KHAZANAH MEGATRENDS FORUM 2012

THE BIG SHIFT
Traversing the Complexities of a New World

CONCEPT PAPER

The global financial crisis four years ago was a significant event, both in the severity of its impact and its consequences on the global economy. While an apocalyptic global financial breakdown was averted, the crisis itself is still unfolding and shaping the nature and structure of the global economy in some very fundamental ways. The re-balancing and de-leveraging that is taking place are themselves the shifts that are shaping the economic landscape. Four years later, some semblance of a 'New World' has emerged – a world of re-definition and paradoxes with some historical sense of *déjà vu*.

If the New World referenced in the last millennium referred to the discovery of the Americas and its attendant Euro-centricity, this 21st century New World is one where, ostensibly, the centre of economic gravity will shift to the East. The question is: how new is this New World? The 'rise of Asia' – if it does occur – really means that Asia is regaining the dominant economic position it held some 500 years ago.

The onset of the Age of Discovery in the 15th century, with its great European expeditions and exploration, is an epoch in that sense. It coincided with the onset of Western colonization of the East and the decision by the world's greatest economy then, the Chinese under the Ming, to close itself to the world. The Middle Kingdom decided that they had everything they needed within their borders. Thus began the period of the East to West shift that was defined by the opposing dynamics of discovery and isolation.

Apart from new lands and peoples, it is also the period that saw the rise and primacy of capital as a factor of production. While sovereigns started the naval explorations and mercantilism, it was private capital that kept it going and growing. The present day multinationals saw their origins in the likes of the Hudson Bay Company, the East India Company and the Muscovy Company that were creatures of the 16th century capitalism.

Is the 2008 Global Financial Crisis another epochal moment that will define the era when the shift reverses itself – a shift that is defined by the dynamics of untenable imbalances accumulated over time? Although driven by its relative low costs, the East benefited greatly from the global division between production and consumption in the later part of the last century. Western mass consumption translated into Eastern mass employment and a cycle of international trade and development ensued, but one characterized by surplus exporting economies and deficit importing ones; the imbalance that exacerbated global capital flows. But when low cost Eastern frugality met with high income Western extravagance that increasingly depended on credit, the imbalances gained their deleterious impacts. Capital and financial markets became too smart for their own good, too smug, and the world saw intermediation becoming a bigger industry than production. The correction had to happen and the 2008 Financial Crisis seems inevitable on hindsight.

Yet again, does the East-West dichotomy really exist?

As the West attempts to deleverage in the wake of financial meltdown, its economies are also attempting to restructure, by rebuilding the manufacturing capabilities they gave up during the phase of globalization in the late 20th century. However, for the global supply chain to shift from West to East, emerging economies have to be in a position to provide the demand for goods and services from developed countries. Economics and economic history suggest that neither production nor consumption alone can be the basis of an economy. It is sustained exchange that creates value and employment, and forms the basis for further technological innovation.

On the other hand, this apparent shift in economic power has not been accompanied by a similar shift in geopolitical influence. The leadership of global institutions such as the UN, IMF and the World Bank – which are themselves undergoing a period of revision and reinvention – remain under the influence of developed countries, in particular Western Europe and the USA.

The other factor that should be considered when analysing the great shifts over the last 500 years is that these shifts were driven by an explosion of technological advances that led to the Industrial Revolution, space exploration and the digital age. The culmination of these advances eventually catalyzed global inter-connectedness which created efficiencies in supply chains by geographic specialization and locations of activities. This hyper-interconnectivity however, is a double-edged sword: localized disruptions such as the Japanese earthquake, Middle-East uprisings and floods in Thailand have the power to negatively impact global supply chains and therefore the world economy.

The merging of the forces of globalization and the Information Technology Revolution were in fact described as a “Big Shift” by John Hagel III and John Seely Brown in their 2010 book, *The Power of Pull*[1]. While Hagel and Brown argue that this Big Shift creates pressures an disruptions because of the existence of outdated and dysfunctional institutions and practices, they also argue that the Big Shift also unleashes a massive flow of ideas, innovations, new technologies and market opportunities that need to be tapped into to generate productivity and growth.

We perceive the Big Shift as going beyond the impact of technology and globalization; it encapsulates the marked changes in political, economic and social institutions that have emerged in the last century to create a new world in the first ten years of this millennium.

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[1] 2010, Hagel III, J. and Seeley, J., *The Power of Pull: How Small Moves, Smartly Made, Can Set Big Things in Motion*, New York, Readhowyouwant.com Publishers

As is evident from history, great shifts do not happen without conflict, and the drastic changes marking the last century were no exception. Break-ups of empires, two World Wars, de-colonization, and a war of ideology between capitalism and communism exacted their toll on humanity, but also provided the platform for periods of innovation, growth and the creation of new wealth. However, while capitalism may have won the Cold War, it is a pyrrhic victory – one that has come at the cost of ever-widening disparities between the privileged and the marginalized. Acemoglu and Robinson in their latest book[2] state that the differentiating factor between countries that have prospered and those that have not is that the former are governed by 'inclusive' as opposed to 'extractive' institutions. Nonetheless, as the popularity of the 'Occupy' movement has illustrated, economic and political institutions have in general become more extractive; the deregulation and liberalization of capital and policies favouring owners of capital at the expense of workers have contributed to increased inequalities in wealth and income – indicating that perhaps it is capitalism itself that is the most extractive institution of all.

What is clear now is that despite these great shifts, the fundamental challenge for humanity remains: if we are to continue to prosper in the centuries to come, we must address the great imbalances in opportunities, wealth and power that continue to provide the impetus for societal conflicts throughout the world. While there may be indications of geographic-centricity to some emerging trends, given the connectedness of the world, the new world is global. More important is a cogent understanding of the shifts themselves, and the ways in which the challenges posed by these shifts must be navigated by everyone – regardless of location or the enterprises they are involved in.

The 2012 KMF therefore proposes the theme of *"The Big Shift: Traversing the Complexities of a New World"*. The key questions the Forum seeks to answer are:

- Is the Shift structural, and therefore permanent? Or is it part of a Kondratieff wave, which implies that the world will revert to its long-term mean? Different types of shifts require different perspectives: if the Shift consists of many transient and secular changes, then what are the medium-term adjustments that are required for an optimal equilibrium to be achieved in terms of rebalancing inequalities in income, wealth, political participation and societal cohesion? Conversely, given that structural transformations throughout history – the Renaissance, the Industrial Revolution, globalization post-Bretton Woods – have been driven primarily by major technological advances, what are the technological revolutions driving the Shift in the 21st century?
- In terms of economic systems, while global consumption patterns remain constant, the last century has seen a Big Shift in terms of the intensity of use and the distribution of factors of production. Ironically the 'triumph' of capitalism in the Cold War has proven the timelessness of Marx's dialectic of the conflict between capital owners and labour: global financial deregulation has meant that the rate of returns to capital, or rather capital intermediation, far outstrips the returns to labour. This divergence

[2] 2012, Acemoglu, D. and Robinson, J.A., *Why Nations Fail: The Origins of Power, Prosperity and Poverty*, New York: Crown Publishers

led to a possible “epochal moment” – the 2008 financial crisis and its continuing reverberations. How should such imbalances be redressed, and what role is there for governments, markets, firms and technology in the rebalancing of these factors of production?

- Is there a geographic dimension to the Shift, in the sense of a movement in the centres of political and economic gravity from the West to the East? Should the geographic division of supply chain change? Should the production side revert to the West, and is the East capable of providing the demand? On the other hand, given the pervasiveness of global interconnectivity, are shifts in the production system – occurring locally, but leading to global impacts – a permanent feature? If this is the case, what do these imbalances mean to firms, markets and economies?

In the usual KMF tradition, the main theme is looked at from the perspectives of markets, firms, society-at-large and people:

1. Macro-stability and Markets (Markets)

While global markets have somewhat equilibrated in the wake of the 2008 Global Financial Crisis, this equilibrium seems to be less than optimal and certainly less stable: the US economic recovery has yet to be accompanied by a jobs recovery, and the Eurozone continues to grapple with the debt crises of its weaker members. Downside risks and uncertainties remain. Meanwhile, there are signs that the emerging economies, led by China and India, will be able to sustain their growth trajectories, although questions remain on their ability to sustain demand while developed markets de-lever.

How viable is this shift in global economic activity eastwards, without the changes towards more inclusive institutions, both political and economic, which accompanied the rise of the West following the Industrial Revolution? Is such a shift even occurring, or are the dichotomies in global supply chains more perceived than real? What role should global economic institutions play, given that the world created by the Bretton Woods system has evolved? What are the prospects for the Eurozone and what are the implications if it were to collapse?

2. Firms and Transformations (Firms)

The advents in science, technology, communications and mass production during the Industrial Revolution ushered in a prolonged period of almost relentless progress in human development. Mass production technologies like the ‘Spinning Jenny’ and the steam engine paved the way for, among others, the invention of the integrated circuit and miniaturization 200 years later. This in turn led to the Internet Revolution, indubitably the most far-reaching and democratizing technological movement in the history of humankind. Social media, for instance, has been credited with enabling the Arab Spring and the Occupy movements – bringing together different classes and causes in the pursuit of a seemingly single cause. Examined more closely however, this great ‘democratization’ reveals several factions and fractions. The irony is that – while progress in technology and communications has brought more people together – this rise in participation reveals that “the masses” actually consist of disparate and diverse needs and interests.

How should firms adjust to this paradoxical effect of technology becoming more democratized, yet more personal? Should firms compete towards the lowest common denominator or cater to different consumer-types with divergent welfare functions? What is the new model of a firm?

3. Growth and Inequalities (Society)

Political events over the past few years, both globally and domestically, have highlighted the importance of what Acemoglu and Robinson label "inclusive institutions" – governing institutions that maximize not only economic but also political participation. Meanwhile, Hernando De Soto's work in analyzing the Arab Spring has also highlighted that the origins of the social revolutions in the Middle East lie not just in political disenfranchisement, but are deeply rooted in the absence of individual property rights and economic participation in the countries involved.

Can countries – particularly those that have focused on economic growth at the expense of participation – continue to prosper without being more inclusive? How do countries deal with the emerging demographic tsunami in the emerging economies? How much "pain" related to structural reform can countries undergo in order to achieve such reforms?

4. Leadership and Complexities (People)

A recent report produced by a team led by Ricardo Hausman and César Hidalgo[3] posits that economic growth is driven by "economic complexity" – fundamentally defined by the ability of an economy to generate "productive knowledge" through re-aggregating clusters of know-how by connecting people through organizations and markets. At the root of economic complexity, therefore, is human capital. In turn, human capital can only be an effective driver economic growth within an environment that is conducive towards creativity and innovation.

This highlights the importance of strong leadership – whether at the firm, society, or governmental level – to create such a conducive environment, not only in terms of physical infrastructure, but more importantly in building an environment of trust and freedom, balanced with responsibility.

On the other hand, "complexities" can also be defined as the effects of increasing global interconnectedness. Witness, for instance, the global repercussions of local disruptions in key nodes of the global supply chain such as the floods in Thailand and the Japan earthquake in 2011.

What are the specific roles for leadership of all enterprises in both generating and managing complexities, particularly in a world that is becoming ever more interconnected?

[3] 2011, Hausman, R. et. al., *Atlas of Economic Complexity*, Massachusetts: Massachusetts Institute of Technology