Russia in the Mirror of Other Emerging Markets

Good morning. I want to focus my opening remarks on the changes in the world economy, which create unique opportunities Russia can take advantage of. In contrast to some of the earlier speakers, I would advise Russia to not just look West, but also to look East and to look South for opportunities.

In the last thirty or 40 years, every country that has successful and rapidly made the transition from poor country to rich country has followed a strategy with three basic characteristics – it has been led by labor-intensive manufacturing, it has been export oriented, usually supported by a very competitive, if not undervalued, exchange rate, and these exports have been targeted at industrial countries. I am, of course, excluding the handful of countries that have been lucky enough to find enough mineral resources on their land, and have managed them well enough to transition from poor to rich without going through manufacturing.

The classic examples, of course, of manufacturing export led growth have been Japan and South Korea, and now China and Vietnam.

Why were these strategies successful? Unskilled manufacturing – such as manufacturing T-shirts -- was often the only entryway into value-added exports, as well as the primary way an unskilled labor force could be utilized. An undervalued exchange rate gave a country an initial competitive advantage that could overcome its other deficiencies such as an inadequate infrastructure and poor economic and legal institutions. And industrial countries were often the primary sources of excess domestic demand – why would one export to a neighbor who was equally poor.

Changes in the world economy have, however, altered the set of possible growth paths. This is good for Russia, a country that does not fit the typical pattern of the poor emerging market, but is also not yet rich. Perhaps the three biggest changes are the reduction in communication and transportation costs, the deconstruction of the value chain, and the growing productivity, incomes, and demand in the non-industrial world.

Start with the reduction in communication and transportation costs. It is obvious that this has created a market for services that did not exist before. The call-center operator in Manila, Philippines, answering queries from Dayton Ohio is one example, but so is the hospital in Mexico that gets medical tourists from the United States, lured by sun, sand, and stitches. Indeed, the Mexican government is negotiating with the US government to allow US citizens to get Medicare reimbursements for treatment in Mexico.

Both these are examples of mass-produced services, that can be provided by the educated, and tend to play off the tremendous cost difference between industrial countries and emerging markets. In some ways, they are just old trade – the only difference is that services that did not trade in the past are now traded.

By contrast, the deconstruction of the production process has changed the very nature of what is traded. In the past, the entire production chain had to be close together, usually within

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the same country. So a country could produce cars only if it were moderately good at every aspect of the production process. This meant that the most sophisticated aspect of a product determined who would make it.

No wonder most countries started with textile and clothing industry, where no part of the production process was terribly complicated.

But with improvements in communication and transportation, countries can specialize, outsourcing the rest. India, which did not have the expertise or the infrastructure to make the entire modern car at reasonable cost, could nevertheless use its engineers to create a state-of-the-art car parts industry, which exported worldwide.

The specialization of China in fabrication, of India in software, of the United States in legal and consulting services exemplifies deconstruction, with countries focusing on their strengths without their weaknesses holding them back. It ensures that there are multiple points of entry in the global production process, not just at the very bottom with textiles.

But in this new world, countries become really wealthy only if they can own critical aspects of the production process, typically overall design, branding, and marketing. The Apple IPOD retails for about $199, of which only $50 is the manufacturing value added created in China. The rest accrues to Apple USA as a return for its design and innovation. Industrial countries hold sway partly because they have been more innovative, their companies have historically owned the brands, and because what sells in the West is what the rest aspire for. But this will change.

In the past, purchasing power used to be in the industrial countries, so everyone used to target exports at them. And industrial country manufacturers had a special advantage because it was a market they knew well, their own. But emerging markets have grown richer, based on tremendous productivity growth. Last year they accounted for more growth in global income than the entire industrial world put together. The fast growing non-industrial countries of the world are where demand is increasingly going to be, and smart companies in emerging markets understand this.

Consider ways the consumer in emerging markets is different. Tata with their $ 2500 Nano car recognize that the emerging middle classes need a reliable low cost car, not an over-engineered behemoth. The question the consumer in India asks is, “Is it safer than my motorcycle in transporting my family?” not “Is it safer than Volvo?”. And while focusing on this market in India, Tata understands there is a worldwide middle class market – in Africa, in Latin America, and in Asia -- that the industrial countries have ignored.

Consider another difference. Information about customers is less likely to be shared electronically in emerging markets, usually because the links between the customer and the formal system are few, and unique national identifiers have only recently been created. This forces service providers to be more innovative. For example, Standard Bank in South Africa decided to scrutinize the deposit records of its customers to see if it could find bankable ones who had been ignored. It found a number with high deposit balances and steady monthly deposits, but no discernible source of income. One suspicion that must have crossed their minds is that this could have been income from petty crime.
Yet the average customer was over 70 years old, hardly someone liable to thuggery. On reflection, which was later confirmed by investigation, they understood these were elderly parents getting steady monthly remittances from their children, and therefore extremely good credit risks that had been ignored by other banks. And these customers became an important source of revenue for the bank.

Partnerships are forming to take such acquired skills across emerging markets. South Africa’s Standard Bank has tremendous experience in meeting the needs of African companies, needs that are different from those of the standard Western multinational. Recognizing this, China’s ICBC has taken a strategic stake in Standard Bank so as to jointly service the increasing number of Chinese firms doing business in Africa.

Finally, corporations that have understood the intricacies of production for emerging markets may well find they have capabilities that allow them to produce more efficiently in industrial countries. This is precisely what Cemex in cement or Mittal in steel have done – sharpened their skills in difficult emerging markets and used these capabilities to take over and improve the performance of industrial country firms.

How does Russia stand positioned to benefit from these changes? Demand from non-industrial countries will necessarily be more commodity intensive than demand from industrial countries. So the shift in the weight of demand will benefit commodity producers like Russia, probably more in energy than in metals, where supply can ramp up more easily. Russia also has its own population, which is rapidly increasing consumption, albeit from a low base, thus providing opportunities in areas ranging from retail finance to personal care products.

But Russia’s truly unexploited opportunity lies in its well-educated work force. Russia’s scientific, engineering, and artistic strengths are indeed extraordinary, though of course, more can be done to improve higher education and healthcare. But to truly utilize the strengths of this work force, Russia has to create a more enabling environment, including reducing the burdens of bureaucracy and improving the climate for investment. I do not see why Russia’s government cannot meet these challenges. And as it does, Russia will plug itself into many critical points of global supply chains, making better use of its latent capabilities. These are indeed exciting times for Russia.

My main concerns, however, have to do with challenges emanating from Russia’s very strengths. First, while the commodity windfall will help stabilize government revenues, they put upward pressure on the exchange rate, which tends to make it harder for domestic non-commodity producers to compete. This is the so-called “Dutch Disease” which will need to be addressed by constraining consumption, especially government expenditure, and expanding investment.

Second, natural resource rich companies are easier for governments to expropriate. When natural resource rich companies account for a large weight of the property values in a country, the overall security of property rights becomes harder to establish. This can inhibit investment.

Third, revenue windfalls from commodities typically tend to make governments less reliant on taxation, and therefore a little more independent of popular opinion. The Curse of
Natural Resources has turned many a government autocratic, to the detriment of its people. Of course, the Curse is not an economic law, but a challenge to overcome.

Increasingly though, as Russia’s human capital, and not its commodities, account for more of its income another set of challenges will emerge. If Russia wants to harness the creative juices of its tremendously well-educated and burgeoning middle class, it will have to give them a sense not just of economic well-being but also of full political autonomy and self-expression. By most external accounts, Russia’s democracy is work-in-progress. When you look around the world, you do not see any people of Russia’s level of education, who are not part of a vibrant democratic process, and I have no doubt that Russia too will be transformed by its people in that direction.