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Searching for Growth in an Unstable Global Economy

A conversation with Mikhail Fridman and Anatole Kaletsky

Editor's note: The transcript of the conversation has been edited for clarity and readability.

Mikhail Fridman: Last year I wrote an article in the *Financial Times* – "Tricks of the mind turned oil into gold" – in which I said that the oil price had remained high because people perceived there was a shortage. I said that we were probably facing a new phase in which people would not fear the end of oil. Today, it's more or less clear that this is so.

Anatole Kaletsky: I was very struck by that article. I have a similar view about the oil price. If you look back over many years, there have been periods when people believed Malthus – that the world's population was running out of oil or food or whatever – and that natural resources were the basis for all human wealth. These have alternated with periods when the world rediscovered Schumpeter – that there is always capacity for innovation, and that innovation is the main source of economic progress and of wealth.

There is a related point about competition that I think you also made: monopolies can be preserved for a long time, but not forever. It is widely believed that oil is different from other commodities because the oil price has always been set by a monopoly. But actually, you can break up the past 40 years into distinct periods. Half the time the oil market really was a monopoly. But between 1985 and 2005, oil traded like any other commodity, with prices determined by supply and demand, and production costs.

MF: So, as we agree on the causes of the falling price of oil, we should discuss the broader consequences. In my view, the impact of the lower oil price, coupled with other economic factors, is leading to volatility in politics and markets – there are signals of a major tectonic shift happening before our eyes.

The economic outlook is unstable. Extreme volatility in the markets has become



the norm. This instability is usually attributed to two main factors: the sharp decline in the price of natural resources, and the slowing of China's growth. Yet these factors are seemingly contradictory. Cheaper resources should, in theory, benefit China, the largest importer of natural resources. Western economies, which are the main consumers of Chinese exports, should also be helped by cheap energy – but there is no sign of that, either.

What unites these factors is that, while we are living in an era of globalization, it's not progressing in the way that was expected a few years ago. People get access to information almost immediately, and the world believed that this access would allow more backward countries to join the club of more successful countries more quickly than before. So the emerging markets would develop faster than developed countries because the base was much lower. It's now clear that globalization is not a linear, progressive process, but a circular one – and I think this is very alarming in some respects.

AK: What do you mean by a "circular" process, and what consequences does it imply?

MF: If you look at the broader picture, and not portions of the picture like U.S. market performance or the China slowdown or the migration crisis, one can see that a whole series of seemingly unconnected events are actually connected.

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Fragility and instability are spreading like a virus, infecting countries and continents. Those who only yesterday were on the margins of European politics are bursting onto center stage. Some are left-leaning political movements, like Syriza in Greece and Podemos in Spain. Some are right-leaning, such as the National Front in France, Fidesz in Hungary and AfD in Germany. But all are populist and anti-establishment. And it is not just Europe that is being shaken up.

The United States, which was built on the principles of free markets and openness, is rallying to presidential candidates who are either propagating socialist views or arguing for isolationism. This populist advance reflects an obvious and sad fact: old and tested truths no longer satisfy modern societies, and need to be reviewed and redefined.

AK: Why do you think this is happening, and how is it connected with globalization and natural resources? I wrote during the banking crisis that turmoil was a predictable response to the breakdown of one specific model of global capitalism. Judging by past experience, a likely outcome could be a decade or more of soul-searching and instability, leading eventually to a new settlement in both politics and economics. I argued in my book, Capitalism 4.0, that the breakdown of deregulated financial capitalism would trigger a fourth seismic change in both politics and economic thinking - that global capitalism is entering a new phase of its evolution. Are you suggesting something along these lines?

MF: I think that the crash of the oil price symbolized to a certain extent the end of the era of economic development based on natural resources. Land, minerals, oil and gas, water and other resources were seen as the main components of national treasure. This seems to me to be changing, although, of course, not overnight.



AK: And what in your view could replace national resources as the main form of what you call national treasure?

MF: I believe that the main source is no longer natural resource rents, but the social infrastructure that allows every person to realize their intellectual and creative potential. This represents a paradigm shift in economic development, to a new era in which ideas can be turned into new scalable services in a short space of time. And the consequences are farreaching.

I think that has happened in the developed countries. Silicon Valley is not the only example, but it's probably the brightest one if you look at a company like Google. In 1991, there were two young guys in a garage who created a search engine that has formed the basis of the world's first or second largest company. I think the West now has the best conditions for making breakthroughs in various spheres of human activity, be it in biotechnology, robotics, logistics or transportation. It is also

clear that countries lacking what I call sociopolitical ecosystems, in which these businesses are created, are disadvantaged. The establishment of a balanced social system and a competitive, rule-based environment requires big shifts in values and thinking, as well as the breaking of stereotypes.

AK: That's a point you make very clearly. But where do we go from this diagnosis? What is the prescription that follows?

MF: To understand this shift, and therefore what a country needs to do to replicate it, you need to look at how the change occurred.

There are three pillars to this new competitive advantage. First, you need talented people who are very well educated, like those two guys at Google – one of whom was born in Russia. (His family immigrated to the United States when he was young.) This combination of exceptional talent and education is more crucial than ever because we are entering a disruptive era driven by extraordinary levels of human creativity.



The term "indigo" has been used to refer to children with special or unusual abilities. Today we are in a new era in which especially talented individuals and the organizations they create are able to realize new levels of human potential and economic achievement. So I refer to an "indigo" generation that is shaping tomorrow's economy and creating national wealth.

We know from biology that human intelligence, talent and creativity exist everywhere and are equally distributed among nations and races. Good education may not be available everywhere, but all large developing countries have serious universities. Moreover, people from these countries have a chance to study abroad or to take online courses provided by the best universities in the developed world.

AK: So talent and education are available everywhere. What, then, is missing?

MF: The second of my three pillars is probably the most important. It is really an ecosys-

tem, with legal infrastructure that can protect property rights; competition policies to ensure that a small company cannot be oppressed by a big one; hundreds of suppliers of different business services, starting from venture capital, to banks ready to finance, to suppliers of services like web design, IT support — whatever. This kind of collateral enables ideas to arise and businesses to be created quickly and to expand within a very short time.

Third, this indigo economy needs a digital world that allows the innovators to distribute their products widely almost immediately and to collect data to understand the behavior of their potential customers.

AK: So how can developing markets take advantage of these new conditions?

MF: Well, the most problematic area for the functioning of a new-era economy is the creation of a social and institutional environment congenial to innovative companies. What might be called the politico-economic

"cloud," which is even more important than the technological cloud that everyone now talks about.

This institutional cloud cannot be created overnight. It has evolved as a result of a profound social and political development that Western societies have experienced over centuries. A firm legal system, competition rules and a system of checks and balances do not automatically result in the creation of a Silicon Valley – but they are necessary preconditions.

AK: That's very persuasive. But why should it be so much more difficult for emerging economies to create this social infrastructure if the understanding already exists? If you look at Singapore or Taiwan or Korea (and their achievements), why are you convinced that other developing countries will find it more difficult to create this infrastructure?

After all, there is a contrary argument: a few years ago, people believed that globalization and technological progress would allow emerging economies to catch up faster than ever before. It takes 15 or 20 years and hundreds of billions of dollars to build a railway network, an electricity grid or a road system. But, in principle, it doesn't take that long or cost that much to create a properly functioning legal system or accounting system.

MF: This is the nub of the problem. Everything depends on whether there is the political will to do what's required to create and sustain a modern business system. It doesn't need financial investment; it needs a social consensus. By the way, the former Soviet Union was a great counterexample that shows what I mean.

When the USSR collapsed at the end of the 80s and beginning of the 90s, I remember I started to meet foreign investors. All were totally certain that the Soviet Union would overcome its problems because of a very convincing argument. They said "you have a very

well educated population; you have a huge amount of natural resources; you have technological achievements in areas like rockets and atomic energy, military techniques and all these kinds of things. So, therefore, you will very quickly reach the level of developed countries."

It didn't happen in Russia because the mind-set of people is not based on a piece of paper that is called the law; it's based on history, tradition, beliefs and religion, going back hundreds and hundreds of years. The culture of any society is probably the most

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nurtured parameter of any society. You and I, as cosmopolitan people who travel internationally, know that it's impossible to change culture quickly. It's possible to make new leaders. But if their culture is not respectful of the society, all their changes will be very temporary, very superficial.

Let's continue with the example of Russia. All these "new" concepts of freedom of the press, freedom of speech, of democracy and elections, privatization, everything is very vulnerable. Why? Not because President Putin is imposing a new form of law, which is believed here in the West, but because the reforms that were done by former President Yeltsin never penetrated to the bottom of the soul of Russian people. Never.

AK: So this is the cultural infrastructure that you describe as key to global economic development? You cannot just sign a piece of

paper, which is what Yeltsin thought was enough to create a new kind of society. You'll recall when Yeltsin rescued Gorbachev after the coup in 1991. He turns up, signs a piece of paper – and the Communist Party is abolished. Communism is finished; we are now in the new world

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I think you are saying that creating a modern economy and business system is actually more difficult, more time consuming, more costly than building the railway or electricity system. So what does this mean for developing economies like China and India that are more important than Russia as engines of growth for the world economy?

MF: Emerging-market governments have typically favored fast physical infrastructure projects at the expense of building institutions and independent legal systems, and encouraging competition. These latter goals seemed like long and difficult tasks that did not match traditional values and often contradicted the interests of the ruling elite.

The most obvious example is China. There, the development of institutions was sacrificed for the sake of building new cities. Having realized the scale of problems related to the weakness of its institutions, the government has responded in its usual way, employing tactics of further centralization and repression.

Another great example is Brazil. It seemed

like it had been completely fixed with Lula. He had set up a proper system of laws and everything. But the moment you begin to peel away the surface, it turns out that nothing has changed and it's worse than ever before. Turkey is another unfortunate example.

In short, with the possible exception of India, a repeat of China's economic miracle or a boom in any of the other big emerging markets is unlikely.

AK: Isn't there a contrary argument based on Eastern Europe? Look at the Eastern European countries that have relatively quickly joined the European collaboration, like the Czech Republic, or even Poland. Why? Because there was unity of purpose? Because they were mentally ready?

MF: Well, look at Poland and Hungary. Even there it turns out that perhaps these Western values are not as deeply rooted as we imagined two years ago. But this brings me to another important point. I believe that religious rules and traditions are crucially important, even though in the modern world religion is not so visible anymore.

AK: Is this because cultures are built on religion? That seems to be one lesson of history.

MF: Yes, religion is a part of culture, a seed that is so deep. Look at the Baltic states. You know when they broke free of the Soviet Union they just immediately switched. Look at Estonia. It's a normal country. Of course, you could not completely avoid the effects of 40-50 years of Soviet rule. There is still a generation there of ex-Soviet people. But nevertheless it is much easier to change Estonia than Romania or Hungary.

AK: So if you are living in Brazil or Turkey do you just give up and say, if I'm an intelligent person I have to emigrate to the United States or to Western Europe? Or is there something else, some kind of hope that we could hold out?



MF: This is very difficult challenge. To cure problems you should have clarity about what kind of bitter pill you need to take. It seems to me that the support these countries expect from all their natural resources or cheap labor will diminish quickly, and they should focus on building institutional ecosystems. It's sad news. But the cloud has a silver lining: in the end, success or failure does not depend on abundant fertile land, deposits of oil or ore, or whatever.

AK: I think there's a contradiction here. You're saying that they need to change their societies. But actually, you've established that they really can't do this quickly – it takes a very long time. Even if they're trying, even if

the people at the top understand your diagnosis, do you think they can implement the necessary reforms before their people lose patience and turn against the reform process?

MF: I think most governments in emerging markets have never addressed this very clearly. They have to create more-just societies in places where the sense of justice and the rule of law are lacking. What's important is to create an open society. And a functional open society depends on the social infrastructure on which voting is built. Just having a vote doesn't give you that social infrastructure.

AK: I think that is an important conclusion. Democracy may be a necessary condition, but it is not a sufficient condition. So some parts

of the developing world will move in the right direction, but many will not.

MF: Yes. The demands of the indigo economy mean that the rate of economic growth in many emerging markets will lag behind that of the developed world, further widening the gap in incomes and standards of living. The resentment driven this inability to catch up with the developed world will increase. Emerging countries are likely to feel increasingly jealous and hostile toward rich countries, while rich countries will try to isolate themselves from their poorer and embittered neighbors.

On the other hand, there will be some successes. Among developing nations, India is a good example of a country on the rise because it doesn't have the legacy of an authoritarian past. Let's not call India a democracy; let's call it a country with a system of checks and balances.

AK: With a proper legal system based on English law?

MF: Of course it's not perfect. But still, it's working somehow; somehow the infrastructure required for business there does work. That's why I see the chance of a breakthrough in India.

AK: So in your view India has a good chance because of its legal and political infrastructure. This relates, by the way, to one of the points that I have been making for the past few years about China. One of the biggest contributions to China's remarkable development in the past 10-15 years was actually made by Margaret Thatcher. Why? Because Thatcher gave China something that they could not have created for themselves in 10, 15 or 20 years by handing over Hong Kong.

Hong Kong was a functioning financial center that had developed over 99 years precisely because it had the legal and social infrastructure that you have been talking about. The Chinese were able to import this for nothing and rely on it to a very significant extent to help the development of Chinese business and finance. Without that gift, a lot of China's business development might not have happened.

On the other hand, Taiwan, Korea and Japan have managed to create their own successful business and financial cultures. But to some extent, they were forced to create this infrastructure under American occupation or influence. Another way of expressing the phenomenon you're describing is that emerging economies are facing resource traps or so-called middle-income traps. Many of them have reached per capita incomes of, say, \$7,000 to \$10,000 a year. But only three or four of them have managed the leap beyond.

MF: That's the point. You can't go further unless you reshuffle the whole system.

I think globalization is becoming circular. A few years ago it contributed to the narrowing of the gap between emerging markets and the Western world. But it could come to serve as a channel for selling the goods and services of the indigo economies to the countries that cannot compete in quality or price.

Rising resentment could further empower political populists to fan hatred toward the more prosperous and successful. Populist politicians are already among us, promising simple solutions to complex problems. It is a dangerous recipe.

But in this new economic era, one cannot build an economy based on the creative energy, free spirit and self-fulfillment of millions of individuals if they are cut off from influencing the most important decisions about their own society. I hope that the indigo era toward which we are heading will finally end these dangerous misconceptions. The successful economy is an economy of free people. And this means that the world must become more and more free.