapolation of current trends. The forces driving this relative decline will only intensify in the future.

What can be done to improve New Zealand's positioning?

The answer in my view is: quite a lot, and with a higher likelihood of success than most frustrated reformers in this room might expect. Why am I so hopeful on this score?

First, New Zealand has several key economic strengths in terms of the framework for success outlined in the earlier part of this address. We have inherited and evolved efficient high-quality institutions; property rights have traditionally been strong; and we are open to international trade. It is critical that we build on these strengths. The type of ad hoc tinkering recent governments have engaged in or contemplated, involving taking or undermining without compensation specific long-standing property rights, must be forcefully resisted. Every step in this direction is a step towards pre-reform Russia.

Secondly, history shows that the fact few of us here tonight expect New Zealand to become a South Pacific tiger any time soon has little predictive relevance. Few of the economic success stories I have mentioned this evening were expected. The reforms launched in

Wellington in July 1984, for example, were a total surprise, not least to the people who worked most closely on them.

Thirdly, there is the question of political leadership at the highest levels. For the last decade or so New Zealand's political leaders have sought to retain power by placating and balancing narrow short-term political interest groups through incremental and relatively minor policy adjustments. It does seem that New Zealand's system of mixed member proportional representation (MMP) has exacerbated this tendency; incremental decisions favouring special interests have tended to take precedent over bold decisions favouring the majority. We have lived through a 'tolerable if the world were static' period; however, in a period of extraordinary change the costs over time of this leadership style become large indeed. There are good reasons to expect this situation to eventually change, not because of personalities but because of fundamentals. Leading New Zealanders to embrace a more competitive economic model would generate substantial economic benefits and, for a skilled politician, substantial political payoffs.

Fourthly, there is the question of size and flexibility. In a world of dramatic change, nimbleness and flexibility are valuable assets. In my view it is no coincidence that many of the world's most successful economies are small – Singapore, Norway, Finland and Ireland to name a few. We are not highly flexible and responsive today – but we could become so and much more quickly than many of the world's largest economies. Similarly, in business, for reasons I have discussed, in a world of intensified Schumpeterian creative destruction there is often scope for small, highly entrepreneurial businesses to quite quickly become very large. Here, our large professional diaspora may eventually become a valuable catalyst, but only if our best entrepreneurs are prepared to move from Sydney, London and New York to Lagos, Lahore and Almati.

Top-flight New Zealand businesses should also be able to adapt more quickly than their multinational peers to the huge new business opportunities I discussed earlier. To do so, however, they will need to be bold and entrepreneurial and prepared to build the kind of deep local

platforms I mentioned before, or build alliances with emerging market businesses that already have such platforms. This nation was built by risk-taking explorers and pioneers – precisely the attributes required in today’s global economy. Yes, you need to be bold and extremely committed but you *can* participate fully in an historically unique opportunity for value creation. And it is a lot more fun that watching others do it on CNN!

Fifthly, through sheer good fortune, the industrial structure of the New Zealand economy will probably be quite advantageous during the era of accelerated global convergence. On current projections about 2 billion people or around 30 percent of the world’s population could join the ranks of the middle class by 2030. The incremental demand for raw materials to satisfy the investment and consumption bulge resulting from this middle-class explosion will likely dwarf all previous commodity cycles. Just as the fastest-growing economies following the industrial revolution were commodity exporters, the era of accelerated economic convergence is likely to favour countries with a high share of primary commodities in their exports.

What might prevent successful re-positioning by New Zealand?

These arguments suggest that New Zealand has considerable scope to be a global winner as accelerated economic convergence takes hold and to once again be acclaimed as a country that stands out from the crowd. The final question I would like to discuss, and perhaps importantly to pose, is: what might prevent such success?

I can think of only two things that will stop New Zealand become a major success on the global economic stage. The first is cultural and attitudinal, the second is constitutional.

To be successful, New Zealand has to recognise that competition is an unavoidable fact; to think that one can insulate oneself from it is to engage in dangerous and naive deception. This danger will only increase as global change accelerates. I think you all remember what happens to All Blacks when they are put in cotton wool. That is what we are doing

as a society given the role and extent of government. I have a feeling that most New Zealanders would agree with this statement. However, agreement has got to be translated into action. The silent majority must stand up and express themselves and fight for the simple common-sense values associated with an open, competitive society and economy, an economy that can underpin a resurgent New Zealand.

We need to be more aspirational and to see economic and business success as something to be proud of rather than something it is impolite to dwell on. There is nothing wrong with modesty. However, our cultural conditioning to 'not stand out from the crowd' may be lethal in a world of transformational growth. Many of our values derive from our small size and geographic isolation and many of them are great. But cultural cues that lead us to behave as if we are insulated and somehow safe from the outside world are likely to be extraordinarily misleading and dangerous in the world of today.

The second potential barrier to success in my opinion is New Zealand's system of proportional representation. Jim Rohwer in his book *Asia Rising* discusses what he terms the "paralysis of Western democracy by interest groups". He puts it well in my opinion when he says that "social protection is at heart a doctrine of conservatism: It is about guarding people against the destructive effects of change, which in practice means guarding them against change full stop, since the creative and destructive aspects of it come as a package ... Countries with big, activist governments will be far less able to cope with the increasing pace of change".¹

In a world of unprecedented change and growth, political leaders need to be able to lead and manage change. They need to be able to make policy choices quickly and efficiently. Under Roger Douglas the top marginal tax rate was reduced from 66 percent to 33 percent; virtually all agricultural assistance was removed in a short timeframe and the

¹ Jim Rohwer (1995) *Asia Rising: Why America Will Prosper as Asia's Economies Boom*, New York: Simon & Schuster, pp 21-22.

global competitiveness of our agricultural industry was re-established. Ideally, our policy settings should never have been so bad in the first place, but the point is that such bold modernisation is inconceivable today. We know what kind of political behaviour our current constitution generates: gradualism, populism and the quasi-corruption arising from disproportionate pandering to tiny minorities. New Zealand not only needs to address future global changes but also to catch up with policy change that has not occurred in the last 15 years. If we move to a constitution that permits government to promote a high-performance economy and avoids excessive capture by narrow interests we will be positioned to become global winners rather than global has-beens.

To summarise, the next several decades of accelerated economic convergence will likely see the fastest growth, most rapid structural change and greatest economic inclusion in history. For countries and for businesses the potential for growth and development will be unprecedented, but so too will the challenges. As the pace of change accelerates and global competition intensifies, the gap between winners and losers will be greatly magnified. With current social attitudes and policy settings New Zealand is poorly positioned to excel in this new world. Without change our economic decline of the last 40 years will continue and potentially accelerate.

Nevertheless, there are compelling reasons to believe that New Zealand can and should be a global success story; that New Zealand can have a tremendous resurgence and be recognised as a top performer on the global stage. In my opinion two things need to be done to achieve a transformational outcome for this country. First, mainstream New Zealand must express and live the values that underpin a competitive, enterprise-based economy. Secondly, we must move back to a system of government that gives our democratically elected leaders the flexibility to promote high economic performance without excessive pandering to narrow sectoral interests.

In my opinion both of these goals are readily achievable.

Vote of Thanks *Douglas Myers*

STEPHEN SPOKE OF THE HONOUR AND PRIVILEGE of delivering this year's Trotter lecture. I too feel honoured to be asked to thank him on behalf of all of us tonight.

Before I do so, I would also like to say, as one of the many privileged to have known and worked with Ron, how much we all miss not having him here tonight. Ron was a giant of a man in every sense, and he cast a long shadow. I do not know what it is about rural Taranaki backgrounds, and I have only known three: Ron, Stephen and Alison Gernhoefer, principal of Westlake Girls' High School. All I can say is – it is a pity about the rest of us.

In his retiring speech, the master of my Cambridge college said that he had come to the view, at the end of his career, that his belief that academic excellence was the determinant of success in life was wrong. What counted was vision, tenacity and charm, and of the three charm was the decisive one. Ron has all three in spades, beside being loveable and admirable. He was the decisive force in establishing the Business Roundtable and hiring Roger Kerr – amen to that. Roger's invitation to Stephen to give this year's Trotter lecture was inspired, and made the more so every day the financial meltdown has run its course.

Stephen, we greatly appreciate that you have taken so much care to assemble your views for this lecture and to share them with us so

openly. If that means being undiplomatic, so be it. The fact that they have been formed as a result of first-hand experience in countries at the centre of this past decade's growth dynamic makes the message more compelling.

Distance from New Zealand need not lessen one's interest, nor disqualify one's opinions. In fact, distance can bring balance and clarity, as your speech demonstrates. Some here may find the ideas disquieting; indeed I trust they do.

A lack of confidence has informed many New Zealanders' views of the world, including a certain defensiveness towards the Kiwi diaspora, yet who better to bring fresh thinking than those who have gone offshore in search of career opportunities and succeeded.

Your lecture's main theme – the likely out-performance of what are loosely called the emerging markets of the world today – has been more confidently expressed than I have heard elsewhere. Your view that there is more than one model for economic success is surely right, as is your view that economic growth is the precursor of social and political development. Victorian values that underpinned Britain's economic pre-eminence in the nineteenth century – hard work, thrift and family support – are more highly revered today in China and India than they are in the West, where many have become obsessed with rights and welfarism.

I agree that the developments you outline can be positive for New Zealand. New Zealanders are by nature pragmatic. The post-1984 reforms showed that, MMP aside, there are no great institutional barriers to change. In fact, I am always cheered on returning to New Zealand by both the optimism and generally sensible outlook on life. Yet apart from the decade after 1984, the role of government in respect of economic growth has too often been malign, spawning regulation and constraints on private initiative. Whilst wealth disparity in a small society will always be a contentious issue, there has been a preoccupation with levelling down rather than levelling up.

The primacy you give to enforceable and transferable property rights is also a timely reminder of the lack of regard by too many governments, particularly our most recent one, for this vital building block for economic growth. It is pleasing to see the new government showing greater respect for property rights and for the other traditional values that made New Zealand great.

Will New Zealand take advantage of the opportunities you laid before us? The large numbers leaving each year have been saying no and, as you say, there has been little in our recent past to disabuse them. What is needed is the confidence to embrace change, to be adaptable and outward looking.

It is easy to agree with PV Narashina Rao, the prime minister who presided over the 1991 Indian crisis, when he said “that decisions are easy when no options are left”! It would be good if New Zealand could *choose* to do the right things.

Stephen, on behalf of all of us tonight, thank you for your uplifting and challenging presentation and for delivering it in person at this stressful time. It deserves a wide circulation. I hope the media focus on the message and that Wellington’s elites wake up to the exciting world you have outlined to us tonight and get in behind.