Megatrends

Issue 2 | 30th September 2014

The Official Khazanah Megatrends Forum Magazine

Special Address
by Dr Ha-Joon Chang
Pg 2

Luncheon Address
by Tan Sri Andrew Sheng
Pg 3

KMF 2014 Special Event:
Malam Terang Bulan
Pg 4

www.kmf.com.my

The Grand Ballroom, Level 3, Kuala Lumpur Convention Centre

Special Session:
In Pursuit of Happiness - Ethics in an Age of Efficiency
Major religions and belief systems can converge on a set of shared values that can lead us to individual and community happiness. **Pg3**

Session 2: Firms and Transformation
Convergence is biggest driver of innovation but convergence is also greatly increasing risks to firms **Pg7**

Session 1: Macro and Markets
Opportunities exist in Malaysian companies with sizeable exposure in ASEAN **Pg6**

Scaling the Efficiency Frontier: Institutions, Innovation, Inclusion

Coupling a deft description of the global economic landscape with a potent reminder that Malaysia — and the rest of Asia — must find its place in a decidedly new world order, the keynote address of the Khazanah Megatrends Forum 2014 brought into focus the paradigm shifts that are needed in order to scale the efficiency frontier and steer the world towards a sustainable growth trajectory.

Beginning the speech by crediting Malaysia's achievements thus far and acknowledging the country's transition into a modern and diversified upper middle-income economy, His Royal Highness Sultan Nazrin Muizzuddin Shah Ibni Almarhum Sultan Azlan Muhibbuddin Shah Al-Maghfur-Lah stated that the prescriptions that worked well in the past cannot be considered capable of the same in the future. To do so would be to reject change and run the risk of becoming "architects of decay," borrowing a term deployed by former British Prime Minister Harold Wilson in his 1967 speech to the Consultative Assembly of the Council of Europe.

Continuing the emphasis on policy responsiveness in a world of rapidly depleting resources and cross-border mobility of financial and human capital, HRH Sultan Nazrin Shah observed that the Asian Century is neither inevitable nor preordained. The often predicted convergence of emerging economies with developed economies is not a given and in fact questioned, as the impact of traditional growth drivers such as supply chain-oriented trade and commodity prices begin to recede. This underlines a greater urgency for emerging economies to pursue innovation as a more sustainable, alternative driver of growth.

Casting a deeper gaze at the celebrated headline economic figures coming out of emerging economies, HRH Sultan Nazrin Shah stated that the rise in the absolute size of these economies has not coincided with a

commensurate increase in average incomes and living standards. While the sheer size of the Chinese and Indian populations for example undergird the size of both economies, this also means that they require significantly more growth in order to experience similar living standards as the developed world. It is at the nexus of wealth concentration and opportunity (in education, employment and commerce) that interventions must be carried out in order to achieve the desired standards of living. Sustainable, inclusive development can only take place with adequate levels of social mobility.

Due to a yawning gap between the wealthy and the needy in a world where the poorest 50% of the global population commands the same amount of wealth as the 85 wealthiest individuals on the planet, economic dynamism suffers, a victim of society's folly which does not allow for the optimal allocation of human capital to functions that it best serves. History and current events are replete with examples where, in the words of German sociologist Ulrich Beck, "[C]onditions of inequality and historical injustice have given rise to a feeling of hate in the world—a deeply-felt hate that cannot be easily overcome with a few good words." HRH Sultan Nazrin Shah stated that such a fate must not befall Malaysia.

Driving home the importance of understanding the socioeconomic dimensions of growth, the keynote speech proceeded to *...continue on Pg 2*

...continued from Pg 1

unpack the assumptions that frame world-views on incentive structures. The time is right and the need is urgent for paradigm shifts in the way we respond to incentives and shape our decisions therein.

The first paradigm shift resides in the paradigm of production, i.e. the transformation of resources into output. While the modern-day economy has perfected the art of synonymising growth with production, this has also equated unused resources as idle or wasted, impelling a race to explore, extract and produce that inadvertently encourages over-production at the expense of sustainability.

The paradigm of maximisation is also in need of rethinking. The existing worldview that rewards economic actors for present performance penalises those who have calibrated their decisions for a longer horizon. This is not the exclusive domain of emerging economies. An example cited is the practice of firms in the United States that do not channel their accumulated cash reserves into long-term capacity but instead buy back their own shares in an action to boost earnings per share and by extension, executive remuneration. This squarely privileges the short-term view of interest and prioritises personal gain over organisational, long-term interest.

Instead of maximisation, a paradigm of optimisation recognises that for many decisions, there exists an optimal point beyond which expansion would be counter-productive and excessively risky. Mimicking the properties of evolutionary biology, optimisers seek to contribute towards the sustained vitality of the economic ecosystem.

The final paradigm is that of resource ownership, which should transition to one of stewardship. The introduction of private rights over resources inadvertently leads to the conception of resources as being at humans' command, dulling incentives to preserve them for future generations. Implicit in the paradigm of stewardship on the other hand, is that the right to derive profits from these resources are temporary and that it is our duty to ensure that they remain undiminished and uninjured for future generations.

Accepting the notion that we are trustees rather than ultimate controllers over resources places the ethos of sustainability at the heart of the pursuit of growth. Describing the three paradigm shifts as one of the greatest tests of our time, HRH Sultan Nazrin Shah stated that successfully recalibrating our collective worldview is a cause that is worth fighting for, and most certainly one that is worth winning.

Special Address

Scaling the Efficiency Frontier: Institutions, Innovation, Inclusion

by Dr Ha-Joon Chang
Reader, Faculty of Economics, University of Cambridge

How to Develop the Economy	• **Countries cannot develop simply by following their comparative advantages.** • In the short run, this strategy may maximise the benefits of international trade for developing countries. But in the long run, sticking to comparative advantage industries locks developing countries into activities that have little prospect for productivity growth and hampers economic development. • **Malaysia needs to develop its productive capabilities** in 'non-natural', 'comparative-advantage-defying' high-productivity activities (manufacturing and high-end services) in order to take its economic development to another level.
Economic Development and Innovation	• **Economic development is in essence a process of innovation**, as it means doing new things – producing new things (Schumpeter's product innovation), producing the same things differently (process innovation), and exporting to new markets (opening up of new markets). • Even countries that are not on the international technological frontier are engaged in 'innovation' when they develop their economies, as they can do this only by doing new things and doing things differently.
Encouraging Innovation	• **People become more conservative and consequently less entrepreneurial when there is too much insecurity** and there is no 'second chance'. • **Need institutions e.g. bankruptcy law to encourage entrepreneurship** by reducing the downside risk of doing new things ('socialisation of risk').
The Welfare State	• **The welfare state can also be understood as an institution** to encourage entrepreneurship and innovation. • **The welfare state can facilitate industrial restructuring and thus economic development** by making workers more accepting of changes, especially if it provides not just income support and unemployment insurance but also subsidised re-training and re-location, as in Scandinavia. • Social inclusion is not just a matter of 'sharing' but also of promoting entrepreneurship, economic restructuring, and economic development.

Luncheon Address

Innovation, Inclusion and Institutions - The Human Frontier

by Tan Sri Andrew Sheng
Board Member, Khazanah Nasional Berhad;
Chief Adviser, China Banking Regulatory Commission

Rethinking Ideology, Institutions, Innovation and Inclusivity	• **Economic development needs a systemic view of growth** or jobs, inclusivity and environmental sustainability through new lenses of relationships, patterns and context. • **Transformation cannot be done without risk-sharing,** hence the need for inclusivity. The government has to address fundamental factors of inclusivity i.e. equal access to job opportunities and education. • **Malaysia has to change at both process (ease of doing business) and product (competitive market) level.** Transformation can only be done with adaptive institutions, continuous innovation and equitable risk sharing.
Getting Innovation and Inclusion Right	• **Progress comes from collective knowhow.** However, accumulating productive knowledge requires structural changes, trial and error. We need to have a culture that allows people to make mistakes and learn from them. • **Productivity growth must come from innovation** and as innovation occurs in clusters, we need to have a cluster push. • **Conventional finance worsens inequality** - Islamic Finance/risk sharing or equity finance is the way to go.
Malaysia's Challenge in Institutions, Innovation and Inclusion	• **Malaysia's challenge lies in innovation,** with a ranking of 13/24 in ADB's Asian Creative Productivity Index. Malaysia scored slightly above average on financial institutions and governance, but lags behind in scientific output and agricultural productivity. • **Talent is available in this country.** Malaysia is well poised to become a knowledge-based high income, inclusive society, but we must choose our comparative advantages well to build our innovative strengths as we are lacking in terms of scale compared to China and Indonesia. • **Khazanah is an example of how inclusive networks work.** We should build on this pioneering institutional innovation to help Malaysians improve innovative processes and products.

Special Session

In Pursuit of Happiness - Ethics in an Age of Efficiency

Dr Nungsari Ahmad Radhi

Stephen Young

Caroline Russell

Datuk Dr Hasan Mad

Islamic Worldview	• **Islamic principles describe universal aspirations of humanity.** Islamic scholars have highlighted six important categories – preservation of life, property, intellect, lineage, dignity, and religion. • **Human rights are specified by God**, no human agency can take it away. • **Many Muslims are ignorant of their intellectual Islamic heritage.** The science of Islamic law for example, was developed many years ago. However, Islam is not currently taught with the same intellectual rigour as the sciences.
Finding Common Ground	• **Major religions and belief systems can converge on a set of shared values** that can lead us to individual and community happiness. • **There may be trade-offs between efficiency and ethics.** However, it is still important for businesses to adopt an ethical framework in its decision-making process.
Moving Forward	• **Institutions play an important role to develop intellectual discourse** of similar levels to scholars such as Ibn Sina (Avicenna). • A deeper understanding of usury (riba') is necessary to develop the Islamic concept of a usury-free economy.

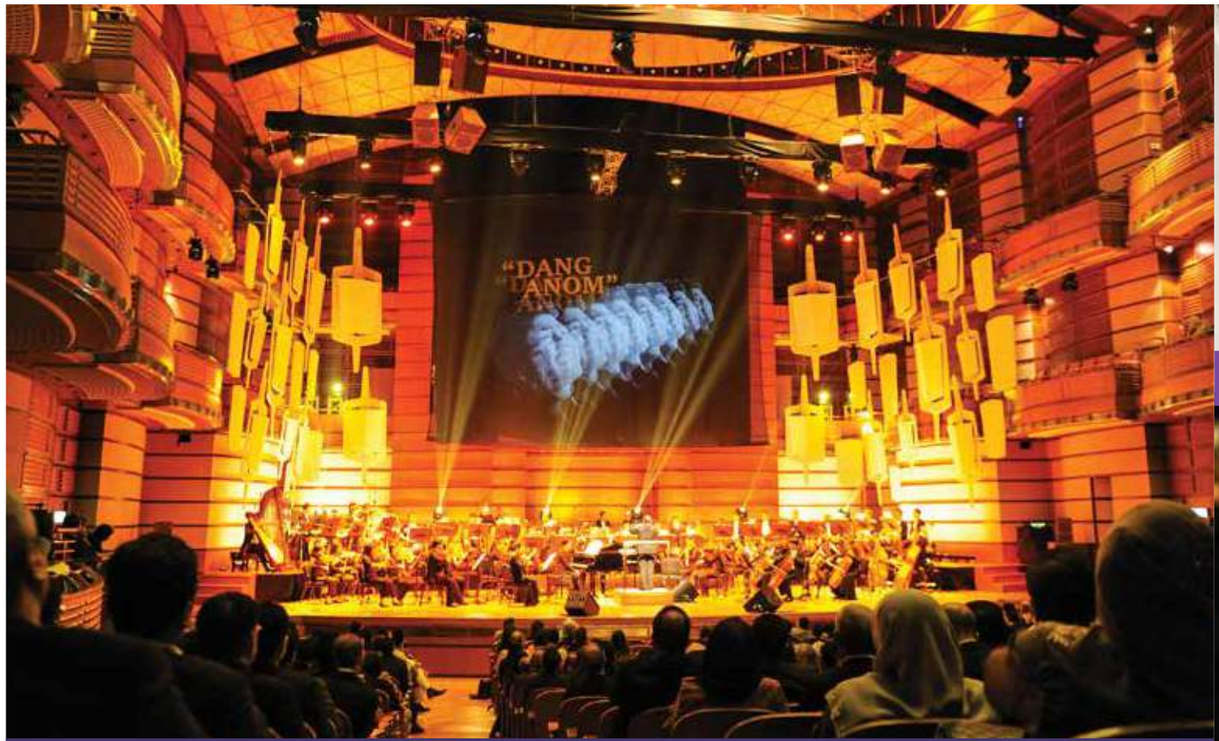
KMF 2014 Special Event: *Malam Terang Bulan*

Continuing the tradition of a Monday evening 'right brain' special event as part of KMF, this beautiful show took place in the Dewan Filharmonik Petronas (DFP), in the presence of HRH Sultan Nazrin Shah and HRH Tuanku Zara Salim.

Tan Sri Dato' Azman Mokhtar opened the proceedings by welcoming Their Royal Highnesses and relating the background to the Senior Fellowship which provided the material for this event through an extensive research project. He then welcomed Datin Saidah Rastam, the Artistic Director, to the stage, as well as launching the book *Rosalie and Other Love Songs*, which was also a product of her research project.

The energy before and during the event was electrifying. The performance featured a number of stars including Dato' Sheila Majid, Dato' Zahim Albakri, Chacko Vadaketh, Dayang Nurfaizah and Musly Ramly, to name a few.

In the audience were many VIPs, veteran artists and representatives of the artistic communities, KMF attendees and others. Their standing ovation spoke volumes for the quality of the show.



The Dewan Filharmonik Petronas was decorated with panels inspired by the facades of Parliament House and Angkasapuri

Tan Sri Dato' Azman Mokhtar accompanies Guests of Honour, HRH Sultan Nazrin Shah and HRH Tuanku Zara Salim

Invitations to 'Malam Terang Bulan'

Datin Saidah Rastam, Artistic Director, 'Malam Terang Bulan'

Dato' Sheila Majid opened the show with 'Tunggu Sekejap'

Dayang Nurfaizah performs 'Rumba Gembira'

Musly Ramly delivers a rendition of 'Hitam Manis'

Narrators of the evening, Chacko Vadaketh and Dato' Zahim Albakri

Session 1

Macro and Markets

Somewhere over the rainbow - in search of alpha over the frontier

David Marsh

Claire Barnes

Simon Ogus

Global Macro Backdrop

- **There is a disconnect between financial markets and the real economy.** Quantitative easing (QE) has caused a bull-run in financial assets; but strength of the underlying real economy may be more subdued than that implied by expensive valuations.
- **EM Asia is more equipped to weather tighter US monetary policy.** Since the Asian Financial Crisis, EM Asia has boosted FX reserves and lowered its foreign funding gap. Countries that are undergoing structural reforms (e.g. India) have better medium-term prospects.
- **Geopolitics does not matter until something blows up.** Markets may have been too sanguine about the prospects of geopolitical hotspots (China-Japan, Russia-Ukraine).

The Search for Alpha

- **Combination of lofty valuations and shaky growth fundamentals favours thematic investments.** For instance, investors could profit from accurately forecasting the optimal energy mix for the future; Asian banks may benefit from tighter regulatory requirements in the West by becoming principal bankers in more routine banking transactions.
- **Excess liquidity has led to lofty valuations for large-cap stocks.** However, for long-term investors (PE firms, SWFs), there are opportunities in relatively credit-short countries (e.g. Vietnam), or companies that cannot easily/cheaply access credit (e.g. mid-to-small caps).

Malaysia's Potential

- **There are still gems in corporate Malaysia.** Opportunities exist in Malaysian companies with sizeable exposure in ASEAN, where there is still room for growth as economies become more developed. Similarly, as oil & gas majors rotate capital back into e.g. the US, there is room for Malaysian players to take over their place.
- **Malaysia has good institutions, and is still an "affordable" country** relative to e.g. Hong Kong/Singapore. This, and the country's openness to foreign investments, can help attract capital into value-added industries e.g. mid-to-high-end manufacturing, education services etc.

Session 2

Firms and Transformation

Solving the 'impossible trinity' of creating value through institutions, innovation and inclusion

David Frigstad

Cheryl Yeoh

Tan Sri Dato' Zamzamzairani Mohd Isa

Innovation as a Culture	• **Education, strong institutions and "tolerance of dysfunctional personalities"** are needed to foster innovation. • **Innovation cannot be delegated to a "Chief Innovation Officer".** Corporate cultures which are hierarchical do not work. • **Expectation of failure is important.** People should not be punished for failures, "serial entrepreneurs" are often favoured. • **Companies need to constantly evolve** to meet consumer needs. How companies respond and adapt are key to their survival.
Open Ecosystems Drive Innovation	• **Convergence is the biggest driver of innovation** but it also greatly increases risks to firms. Moore's Law is now disrupting every industry. • To be globally competitive, firms need to scale and leverage on technology. • **The role of Government is important in providing the ecosystem** (for e.g. kick starting R&D projects), however private sector funding needs to be increased to foster innovation. • **Feedback loops are a key element of an innovative ecosystem.** It is important to learn from previous mistakes and institutionalise learnings.
Investing in the Future	• **"Play it safe" CEOs often miss the boat.** It is important to manage all stakeholders' expectations for both near-term and long-term returns. • **Only 2% of firms are investing in the future.** Firms should spend a lot more time visioning the future and hiring for their future vision. • It is not about predicting the future, but being prepared for the worst case scenario.

Reflections on Day 1 by Tan Sri Dato' Azman Hj Mokhtar, Managing Director of Khazanah Nasional Berhad

The topic of this year's forum brings us back to basics. As the concept paper highlighted, Malaysia's economy is at a crossroads. It can no longer rely on purely input-led growth, but will need to innovate and increase the productivity of those inputs. How effective do you think the sessions were in addressing and generating debate on the topic of productivity and innovation-led growth?

All three keynotes, from HRH Sultan Nazrin Shah to Professor Ha-Joon Chang and finally to Tan Sri Andrew Sheng, cogently addressed the productivity challenge faced by Malaysia today. Malaysia is now at a turning point in its economic history. We stand on the verge of becoming a High Income Nation (GDP per capita USD15,000), but this necessitates a fundamental change in our business model. This model of growth must be rooted in innovation, not just technological innovation but also process innovation.

The speakers today also touched upon the goal of raising productivity, which is to build better firms and ultimately a better country. Achieving this will require the three I's: Institutions, Innovation, Inclusion. We need all three I's to drive and also to sustain economic growth.

For innovation to flourish in a country like Malaysia, we need to remove the fear of failure and promote values which bring a fractured society together, such as ethics and inclusion. Entrepreneurs, corporate managers and government-linked investment companies need to be allowed to pursue their ideas even at the risk of failure. The government needs to set up the right institutions which both unleash entrepreneurship yet provides a social safety net for the *Rakyat*. And all elements of society have to come together with the common understanding that the space for small nations to thrive is precarious, that sacrifice will be needed, and that we are all in it together.

As Winston Churchill once said, "Success is not final, failure is not fatal: it is the courage to continue that counts."

In his speech, HRH Sultan Nazrin Shah presented three paradigm shifts: production to preservation, maximisation to optimisation, and ownership to stewardship. How do you relate those paradigms to the Khazanah ecosystem?

At Khazanah, we strive for the three paradigms of preservation, optimisation and stewardship in our daily work. On the issue of production vs. preservation, we look at sustainable development not only as an investment sector but also in how we filter our investments. We apply principles of responsible investing which not only means do no harm, but also do good. We strive to create more than just financial returns, but also overall positive economic outcomes.

From an optimisation standpoint, at Khazanah you have to solve for multiple variables simultaneously. Take our Iskandar project for example, we seek a reasonable return not just for us but also for our partners, and we do it in such a way that it doesn't contribute to environmental degradation and is socially inclusive. This is a different investment style than companies looking to make purely financial returns.

Finally, the notion of stewardship or *amanah* (trusteeship) is embedded in our organisation. This is a value that runs deep. For the past 20 years since 2004, our mandate has been to build a stakeholder economy not just a shareholder economy. This is how we build true value.

Khazanah Global Lectures 2008-2012 Book Launch

The opening of KMF 2014 was followed by the launch of the book *Khazanah Global Lectures: 2008 - 2012*. This book is the second in the series which began with *Khazanah Merdeka Series: A Year in Pictures 2007/2008*, and continues the documentation of this major lecture series. The book features lectures by Dr APJ Kalam, Sir John Bond, Dr Manmohan Singh, Mary Robinson and Victor K Fung.

HRH Sultan Nazrin Shah launched the book in the presence of Tan Sri Dato' Seri Utama Nor Mohamed Yakcop, Deputy Chairman of Khazanah Nasional Berhad and Chairman, Khazanah Research Institute; Tan Sri Dato' Azman Hj Mokhtar, Managing Director, Khazanah Nasional Berhad; Dato' Charon Wardini Mokhzani, Executive Director in the Managing Director's Office, Khazanah Nasional Berhad and Managing Director, Khazanah Research Institute and Raja Tan Sri Dato' Seri Arshad bin Raja Tun Uda, Board Member, Khazanah Nasional Berhad.