THE RISE OF THE STATE

PROFITABLE INVESTING *and* GEOPOLITICS *in the* 21st CENTURY

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Past and Prologue

At a party during a trip to China in the 1930s Nikos Kazantzakis, one of the foremost writers and thinkers to emerge from Greece in the 20th century, became involved in a deep conversation with a mandarin. Kazantzakis noted that both the communists and the Japanese were advancing toward Beijing from different directions. Was the man scared? Kazantzakis asked. The mandarin, at one time China's ambassador to France, smiled. "Communism is ephemeral, Japan is ephemeral, but China is eternal," he said.

China is not new to the power game. For 500 years Imperial China was the world's preeminent force. At the height of its influence, between 1440 and 1433 AD, China's navy was the most formidable in the world in terms of sheer size as well as reach. Chinese Admiral Cheng Ho commanded ships that weighed 1,500 tons, with firepower and cargo capacity incomprehensible to his European counterparts.

Control of the seas and the extensive trade relationships it facilitated were the foundation of China's economic and political superiority. Because of a strategic decision to shift resources to strengthening its defenses against potential land invaders, by 1436 the mighty Chinese navy had been disassembled. The end of its power was not far off.

More than 500 years on and China is leading emerging economies in a rebalancing of the world's economic and geopolitical order. The increase in global trade, coupled with pragmatic leadership, set the stage for the awakening of what was a slumbering dragon. Furthermore, other countries that have also benefited from free trade and that also enjoy continentlike characteristics complement the rise of

China's star, Brazil, India, and Russia—the remaining three elements of the BRIC mosaic—are each in its own right important elements in the world's transformation.

Only in the aftermath of the crisis that nearly ruined the financial system in 2008-09 did the majority of people start understanding the growing importance of these emerging nations to global economic well-being. For the first time in financial history, major emerging economies were able not only to avoid total destruction when the developed economies were in dire straits, but also the leaders among them have actually delivered solid growth amid what was otherwise the worst economic downturn in seven decades. The relative resilience of these economies, primarily China and India, has helped the global economy absorb what would otherwise have been fatal blows.

The multiyear process that resulted in these economies playing a prominent role in stabilizing the global system, unfolded while the West was engorging itself on cheap credit and unsustainable consumption. During these fat years of self-congratulation, relatively little attention was paid by the West to the serious structural reform that Asian countries, in particular, in the wake of the regional crisis of 1997-98, had undertaken. The reality is that strong economic growth in the emerging world allowed the majority of the Anglo-Saxon economies to follow spendthrift fiscal and easy monetary policies, prolong the economic cycle on the upside, shorten it on the downside, and only delay an inevitable reckoning.

Responding to what now looms as the first in a series of upsets that will result in its eventual decline as the global hegemonic power, U.S. leaders—financial and political—managed, sadly, to discredit John Maynard Keynes in the eyes of the majority of Westerners. This result, however, springs from the vanity and hunger for power that led those who would relegate Keynesianism to history's dust heap to disregard Lord Keynes' advice in 1946 that the "classical medicine"—letting a recession run its natural course—must also be allowed to work and that government intervention would be ineffective in the long term otherwise. Our sophisticated society ignored substance in favor of superficiality and so the financial system continues to wither. Western countries, typified by the largest, the United States, lived beyond their means for too long, all the while developing a sense of invulnerability to the economic cycle and contempt for other growth models. It was not just the greed of "evil bankers" that brought the Western financial system to its knees. The greed of the public, the most dangerous of all avarice, also played a great role.

The failure of the state to effectively monitor markets beforehand led directly to inevitable, extraordinary intervention after the fact of the near-collapse of the financial system—the de jure and de facto control of the economy by the state. What we have, too, is the looming danger of moral hazard, a culture in other words of nonpayment, where everyone has recourse to a central authority. Because neither side of the great American political divide properly understands even what are considered well-known theories on the role of government in the economy, and the people who elect them aren't seriously concerned because they've effectively voted themselves rich, the door is now open, at least partially, to the destruction of the free market-based model of growth. This is the breach the West has opened.

But the crisis of 2008 also revealed that there are different ways to foster economic development, and that these varying structures can also lead to positive outcomes. Beginning in the mid-2000s serious economic researchers warned that "the cross-country evidence on the growth benefits of capital-account openness is inconclusive and lacks robustness." As the global recession that closed the decade revealed, relying less, not more, on foreign capital for growth has been a better recipe for success than the majority of economic experts and other Western commentators would have had us believe. The financial crisis demonstrated that countries that followed gradual approaches toward more open capital accounts had one less thing to worry about once the situation deteriorated rapidly in late 2008. Others, those in a hurry to follow the Holy Grail of Western financial success had significantly more exposure to cover.

Until recently a substantial part of Western elites propped up the idea that emerging economies would support the spending habits of their Western customers in perpetuity by financing their consumption via the endless purchase of bonds. These export-based economies in need of destination markets for their products had no alternative. This assumption is as false today as it was in the waning days of the 20th century when it was first advanced. What most expert commentators failed to notice was that while these economies did lend money to their Western customers, they were at the same time strengthening their own financial infrastructure.

The primary manifestation of this maturation is the rapid expansion of existing and proliferation of new sovereign wealth funds (SWF). The strong growth of these investment vehicles has set in motion a process through which emerging economies will evolve from creditors into owners. The rise of SWFs is a direct consequence of globalization. Oil-related SWFs have been around since the early 1950s; the expansion of global trade and the gradual opening of international markets have endowed nonresource-rich, export-based economies to support the creation of similar state-owned asset managers. Without free trade, SWFs would have remained what they have always been, namely a loose pool of money trying to find ways to diversify away from oil.

Asian nations have been at the forefront of this SWF process. The structural economic boom in the emerging economies has allowed new players such as China to enter the investment arena with money that's basically controlled by the state but is allocated primarily with investment returns in mind. Nevertheless, only the most naïve observer would suggest that investment decisions made by SWFs are entirely devoid of geopolitical considerations; the long-term economic development of one particular nation-state is inevitably a matter of strategic importance to its neighbors, and vice versa. Sovereign influence is a fact of international capital flows and always has been. That SWFs overtly owned by the states that sponsor them has nevertheless aroused a great deal of suspicion among the US- and EU-based commentariat.

Despite the short-term distractions caused by ambitious politicians, SWFs are here to stay. And the most significant investment development for the next decade will be SWFs soliciting funds from individual investors in their respective countries on a widespread basis. Singapore's Temasek Holdings, in the summer of 2009, was the first SWF to raise funds from institutional investors, making the next leap all the more possible to imagine. That SWFs will eventually tap their own citizens is not so far-fetched; in fact, the domestic base is theoretically preferable to foreign institutions because the latter are prone to withdraw funds for reasons other than investment performance.

Right now we can only contemplate the impact allowing, for example, Chinese to invest in China Investment Corporation (CIC), the country's primary SWF, would have on the global financial system. Apart from the pure amount of funds that would be at its disposal, this would represent yet another step toward a global system in which government plays not simply a supportive, nurturing role but a robust, active role in economic and financial decisions. Governments in the major emerging economies are already deeply entrenched in the financial game. Governments in the Western economies are, alarmingly, increasing their presence in it. Greater interconnectedness between the public and private sector is the inevitable outcome.

The rise of the state, the way it is viewed here, is about two things. First, geopolitical developments will have increasingly greater influence on the way investment funds are allocated as the coming decade unfolds. Second, government will have greater involvement in people's financial affairs—this is the great legacy the financial crisis of 2008 will leave with us.

The recent course of action undertaken by the US government provides a good example of what you should expect from duly constituted authorities around the world in the future. The US government now controls outright or has significant financial interests in some of the biggest, most important industries in the economy. It essentially owns nearly 50 percent of the domestic mortgage market. It owns an iconic automobile manufacturer. It controls large stakes in the major financial institutions that have only gotten bigger since they were deemed "too big to fail." Only hope informs the view that governmental involvement will be relatively short-lived or easily rolled back and that things will return to "normal" sooner rather than later. The financial problems the US federal and state governments face are of unprecedented proportion. The makeup of American society is also changing. The Baby Boomers—around 70 million people born between 1946 and 1960—are entering their 50s and 60s, and their financial needs are changing rapidly. Saving is now more important than spending. The idea of a safety net is a lot more personal, which makes people more amendable to the idea of greater government involvement in their financial affairs. American individual investors have stepped up their purchases of US government bonds, another indication of alignment of interests with the state and their search for income.

History clearly demonstrates that governments are reluctant to give up control of the economy. Successful challenges to authority in matters of commerce usually come from the people, during times of strong growth, as entrepreneurs struggle against burdens placed on them by the state. If, therefore, we've entered a period of structural stagnation and deregulation is viewed suspiciously by the majority of the people, it's impossible to imagine government ceding control soon.

We are in the early stages of an economic and social transformation the end of which could see governments in control over—though not owners of—the means of production. This is not a new idea. The Austrian economist Joseph A. Schumpeter discussed this outcome, in the context of a market-based economy, in his book *Capitalism, Socialism and Democracy* in the early 1940s. The liberal democracies of the West have now reached the point where implementation of a mild version of the ideas Schumpeter expressed can't be dismissed out of hand. Such a shift will be gradual and relatively seamless, through a democratic process, thus engendering relatively little opposition.

This is a book about ideas, the main one of which is that sustainable economic growth increases geopolitical power, which in turn allows for greater assertion in the pursuit of economic greatness. Consequently the investments made by the new powers, domestically and internationally, are more aggressive as well as different in nature than before.

As the book was written with the long-term investor in mind, we have identified the investment themes we believe will emerge as our forecast for the next decade. The majority of these themes share the characteristic that governmental involvement is present usually as a facilitator, but often as a partner to the private sector. Our energy theme is a good example, as governments are now more involved in every phase of the production chain, while also supporting new energy alternatives through elaborate subsidized schemes.

We also name many companies as potential investment candidates, but these recommendations are simply points of departure for more rigorous analysis the realities of time and space don't allow here.

At the same time, noninvestors will also benefit from understanding the themes we address. The political and economic rise of new powers will affect everyone. The ability to separate reality from fiction is, after all, the most useful characteristic of a citizen of a democracy.

We hope you find *The Rise of the State* a useful tool as you make your way through what is a fast-changing world, where the blurring of private and public will only increase.

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Tectonic Shifts

Governments have always interfered in the investment process. Our contention is that the state's role in finance and the economy will only increase in scope and scale in the decade ahead, for two reasons.

Developed-world economies are in a precarious condition in the aftermath of the great economic collapse of 2008–09. This instability and the extreme measures required to counteract it have exacerbated stresses long-term commitments to citizens have placed on government balance sheets. A paradigm of entitlement has gripped these societies and will prove a difficult burden to shed. At the same time, rising powers feature governments that have traditionally been much more involved in financial and economic matters—practitioners of what many observers have defined as state capitalism.

Here we describe, in broad strokes, the world as it was under US dominance and how it will evolve going forward. Understanding this evolution is most important for the long-term investor. One must look no further than Central Asia to see how economic and political games today's great powers are playing in the region affect the rest of the world. Polycentricism is fast becoming the new norm among states.

Our assessment of how the world will be divided going forward is an effort to prepare the reader for the deep transformation that's already underway. We make no claim that the new financial and geopolitical order we envisage will be a better one. For Westerners, however, the new normal may not be as agreeable as the state of affairs. The example of political and economic order represented by China is a direct challenge to two centuries of accepted wisdom.

Economic and geopolitical scales are tilting eastward. Investors—and citizens—who understand and adapt will find this new world a profitable and exciting one.

In the 1980s, UK Prime Minister Margaret Thatcher was instrumental in blocking the Kuwait Investment Authority (KIA) from controlling more than 25 percent of British Petroleum. The Iron Lady objected on the grounds that she didn't want to see a national treasure owned by a foreign government. The KIA, which was owned by the Kuwaiti government, had to reduce its share of the company to less than 15 percent.

Apart from leading a revival of England's collapsed economy and injecting a dynamism that it until recently possessed, Lady Thatcher was a big proponent of capitalism. She acknowledged, however, that governments had occasionally to interfere, for a variety of potential reasons, in otherwise free markets.

History is full of examples of states intervening in the financial arena for political and economic reasons. The most characteristic examples involve the use of investments or other financial engagements as a geopolitical negotiating technique,[1] as was the case with the English East India Company and the Dutch East India Company. Both companies were founded in the early 1600s to exploit business opportunities in Asia, with initial focus on India and the Indian Ocean, respectively. Both were also involved in politics and acted as agents of the imperialistic aspirations of their countries.

Even the US, which has long projected the image of a free-enterprise haven, maintained high-tariff policies until World War II. "Freedom to trade" rather than "free trade" remains the maxim of its leaders. As recently as 2008, Germany adopted a bill that blocks non-European investors from owning more than 25 percent of a German company.

Peace and Prosperity

As World War II came to an end, the US had clearly evolved into a power financially and militarily able to lead a new era. Its isolationist pretentions were quickly put aside as the new global power was getting ready to take central stage.

President Truman, in an April 1946 speech to a joint session of Congress, observed, "The free people of the world look to us for support in maintaining their freedoms. If we falter in our leadership, we may endanger the peace of the world—and we shall surely endanger the welfare of our own nation." America's "sphere of interest" was now global.[2]

Although the US has been quick to use force in furtherance of its strategic goals, it's also responsible for important institutions with global reach. The most significant in the geopolitical arena are the North Atlantic Treaty Organization (NATO) and the United Nations (UN).

NATO may initially have been designed as its first secretary-general, Lord Ismay, allegedly said, "to keep the Russians out, the Americans in and the Germans down." In practice, it did shelter Western Europe from communism, and the threat of US power guaranteed stability—a prerequisite for economic growth.

The UN's role has been the subject of much criticism. But the UN, overall, has been a positive force in the world—even for the small countries that constantly note their underrepresentation in key decision-making circles. At the end of the day, as Paul Kennedy has observed, "We have a central, self-selected world security body that can be summoned day and night in the event of a new emergency and threat to international order. It is as strong or weak as its permanent members wish it to be. At least, the Great Powers remain inside the tent. At best, they can do great things."[3]

Mainly because of the leadership and restraint it exercised in its post-World War role as one side of a bipolar global power structure, the US has been able to exercise its military and economic power on a global scale essentially unopposed for more than 60 years. The phenomenon of economic globalization, as Baldev Raj Nayar has noted

> ...is not something that has occurred as simply the outcome of some autonomous economic process, but is fundamentally rooted in the geopolitical fact of the global reach of American military power. It is precisely the globe girdling American military presence that has provided the political framework—because of the accompanying security and stability that it assures—within which the Western regime of "embedded

liberalism" has functioned and the massive flows of post-war foreign direct investment have taken place.[4]

America's dominance was also helped by the failure of its two most important adversaries to keep up with a changing world. The Soviet Union eventually collapsed under the weight of its own misguided policies and disastrous economic planning. China suffered more than 30 years of "warlord-ism," genocide at the hands of the Japanese, financially disastrous policies, and oppression under Chiang Kai Shek. It didn't fare better under Mao Zedong, whose "Great Leap Forward" led to the starvation deaths of about 40 million Chinese. The Middle Kingdom's economy, by 1962, was decimated.

State Capitalism

As time passed US economic success, the consequences of which were greater power-projection capabilities and domination of the world's geopolitical scene, made a great impression on the rest of the world. Russia and China set out to emulate this Western model—once given the chance. China, under the guidance of Deng Xiaoping in the late 1970s, was finally able to reverse Mao's disastrous policies and establish a trajectory of economic growth the spectacular likes of which very few people around the world would dare even contemplate at the time. To its credit American leadership at the time, from 1977 and up to the presidency of George H. W. Bush, understood the implications of Deng's market-oriented reforms and, by building upon former President Richard M. Nixon's initiatives, laid a foundation that would allow American companies and investors to capitalize on opportunities in China for years to come.

Ironically, it was Mao's political instinct—a great asset during the early days of his leadership—that led him to bring Deng to Beijing in 1952. Deng was promoted rapidly to secretary general of the party. In terms of importance, he ranked behind Liu Shaoqi, then Chairman of the Standing Committee of the National People's Congress, and Zhou Enlai, the first Premier of the People's Republic of China. According to Mao's contemporaneous view, "Deng is a rare and talented man; he finds solutions. He deals with difficult problems responsibly."[5] These qualities the future leader of China would put to good use for years to come.