Khazanah MegaTrends Forum

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Post-Crisis Mega-Trends: Issues and Challenges

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Opinions are personal to author

Diagnosis: Why didn't we see it coming?

1. **Davos WEF Chairman Klaus Schwab** ***"What we are currently experiencing with the financial crisis and its consequences is the birth of a new era – a wake-up call to overhaul the institutions, our systems and above all, our thinking."***
2. **Queen Elizabeth II: Why had nobody noticed that the credit crunch was on its way?** ***British Academy answer: "the failure to see the timing, extent and severity of the crisis and to head it off, while it had many causes, was principally a failure of the collective imagination of many bright people, both in this country and internationally, to understand the risks to the system as a whole."***
3. **Crisis has profound impact on future Global governance and economy.**

Financial Crisis: Four Failures

1. **Failure to remember History** - we have a history of increasing volatility and financial crises
2. **Failure to see Macro-Systemic Issues** - Unsustainability of Global Imbalance, Low interest rates, Implications of Asset Bubbles and Excess
3. **Failure to understand systemic implications of micro-behaviour** - Embedded leverage in Financial Engineering, bad incentive schemes,
4. **Failure of Economic Thought** - Specialization of academic disciplines and Fragmentation of Bureaucracies had huge blindspots that ignored the really important political economy issues of our times: social inequities, political capture by vested interests, global warming and complex factors that affect financial stability

Fritjof Capra: The Turning Point (1982):

1. Current problems are “systemic problems, which means that they are closely interconnected and interdependent. They cannot be understood within the fragmented methodology characteristic of our academic disciplines and government agencies

- Basically, Capra argues that the present Cartesian, logical, linear, Newtonian approach to analysis leads to a “mechanistic conception of the world” that “has led to the well-known fragmentation in our academic disciplines and government agencies and has served as a rationale for treating the natural environment as if it consisted of separate parts, to be exploited by different interest groups.”

Fragmentation vs. System-wide view at Academic and Government Levels – it does not add up

1. **Fragmentation of Academic Disciplines –**
   Economics wants to be a science, but uses unrealistic assumptions that may be false. Example, the assumption that default risk and liquidity risk are distinct when they become one during crisis
   - In reality, institutions and behavioural characteristics are interdependent, inter-connected and interact in non-linear manner.

2. **Fragmentation of Governance**
   We have One Global Market, but financial institutions are regulated under National laws [Fragmentation of enforcement]
   At national level, different agencies are in charge of different institutions, so that there are overlaps, gaps, turf-fighting and non-cooperation to solve complex social issues

Mervyn King - Banking is Global in Life and National in Death [but regulated in parts] - real issue is not theory or policy but Collective Action at National and Global level

` All partial solutions are by definition not first best.

Richard Posner: Critique on US Reforming Blueprint

-- Lombard Street, July and August 2009, finreg21.com.

- **Premature – advocates a specific course of treatment for a disease the cause or causes of which have not been determined.**
- **Emphasis on the folly of private-sector actors—investors, consumers, credit-rating agencies, above all bankers and and defects in the regulatory structure, leaving out:**

  1) **Errors of monetary policy;**

  2) **Large budget deficits;**

  3) **Deregulation in banking;**

  4) **lax enforcement of existing regulations;**

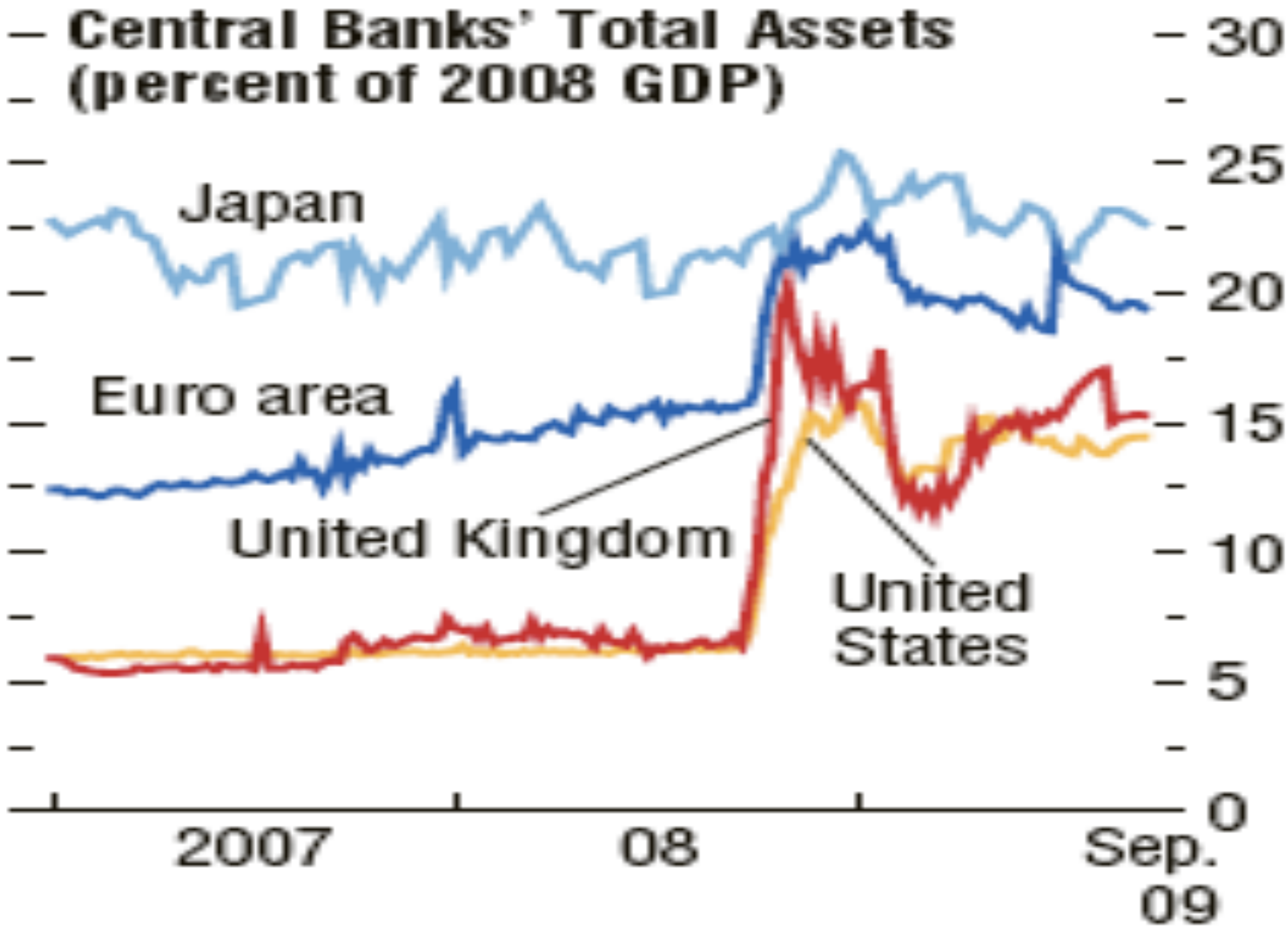
  5) **the complacency of and errors by the economics profession**

Current crisis should be viewed as a <u>Network Crisis</u>.

- **Highly Concentrated hubs (20-25 large complex financial institutions) accounting for over half of global turnover, particularly in derivatives, concentrated in London, New York.**
- **Too Interconnected to Fail – LCFIs are larger than countries**
- **Highly interdependent – LCFIs trade with hedge funds and key clients, dependent on AIG, government deposit guarantee and central bank liquidity provision;**
- **Inter-Active – Markets become pro-cyclical through momentum trading, but reversal becomes vicious circle – lower liquidity, lower prices, insolvency**
- **Simultaneous – failure of Lehmans led to almost instantaneous stoppage of global credit, which affected real economy**
- **Complex – no one understood complexity of financial derivatives**

2. Damage Control: Zero Interest Rate Policies (ZIRP) have serious distortive impact on Global real economy

- The rescue plans guarantee and replace private debt by public debt, sustainable only with ZIRP.
- ZIRP will create even more Carry Trade/Capital Flow Volatility that distort resource allocation
- Exit strategy is hostage to Collective Action to exit together.
- Financial system profitability will be challenged by lower real sector profits, affected by problems of de-leveraging, massive excess capacity and risks due to Global Warming and re-engineering to Quality of Life environment.



Advanced Markets replicating Japan

Are they trying to inflate their way out of problems?

Loss Allocation: Who is winner in financial crisis?

- Subprime losses of $150 bn in 2007 required US Government aid of $13.2 trn as of 19 June 2009
- In crisis year 2008, salaries of top 10 banks rose from $31 bn in 1999 to $75 bn, but cash dividends to shareholders was only $17.5 bn.
- Management took 4.3 times more than shareholders, when shareholders had to inject capital and government guaranteed the deposits.
- Critical principal-agent fiduciary problem
- Essentially, financial sector losses will be paid for by future taxation (large fiscal debt) or inflation.

Present Spending Increase/Tax decrease model is Leverage Machine

- Leverage enabled funding of current consumption through future taxation
- Ponzi Financial Engineering based on complexity, “frictionless” markets, moral hazard + lower and lower interest rates
- ZIRP puts huge volatility on other asset prices, capital flows and exchange rates and underprice risks
- ZIRP creates huge Collective Action Dilemma - no country can increase interest rates, tax rates and regulation without huge capital flows and arbitrage.

World Economic Forum Global Redesign Initiative – April 2009

- Objective: Inter-civilizational and interdisciplinary process amongst stakeholders to guide global economic institutions to contemporary circumstances:-

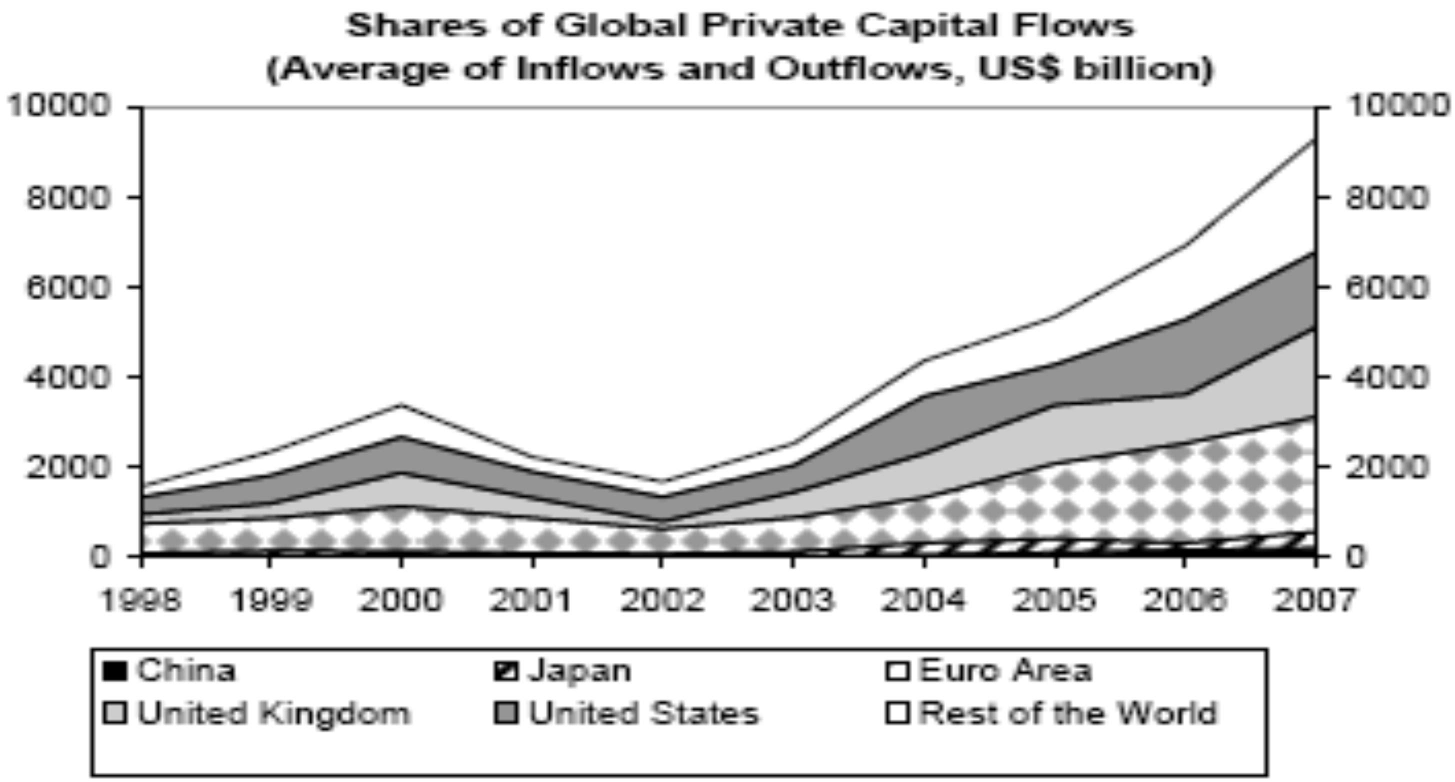
1. Power shift from North to South, West to East
2. World that is more complex and bottom-up
3. Nation states and government structures still play major role but needs interdisciplinary and multi-stakeholder input
4. World needs more systemic approach to decision-making
5. Traditional concepts of global governance need re-thinking

IMF World Economic Outlook October 2009

- The global economy is pulling out of deepest recession since the Great Depression, but recovery is uneven and dependent on policy support.
- Financial conditions have continued to improve. But some countries remain vulnerable to deleveraging in advanced economies and potential shocks to growth
- Going forward, pace of recovery will be sluggish. Policy support and the turn in the inventory cycle will gradually lose impetus. Private demand is likely to be held back for some time by limited credit availability, household desire to rebuild balance sheets, and rising unemployment.
- The overarching risk is that the recovery stalls. Premature exit from accommodative monetary and fiscal policies could undermine the nascent recovery. Moreover, financial strains could persist or even intensify further, particularly if efforts to restore health to bank balance sheets are not followed through forcefully

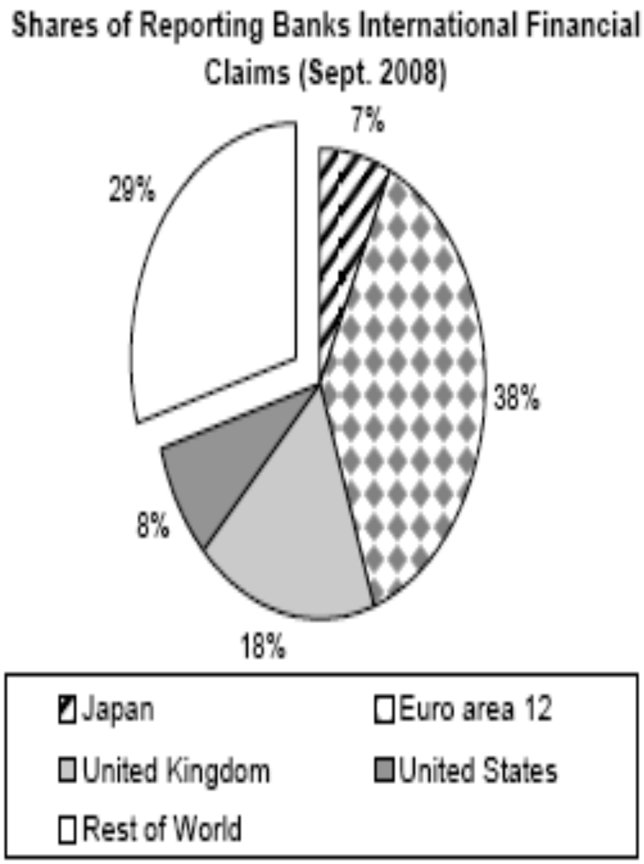
S5: US, EU, UK, JP + China - the new group

The U.S., Euro Area and U.K. represent over two thirds of gross international capital flows

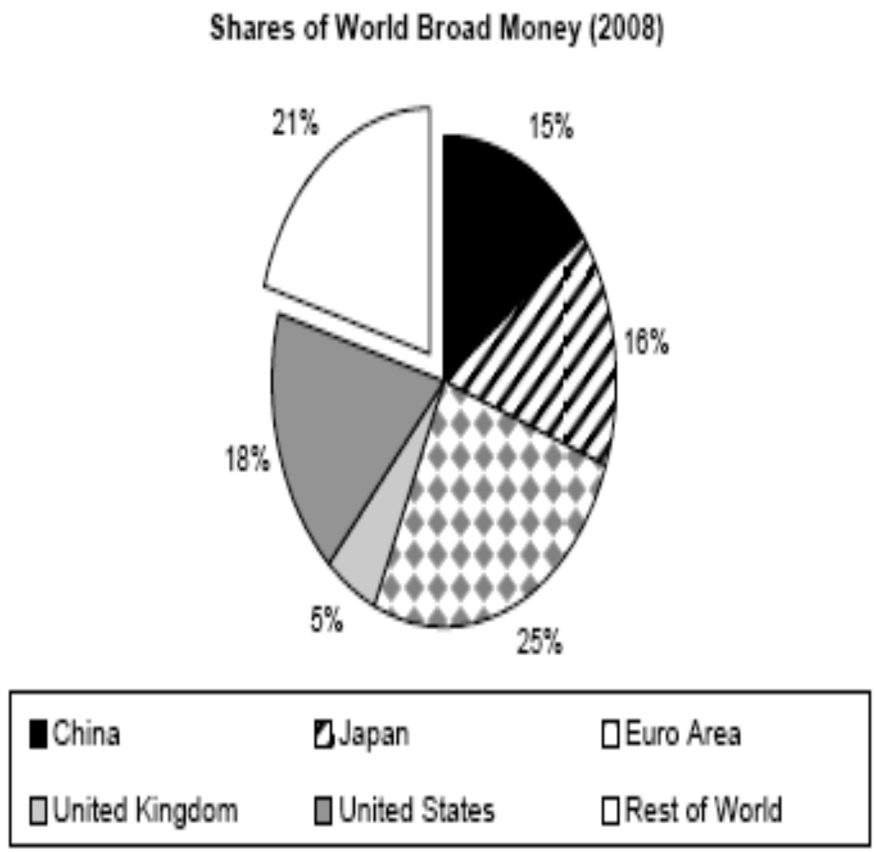


S5 account for major part of global financial activity

Euro Area and U.K. banks account for 60 percent of BIS reported international financial claims

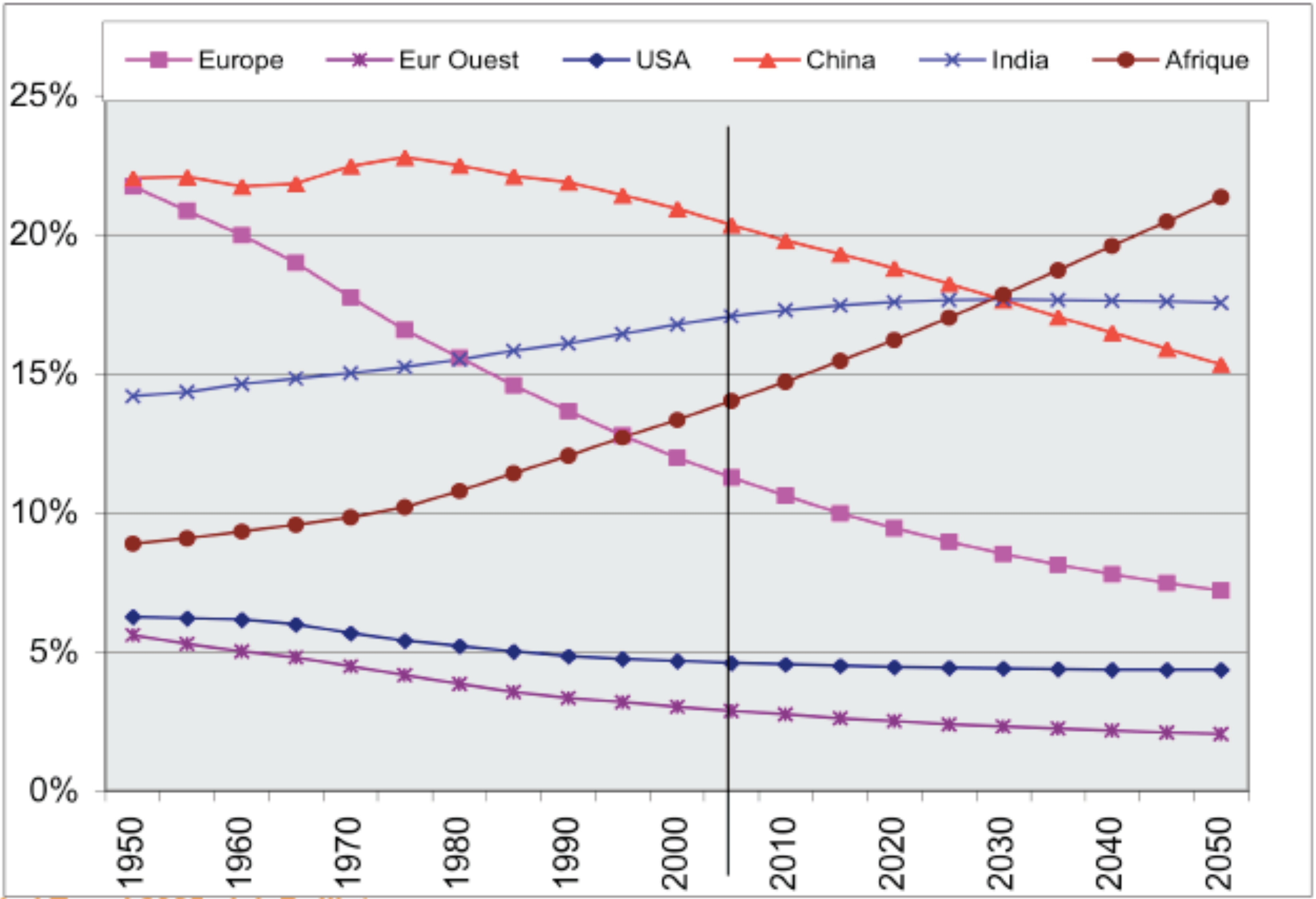


The S5 represent close to 80 percent of global broad money



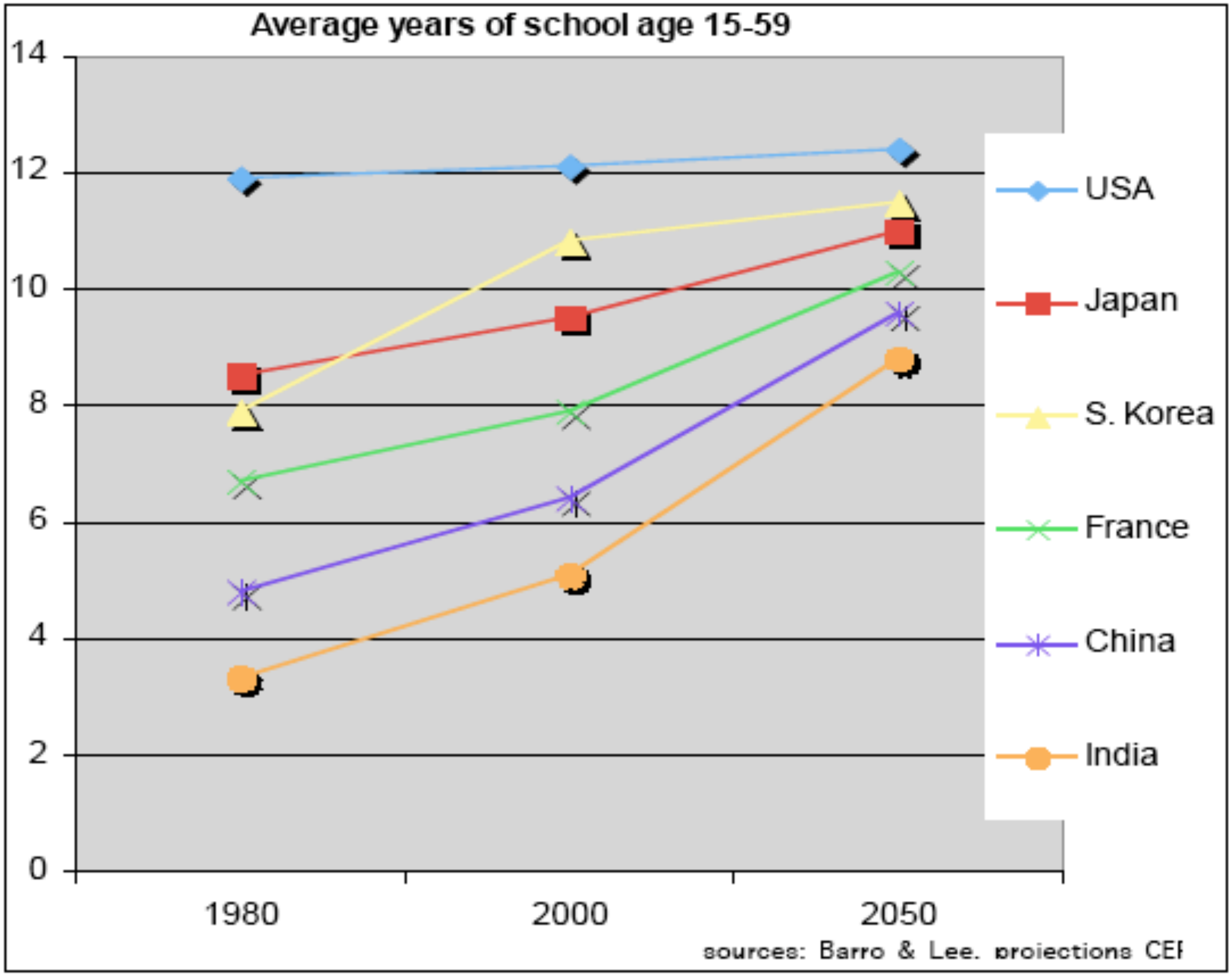
The New Comers in Human capital

China … India … and Africa (% World population 1950-2050)



Global Trend 2025 -J.J. Boillot

Education: a major parameter



Reforming Regulatory Architecture

1. Financial Sector will be subject to more regulation and will have to de-leverage/re-capitalize
2. Simple Playbook requires a few clear and simple rules, firmly enforced, rather than multiple complex rules, lightly or under-enforced.
3. If regulation limits the level of leverage, the bonuses will be capped.
4. Asia is more rudimentary, bank-based, and "Bulge Bracket" banking systems require simpler regulatory standards. Suggest that:-
   - *We should have simpler form of Basle and IFRS for Emerging Markets, with clear priorities for implementation*
   - *Greater co-operation within Asia on implementation and strengthening of Asian financial intermediation*

Global Mega-trends

1. Over-emphasis on Financial Engineering – current Global Financial Architecture only postponed real sector adjustment
2. Real Sector Growth will be slower due to deleveraging, unwinding excess capacity, higher unemployment, and re-engineering to Web2.0, Global Warming and Quality of Life changes
3. Changing Demographics will change Lifestyle consumption
4. Emerging Markets will grow faster, but many uncertainties lie ahead

5. Those who reform and adjust now to more Green economy will be big winner in sustainable development

Knowledge Society Web 2.0 will change lifestyle

- **Broadband availability will create person-to-person contact and Business-to-Business at very low transaction costs.**
- **Huge opportunity for hosting services, social-network sites and netvertising that can generate new business for Malaysia and other emerging markets.**
- **Example: Zee Avi discovered through YouTube**

Web 2.0 is Green

- According to Gartner, in 2007 CO_2 emissions of IT industries worldwide was only 2% of world CO_2 emissions
- In Japan, industries account for 36.5%, transportation 19.1%, businesses 17.8% and households 13.8%.
- Hence, IT industries are green.

Excessive Consumption drove Global Resource Depletion

- Challenge of Medium term financial regulation is how to shift our financial structure to a more "deleveraged" model, consistent with a real sector sustainable consumption that does not add to Global Warming.
  - Completeness of Globalization requires - global tax mechanism, global monetary policy, global financial regulation and global court and bankruptcy laws
- Global Network Collective Action problem of -
  - How to coordinate monetary policy
  - How to prevent regulatory "race to the bottom"
  - How to raise fiscal resources to deal with need for Global Public Goods

Two Simultaneous Crisis – one cyclical, the other non-reversible

- Two immediate crises: global financial and climate change. No single nation can solve both problems.
- Solution to both calls for major change in lifestyle, because we are fast approaching thresholds of irreversible damage to our global climate

In 30 years, Global Climate Change will change Global Real Sector and Governance Model - a Collective Action Problem

- Financial losses are say US$2-3 trillion during this crisis; global biodiversity losses are around US$2-5 trillion annually (EC-sponsored TEEB interim study, 2008)
- Many of our problems are going to be global collective action problems
- This is exactly the problem of getting everyone to work together at national level.

Panel A: portrays vulnerability with a static representation of current adaptive capacity

extreme vulnerability | significant vulnerability | moderate vulnerability | little or no vulnerability | not in sample

Figure 1: Geographical distribution of vulnerability in 2050 along an A2 emissions scenario with a climate sensitivity of 5.5°C.

Panel A: portrays vulnerability with a static representation of current adaptive capacity

Vulnerability by 2100

In the long run, we are all dead.

China's Greenhouse Gas (GHG) reduction efforts

- **reducing energy intensity (energy consumption per unit of GDP) by 20% during 2006-2010;**
- **increasing the role of renewable energy to 10% by 2010 and 15% by 2020;**
- **program to improve the energy efficiency of the top 1000 energy consuming enterprises in nine sectors;**
- **fuel consumption tax on gasoline of 1 rmb per litre;**
- **replacing and adding to the country's stock of coal-fired power plants with more efficient models; and a**
- **Raised the level of forest coverage in the country from approximately 12% in 1998 to 18% in 2009.**
- **tripling its wind-power generating capacity to 100 GW by 2020 from its previous target of 30GW; floated a**
- **proposal for a 40% Renewable Electricity Standard by 2050;**
- **pushed forward new rules on compulsory green procurement for local governments; and**
- **raised the possibility of a carbon tax and a carbon trading regime at some undisclosed time in the future.**

China Mega-Trends

- ***Urbanization—China will urbanize 400 million people between 2000-2030. China already adding 2 billion square meters of floor space each year, half the world's total.***
- ***Transportation—China's fuel economy standards (36mpg) are higher than US (30mpg in 2010), but passenger car sales in 2008 were 6.76 million compared to 6.79 million in US;***
- ***Increasing population—Any relaxation of one-child will have impact on domestic demand***
- ***China Going Global—China's going out strategy - Chinese enterprises to tap natural resources in Africa, Latin America and Southeast Asia.***

New Low-Carbon Energy Market – what is our response?

- According to the research firm New Energy Finance, the value of low-carbon energy market is expected to reach $450 billion annually by 2012, rising to $600 billion annually in 2020.
- In 2007, global investment in sustainable energy raised $148.4 billion of new money, an increase of 60 percent over 2006.
- Total financial transactions in sustainable energy, including acquisition activity, was $204.9 billion.

Some Thoughts on the Way Forward

Can Malaysia break out of the Middle-Income Trap?

1. **Focus on our Comparative Advantages**
2. **What does the fastest growing parts of the World want (S5 + Oil Producers)?**
3. **Can we supply the demand relative to our competitors?**
4. **How do we ensure that we all work together for National Goals?**
5. **What is our New Economic Model?**