Khazanah Megatrends Forum 2013

<u>Concept Note</u>

Growth with Inclusion in an Age of Paradox: Same Game, New Players

<u>Background</u>

The individual pursuit of value creation will, in accounting terms, result in economic growth. National accounting measures are aggregated measures which account for value creation, hence economic growth – but mask issues such as what were the sources of the value creation, and how those values are distributed. Despite attempts at defining alternative aggregate measures of economic performance, aggregate measures such as national product or national income remain the predominant measure of both economic growth and development. The paradox is that economic growth can sometimes be detrimental to development; high but inequitable or unproductive growth does not lead to a sustainable path of economic development.

If the trigger to the 2008 Global Financial Crisis was the collapse of the property market in the US, then the origin to the property bubble and eventual bursting of the bubble lies in the inequalities in American society. The economist and the newly appointed Governor of the Reserve Bank of India, Raghuram Rajan, in his 2010 book, “Fault Lines”, convincingly argued that this was indeed the case. A combination of prolonged loose monetary policy, cheap credit and populist public policies created a huge class of marginal and sub-prime borrowers in the property market, while fanciful financial engineering and lax regulatory regime amplified the total exposure to well beyond the property sector – creating unimaginable wealth to some market players, but also greatly destabilizing the whole financial system.

It is again a paradox that “saving the system” entails saving the financial system that caused the problem in the first place and the constituency that benefited the most leading up to the crisis. It is also the same system that has distorted the economy as a whole, creating such an imbalance between the real and financial side of the economy – a kind of schism that also define winners and loser to this game. Quite clearly, the pure pursuit of value creation, and economic growth through this value creation, has been distortionary and unsustainable.

A sustained and sustainable path of growth is one that is broad-based and balanced. It is broad-based in the participative sense, and balanced between the real and monetary sides of the economy. Growth must come from many and its dividends also accrued to the many. It was Rajan again who exhorted that capitalism as an economic system of incentives and allocation needs to be wrestled from the capitalists in his 2003 book, “Saving capitalism from the capitalists”.

The broader story of growth and development of nations sometimes mirror *Zeno's Paradox* (in which Achilles can never seem to catch up with the slower-moving tortoise).[1] Some countries grow faster, and some grow slower, but they are all in a race of sorts. The tendency, as per Robert Solow's theory of conditional convergence of economic growth, is for more developed nations to have slower growth rates and for less developed nations to have much faster growth rates. But these are mere growth rates. Higher growth rates can be good, though not necessarily so, especially if they are not driven by sound fundamentals or by the actual growth of potential output of the economy. Growth through financial intermediation is an example of unsustainable growth. What we tend to lose sight of, however, is that, despite high growth rates, it is still the position in the ‘race’ that matters. A developed nation, by whatever definition – a nation with strong economic and social institutions, a healthy democracy, sound provision of public goods, well-

[1] To be clear, like many paradoxes, this paradox can be explained. Zeno was limited by a lack of understanding of the concept of infinity. In Zeno's provision, Achilles has to cover infinitely many distances in a finite amount of time, hence the paradox. However, if time is also infinite, given that Achilles is faster than the tortoise, depending on the distance of the race and the head start given to the tortoise, Achilles will eventually catch up to and overtake the tortoise.

protected human rights – with a slow growth rate is in a better place, still, than a developing nation with a fast growth rate. An economically and socially inclusive growth leads to development.

As we saw from last year's Khazanah Megatrends Forum, there has indeed been a shift from the West to the East and North to South, be it in demographics or economic growth poles. There are new Players in the growth Game. Growth rates in China and India have been astounding in recent decades, despite moderating slightly over the past two years. Yet, they remain 'developing' nations still. Whether they can sustain this growth trajectory and become developed nations is still an open question. Indeed, it is reasonable to pose the following question – despite the breakneck speed of growth of these giant nations, will they ever become developed nations? And, towards this end, will big Players such as China and India ever catch up with the United States or with Japan given the current 'Game' of national development? What is a sustainable growth trajectory?

If we take the new Players as Achilles, and the old players as the tortoise, *Zeno's Paradox* suggests that they will never catch up. There is, however, a caveat to this. The assumption is that both the new Players and the old Players play the same game. If the game is changed, the new Players can render the Paradox moot and catch up with the old Players. But what is this 'Game' that the Players are playing?

Let us now examine the 'Game' more closely.

The Development 'Game'

The development game has evolved over time. In terms of economic development, countries have always been 'copycats' for the most part. Consider the original means of economic growth – the mercantilist expansion. This was first driven by the Spanish and the Portuguese, before the British and the Dutch copied that strategy.

The mercantilist strategy of national development then took a back seat when the Industrial Revolution occurred in Britain in the 1800s. The British became the world's largest empire by being the first to truly industrialize on the back of a wealth of technological innovations, such as steam power, metallurgy and machine tools that drove mass production, and subsequently, labor participation and mass consumption. It is noted that the development by industrialization is an inclusive growth path that employs a greater range and depth of factors of production. This industrial development game was later copied by the likes of Germany and Japan.

Like Britain, early industrialization in the United States was borne out of the textile industry. The formula for economic development there seemed straightforward – *mechanize, mechanize, mechanize*. The United States grew even more rapidly with the construction of railroads, and telecommunications, connecting various cities across the United States which became a continental economy.

Taking a step back, we return to the Paradox. If Germany and the United States were simply following the British model, and employing British technology, what would be a reasonable prediction at, say, 1880, for the future of Germany and the United States? Might some erstwhile economist have asked, “Will Germany and the United States ever catch up with Britain if they play the same game as Britain? Will Germany and the United States ever overtake Britain if they continue to follow the same strategy as Britain?” In some ways, what the economist is asking is this: Can you really overtake somebody if you keep following them and if you keep playing them at their game?

If You Don’t Like What is Being Said, Change the Conversation

Towards the end of the 1800s, the United States experienced its own technological boom, driven primarily by a whole wealth of inventions. In particular, the invention of the electric light bulb and the telephone meant that people could work for longer hours and could communicate across longer distances with less cost. These inventions were, to put it simply, game-changers. Further technological progress was driven by the development of the mass production of cars by Henry Ford in the early 1900s. Now, motorized transportation could be used on a wide-scale basis at even lower costs. And, by employing people to build cars, Henry Ford developed the very middle classes who became his main customer base. They were included in the new prosperity. This participative, inclusive growth catapulted the US ahead of Britain as the leading economy in the world, a position it still precariously occupies.

The game changers in the United States were not just in terms of technology. Most of the post-World War 2 expansion in the United States, the golden age of economic development in America, was a result of being the first nation to properly capitalize on: rapid urbanization; the federal government’s devotion to research and development; the primacy of its tertiary education institutions; its demographics. While these were not necessarily game changers technologically, they were game changers nonetheless in the growth game – a strategy of getting as many people involved in the process.

Therefore, when we fast forward back to the present day, we can see that the trend of ‘copycat’ policies still exists. China is pursuing rapid industrialization – focusing on electronics and textiles, among others, driven by low-cost labour. Similarly, India is also attempting to industrialize – focusing on its manufacturing sector and the development of services around the information technology (IT) industry. The new Players have come to enjoy a period of unprecedented growth – driven by a very familiar policy, industrialization, and a very familiar attitude, the copycat attitude. The industries may be different, but the policy remains the same. Thus, to return to the question on *Zeno's Paradox* – how do nations truly overtake other nations in development if they simply follow the methods of other nations who are currently ahead of them? Yes, they may grow faster, but this does not necessarily translate to a better position in the race.

The United States has provided an answer to the question raised by the paradox. To truly overtake a nation in the development 'race', it is not just about running faster or growing more rapidly. A nation has to change the game. By simply following the footsteps of another nation, which is also growing simultaneously, it may never catch up and thus never overtake that nation. This is particularly true in the race for 'development', where the finishing line is also constantly progressing forward. Therefore, like the United States, the new Players, China and India, must change the Game. They cannot play the same Game as the old Powers and hope to overtake them – but a key lesson from history is that growth must be inclusive. Whether the game is changed in terms of the rules of the game (regulations and policies), or in the skills of the Players (education and demographics), or in simply playing a different game (the introduction of a new technology or innovation *a'la* Schumpeter's creative destruction), the new Players and all Players hoping to catch up (or overtake the old Players, for that matter) must learn to change the Game.

Most of all, the egalitarian yet individualistic US model unleashed innovations that translated into increased labor participation which created the virtuous cycle of production, exchange and consumption in what was then largely a continental economy. Consumption could be a major source of economic growth if growth itself was not inclusive.

On the notion of creative destruction, it may also be the case that success contains its own seeds of destruction. The apparent disconnect between the real and monetary sides of the economy – the result of overly creative financial and capital markets – is a source of bane that not only led to instability and economic crisis, but is also instrumental in distorting the distribution of growth. The hegemonic position of the US economy itself is threatened by these excesses, as well as the excessive indebtedness of its households and government.

Meanwhile, the equilibrating global economy is still imbalanced between its real and monetary sides. Prices, relative prices, are distorted by these excessive capital flows and these pricing distortions are affecting incentive structures and influencing decisions in allocating resources globally – typically into non-productive activities that distort further the distribution of the dividends of economic growth.

Quite apart from the question of the nature of the game, of innovation and creativity, is also the question whether society as a whole will benefit from this changing game in the way that the Industrial Revolution and the explosion of global trade in the second half of the last century has lifted millions out of poverty.

<u>The Khazanah Megatrends Forum 2013 Theme</u>

The challenge that confronts us is the tension between value creation, growth, and equity. And to this difficult dynamic could be added sustainability. What is the balance between these competing demands? Can all of this actually be achieved together? But how far away is the time horizon? If it's close, we will not have time to reconcile these seemingly opposing drivers. That would put us in a no-win situation (a paradox?) But if it's far enough away, then we may have a chance to demonstrate that to go far and true, we have to do it all together.

The seeming paradox of the race for growth and development as discussed above brings into focus many key issues that the 2013 Khazanah Megatrends Forum seeks to answer. The theme: ***"Growth with Inclusion in an Age of Paradox: Same Game, New Players"*** acknowledges the geographic shift in growth poles we are witnessing but, beyond that, also recognizes various paradoxes and fallacies that need to be explained and understood to fully understand this game of firms and nations competing (and cooperating) in a single global neighborhood that is itself undergoing a transition. It also recognizes the role of innovation as means to change the game. Most of all, we recognize the need for growth to be inclusive. We seek to take lessons from history, project our understanding of technological progress, and identify the impacts of these changes on society.

<u>The Panels</u>

As is the tradition for KMF, panel discussions will be organized along four perspectives: on how the various markets are affected, what does the theme mean to firms and society in general, and what are the imperatives of leadership?

- **Markets**

➢ The fidgetiness of markets in emerging economies stems from an expected economic recovery in the US and a normalization of monetary policy there. It is rather paradoxical that a recovery in the world's largest economy is bad news for emerging markets. How can this phenomenon be explained? What does this mean to market players?

➢ What will happen when monetary policy normalizes around the world?

➢ Is there possibly a better economic system, hitherto never conceived, that may creatively destroy the present market system and provide the global economy with a more economically and socially efficient way to distribute the planet's scarce resources? And if so, what are some of the intellectual foundations and prerequisites for such a system? After all, in the latter half of the 20th century alone and (particularly in China) in the 21st century, the world has seen the command economy, the free market economy and a system that mixes the two.

- ➢ Is there a system that may better serve the global community – one that breaks out of the conventional wisdom of previously conceived systems? And if so, would not the onus be on the new Players to conceive such systems to enable them to overtake the old Players?

- **Firms**

- ➢ It is a paradox that firms are cashed up – and yet governments are poor, large segments of households are poor, and society is fractious. But states and households are the customers of firms. Without customers, firms cannot survive and prosper. Why is this relationship not more symbiotic? Have we lost our way in terms of the role of firms in society? Or have Governments been partisan or profligate?

- ➢ As the primary drivers of economic activity in all economies, how should firms explore creative destruction? Have there truly been more innovations that are actually 'destructive' or have there been more that are incremental improvements on previous technologies? The same logic of economic development can also be applied to firm development.

- ➢ For firms to catch up and overtake competitors, will it be enough to simply follow the footsteps of those who are leaders? Or is the ability to create something new and Game-changing a prerequisite? And, if so, what sort of leadership and culture would best allow for innovation and creative destruction to occur in firms? In addition, besides technological and process innovation, what about mindsets?

- ➢ Do firms need to consider different goals and different visions, particularly against the backdrop of the rise of impact investing, to move ahead of the Game?

- **Society**

- ➢ There is a paradox that GDP is growing, and yet the majority of people feel worse off. Is the small minority who appear better off a part of the problem – the growing disparity, inequity and inequality across societies? What will it take to restore social justice? And what is true social justice? As Tim Harford wrote in the Financial Times recently: "… the more unequal our societies become, the more we all become prisoners of that inequality. The well-off feel that they must strain to prevent their children from slipping down the income ladder. The poor see the best schools, colleges, even art clubs and ballet classes, disappearing behind a wall of fees or unaffordable housing. The idea of a free, market-based society is that everyone can reach his or her potential. Somewhere, we lost our way." How well can society handle the displacements arising from economic and political transitions?

- What is the correct balance between regulation and empowerment? Between freedom and responsibility?

- What are the effects of playing the Game, especially as today's New Players, on human capital mobility? Would this be the reason that the Old Players still possess the best talent in the world? And, if so, do we see shifts in how global talent is reallocated across the world and what are the paradigms that affect these shifts? What sort of eco-system – be it at a policy level or at a firm level – would best attract talent that can be Game-changers or be creative destroyers?

- In a famous 1993 paper entitled, *"Population Growth and Technological Change: One Million B.C. to 1990,"* Michael Kremer posits that the larger the population (in this case the pool of talent), the faster ideas are generated and thus, the faster technological growth rates are accelerated. If we buy this theory, we can then ask the following: How can the New Players both develop their talent and attempt to rope in global talent simultaneously, thereby providing themselves with the potential to undertake Schumpeterian creative destruction?

- **People**

  - How can we be so well connected through technology and technology platforms such as social media, and yet feel so isolated? How can we live in cosmopolitan mega-cities and feel so alone? What is the new leadership development model?

  - How do we harness this inter-connectedness and Big Data in making leadership more effective?

  - What types of leaders are best suited, in the New Players, to drive catching-up and overtaking in the development Game? Similarly, what types of leaders are best suited, in the Old Players, to ensure that the Old Players continue to remain ahead of the Game?

- What types of leaders best facilitate creative destruction? What sort of information would these leaders need to make the distinction between simply following best practices and upheaving current best practices altogether?

Special Sessions

While the panels examine the theme from the four perspectives described above, there will also be special sessions and side events that will complement them:

- A special event discussing "Ethics: *the Philosophic Approaches to Agreeing to Disagree*" comprising a panel of scholars representing the Islamic, Western, Chinese and Indian traditions of philosophy.

- A special panel discussion on "Women in Society and Business: *Progress, Stagnation or Regression?*"

- An evening session: "*Finding Harmony in Paradox*" – learning from Art, which is an exercise of bringing together contradicting views and harmonizing them into something of beauty, or at least poignancy (a special event on Monday evening).

Conclusion

These are the issues and questions that will provide focus to the discussions and events during the Khazanah Megatrends Forum 2013. As the world continues playing this Game with leading Old Players and rising New Players, it is especially critical for the smaller New Players, such as Malaysia, to develop their own answers to these questions. The discussions and deliberations over the two days of KMF 2013 will contribute towards helping the various stakeholders of Malaysia – a smaller but significant New Player, with her markets, firms, society and people – to develop strategies and ideas in the face of this unfolding transition. May these strategies and ideas aid Malaysia in achieving her goals of becoming a high-income, fully inclusive and sustainable nation by the year 2020 and beyond.