

The Global Agenda

Where next for economics, politics and business?



Dialogue with *The Economist* • Executive Summary

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INTRODUCTION BY KPMG

As we near the end of one of the most tumultuous years in economic history, this is the time to reflect on lessons that have been learned from the crisis, and to map out the path to future growth. Over the past 18 months, we have seen events that five years ago would have seemed unthinkable: the collapse of Lehman Brothers and Bear Stearns; world trade going into reverse; and the first global recession since World War II.

At the same time, we have seen an unprecedented response from policy-makers and businesses. Huge fiscal and monetary stimulus packages have been implemented, including the use of quantitative easing, while there have been systematic programmes of cost-cutting and efficiency at the world's leading businesses. These steps have been effective at dealing with the first stage of the crisis, but now attention turns to the more challenging phase – exit strategies, the creation of a more balanced global economy and preparing for future growth.

This report, which summarises the discussion at the 2009 Global Agenda, clearly illustrates the scale of the challenges ahead for business leaders. In the short term, companies must restore balance sheets, regain the confidence of their customers and address emerging regulatory challenges. But they must also keep one eye on the longer term: maintaining levels of investment in R&D; looking for opportunities that might enable future growth; and developing strategy in an era of major technological disruption.

The economic downturn has accelerated shifts that have been underway for some time. Relatively speaking, major emerging markets have emerged from the crisis in a strong position. There was much discussion at this year's Global Agenda about how to build a successful business strategy in these huge markets. With growth expected to remain fairly weak in many developed countries, it has become all the more important for business leaders to consider how they channel resources and investment to faster-growing parts of the world.

But as speakers at Global Agenda made clear, business leaders must move on several fronts. Not only must they deal with the financial crisis and an ongoing shift in economic weight, they must also consider their response to climate change. In the lead-up to the United Nations Climate Change Summit in Copenhagen, there was much discussion at the meeting about the impact of climate change on business, and ways in which corporate leaders could formulate an effective response to this major global challenge.

These are undoubtedly difficult times, but one should not be too despondent about the future. Throughout history, business has played a fundamental role in the development of technological, financial and organisational solutions to the world's most intractable problems. As this year's Global Agenda clearly demonstrated, a crisis is also a time of opportunity, both to fix longstanding problems in the global economy, and to develop innovative ideas and thinking that can lead to long-term, sustainable prosperity.

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INTRODUCTION

Throughout the third quarter of 2009, evidence continued to mount that the worst of the global financial crisis was now over. Equity markets have rallied, trade and foreign direct investment have stabilised and economic data in many markets point to an incipient recovery. Some countries, such as Germany, France and Japan, have emerged from recession, while there are signs that other major markets are not far behind.

But despite these promising indications, the long-term outlook, particularly in developed markets, remains highly uncertain. In order to stabilise the global economy, policy-makers have resorted to unprecedented measures, which will put huge strain on public finances for many years to come. At some point, an exit strategy must be formulated, and this creates new risks for a fragile global economy.

Throughout the crisis, the story has been very different in China and India, where strong growth has continued. But these markets have not been unaffected by the downturn. The export-led model of China has been badly hit by a slowdown in consumer spending in the US, while India has suffered from a drop in demand for IT and other services.

The eighth Global Agenda, hosted by John Micklethwait and other senior editors from *The Economist*, provided a forum in which to debate the key issues affecting business in what remains an uncertain environment. As ever, this gathering of senior business leaders, policy-makers and influential thinkers provided a wide range of views.

Christine Lagarde, France's Minister for the Economy, Industry and Employment, opened the Global Agenda by discussing ways in which capitalism could be redesigned following the worst economic crisis in many decades. On the eve of the gathering of the G20 finance ministers in St Andrew's, Scotland, this was an opportune moment for delegates to quiz one of the world's most influential politicians about the future of policy and business.

On the second day, the first session was dedicated to the US and Europe, while the second examined India and China. With developed and developing markets facing highly divergent fortunes, delegates wanted to know how to protect their core markets, while at the same time taking advantage of more rapidly growing parts of the world.

An interview with Jorma Ollila, chairman of Nokia and Royal Dutch Shell, closed this year's Global Agenda. The discussion offered a fascinating insight into the role of innovation in a downturn, the outlook for renewable energy, and the prospects for a meaningful deal at the United Nations Climate Change Conference in Copenhagen.

Although the meeting was strictly off the record, we present the essence of the discussions in this summary paper. We thank all participants for their contributions and look forward to bringing you news of future Global Agenda meetings.

RE-DESIGNING CAPITALISM: NEW SCENARIOS

Christine Lagarde, Minister for the Economy, Industry and Employment, French Government

With the first phase of the global financial crisis seemingly over, what steps must policy-makers take to steer the world towards a sustainable recovery? How should capitalism be "redesigned" so that future crises are prevented, and so that long-term economic growth can be resumed?

On the eve of the G20 meeting of finance ministers in St Andrew's, Scotland, Ms Lagarde opened her speech by saying that the title of this event – redesigning capitalism – was the right one. We should not be setting out to make fundamental changes to capitalism, but to fix it. The key is to seek a balance, to reach out and to be inclusive in the current crisis.



Essentially, there are three key questions that need to be answered at this time. First, when can we declare that the recession is over? Second, when will the crisis be over? And third, when will the policy efforts that we have made be decelerated or withdrawn? Certainly, we know how the recession started. Although it is commonly said that the crisis began with the collapse of Lehman Brothers, an institution that had survived the American Civil War and the Great Depression, it could be argued that it predates this seismic event. Indeed, Ms Lagarde suggested that it was a collective failure of a system that had run out of steam because it had overheated.

One interesting aspect of the crisis is that it led to a collective response among national governments. The G20 meetings that took place in Washington, London and Pittsburgh were a creation and consequence of the crisis, said Ms Lagarde. Previously, the G20 had been a gathering of finance ministers; today it also comprises heads of state. There has been a common determination at these meetings to put in place a system that would prevent crises of this nature from happening again.

The response of policy-makers can be divided into three phases. The first phase was in many ways the easiest. The world was facing an unprecedented financial crisis, so what was required was an extraordinary response. The second phase – restoring the system – required policy-makers to “scale back their role as a fire brigade and increase their role as architects of the new system”, said Ms Lagarde. This has involved unprecedented fiscal and monetary intervention, along with the proposal of new regulations.

A number of countries have emerged from recession while others show indications that they soon will do. But while the recession may be over in some countries, the crisis is certainly not. Unemployment is still rising, particularly among young people, and it is not possible to declare the crisis over until jobs are being created again. In order to declare the crisis over, both governments and the business community will also need to articulate their exit strategies in an appropriate manner.

Exit strategies

Phase three – which involves the execution of exit strategies – will be the most difficult phase. Thus far, economies have been providing crutches to economies that are sick, said Ms Lagarde. At some point in time, unless we decide that we want to maintain nationalised banks, those crutches must be removed. Businesses and banks need to operate on their own feet, without support from the state.

A gradual approach will be required, said Ms Lagarde. Consider the “cash for clunkers” policy that some countries have put in place to support the automotive industry. If governments were to remove this suddenly, there is a danger that the whole sector could collapse. Instead, said Ms Lagarde, the French government proposes to remove this stimulus slowly – offering consumers 70% of the “cash for clunkers” offer, then 50% and so on. It is one example of the need to tiptoe out of the stimulus packages that we have put in place so that private investment can once again return.

An orderly exit from stimulus packages will also require close co-operation between national governments. It is important to recognise that some economies will be emerging from recession sooner than others. For that reason, it will be not possible to synchronise an exit. Co-ordination, however, will be essential.

Banking supervision

Ms Lagarde spoke of the need to strike a balance between securing financial stability and enabling competition between banks. She disputed the claim made by some that France is a country that wants to impose strict regulation on the financial sector. “The key is to require disciplined behaviour from banks, but to allow the sector sufficient room to be creative,” she explained. A distinction must also be made between banks with different risk profiles. A bank that concentrates on lending based on strong collaterals should not be treated in the same way as another that combines 50% traditional banking with 50% proprietary trading. Some business models are inherently riskier than others and that should be recognised in any regulatory intervention. A one-size-fits-all approach to capital reserves will not be appropriate. Equally importantly, one must not allow mark-to-market accounting practices to fuel speculative activity.



Sustainable economic growth

Policy-makers have responded to the crisis, but how will we pave the way to stable, long-term growth and what will form the wealth of tomorrow? Just as growth was driven historically by coal, then by the extensive use of oil and telecommunications, so future growth will depend on the application of new technologies, particularly related to non-fossil fuels and the internet. Some of these developments could be susceptible to periods of speculation – the carbon emissions trading scheme, for example. New rules may need to be applied to prevent this behaviour. But the key point is that some of the inventions and innovations that are emerging now – such as those related to energy, nanotechnology and biotechnology – are likely to be the drivers of tomorrow's growth.

Resigning the capitalism of the future requires us to set up new bodies that transcend national boundaries, said Ms Lagarde. There are areas of the economy, including financial services, that must be based around general, international principles, not narrow national ones. The emergence of the G20 as the primary driver of global governance is a healthy development in this regard. The International Monetary Fund also has a larger role to play, not just as a bank of last resort for countries facing economic difficulties, but also as an institution that can provide warnings of imminent crisis and help the G20 to manage global growth in a more disciplined fashion. Ms Lagarde stressed that this was not to suggest that the state should no longer play a role in the economy – state actors remain important. What is important is to have rules and make sure that they are respected.

Restoring confidence

Ms Lagarde then took questions from the assembled delegates. One attendee pointed out that what was needed was the restoration of confidence. Consumers needed to be willing once again to borrow, and businesses needed to be prepared to take risks. Did Ms Lagarde have any views on how to rebuild confidence?

Ms Lagarde responded that the state had a significant role to play in restoring confidence. Deposit guarantee schemes, whereby the state undertook to underwrite losses incurred by consumers from failed banks, were a critical part of this process. She admitted that there was still much to do. Banks should self-insure the systemic risks that they pose. They should pay for the additional cost of improved supervision, and for deposit guarantee schemes. Finally, she suggested that policy-makers need to think about a collective, properly funded insurance scheme that would protect against future crises.

Governance must also be improved. It became clear during the crisis that some institutions had failed to carry out even the most basic responsibilities of governance. One solution to this problem, suggested Ms Lagarde, is better diversity. Boards should contain more women, and should comprise a combination of older, more senior and experienced individuals with those who are younger and can bring fresh ideas. Boards should ensure that they ask the right questions. If they do not understand a product or idea that is brought to them, that should set off alarm bells.

Financial regulation

Ms Lagarde disagreed with a concept raised by one delegate – that some banks are too big to fail and should be forced to divest assets in order to reduce the exposure of the taxpayer. She pointed out that some of the banks that caused the most severe problems in the crisis – such as Northern Rock and Lehman Brothers – were not the largest. Equally, some very large banks that have a significant retail offering are not necessarily posing the most serious systemic risk. The key, she believed, is to engage with very active supervision at all levels. It is not enough to rely on the “too big to fail” argument and capital – together these tools are not subtle enough.

The issue of central clearing for over-the-counter derivatives was also discussed. Ms Lagarde said that improved transparency was an essential step towards resolving the crisis. This should include a clearing system for over-the-counter derivatives so that a better understanding of the positions of each institution, and the systemic risks that they pose, is possible. Improved availability of data is an essential part of this.



One delegate pointed out that there had been no mention of global imbalances in either the Washington or London G20 communiqués, and expressed surprise that such a major issue had not been included on the agenda. Ms Lagarde pointed out that the issue had been mentioned in the Pittsburgh communiqué, and that it was a theme that was gradually becoming more prominent. It was important, however, to be subtle in the approach to this issue. Setting the foundations for the rebalancing of the economy is not something that can happen overnight. In addition, China has to be a major player in any efforts to rebalance the global economy. And in dealings with China, it is important to proceed cautiously.

Looking to the future

Beyond the current crisis, there are longer-term issues that must also be addressed. One delegate wondered whether steps being taken now were merely storing up problems for future generations in terms of huge government debt. Ms Lagarde responded that, in deciding how to address the crisis, policy-makers had to focus on emergency measures. The priority was to deal with the financial sector, and then fix the economy at large. There were many other questions that needed to be addressed. For example, did accounting principles have a role to play in creating the crisis, were leverage ratios excessive, and did bonuses serve as effective incentives or not?

One delegate was surprised that climate change had not been mentioned so far, and wondered whether redesigning capitalism was something that would have to take place twice – first to address the current crisis, and second to move to a low-carbon economy. The key message, according to Ms Lagarde, was that the policy response to climate change was a process that has to involve every country. It must be inclusive, and therefore should be a United Nations process, despite the tendency for UN negotiations to be protracted and cumbersome. The alternative, to address climate change at the G20 level, could lead to the remaining 180 countries saying that they do not recognise the authority of that group.

But the issue of climate change, and that of redesigning capitalism, have themes in common. They require co-ordination and a global response. No country can act in isolation when faced with challenges of this magnitude, concluded Ms Lagarde.

ECONOMIC OUTLOOK FOR THE US AND EUROPE

Chaired by: Philip Coggan, Capital Markets Editor and Buttonwood Columnist, *The Economist*

With governments everywhere taking a more proactive stance in fashioning economic development, what role are the US, Brussels and others playing in shaping a new world order? One year into the Obama administration, what is working, and what isn't? Will today's remedies simply create tomorrow's next set of problems?

Phillip Coggan, Buttonwood columnist and Capital Markets Editor of *The Economist*, opened the second day of Global Agenda by looking at the economic prospects for the US and Europe. Given that these two regions are no longer the engines of the global economy – but perhaps instead, suggested Mr Coggan, the second-class carriages – what were the chances of a smooth ride in 2010?

Mr Coggan suggested that there were two main schools of thought. First, there is a more optimistic group, which he termed the “reverse Newtonians” because they believe that everything that goes down must come up. Some economists, such as Milton Friedman, have found evidence for this phenomenon during previous recessions. A deep downturn, so the argument goes, is an opportunity to clear out the dead wood and create new areas for growth.

Mr Coggan said that there was evidence for a recovery. After running down inventory, companies are restocking and that process is fuelling economic activity and output. Those companies that are most exposed to Asia – such as Australia – are showing a strong recovery and have even tightened monetary policy.



This time, it's different

Other economists argue that this crisis is different. Recently, two US economists, Reinhart and Rogoff, argued in a paper that the effects of a financial crisis last much longer than a typical recession. On average, house prices in the wake of such a crisis endured a six-year bear market, government debt rose by 66% and there was a collapse in corporate and income tax revenues. "This is the hangover school of economics," said Mr Coggan, "where we all overindulged and need to lie down in a darkened room."

In the eyes of the bears, all the efforts made by policy-makers, such as quantitative easing, have only served to prop up the economy. They have brought sales forward, for example by creating tax breaks for purchasing cars so that people buy them earlier. The problems have simply been transferred from the private sector to the public sector. Set this against a longer-term picture of an ageing population, rising healthcare costs and a shrinking workforce, it is possible to argue that the US and Europe will never regain the output they had prior to the crisis.

The revival in equity markets that has been seen this year is a necessary factor in economic recovery but it is an insufficient one. The money supply continues to shrink in some countries and is barely growing in others. Chief executives in this room, who represent large corporates, will probably have no problem getting finance, but small and medium-sized enterprises continue to find it difficult to access funds. There is some debate, however, about whether the problem is one of supply or demand. A large part of the issue may be that companies do not want to borrow, not that they are unable to do so.

Heading for the exit

2010 will be dominated by talk about exit strategies, said Mr Coggan. At some point, we know that quantitative easing must be abandoned. In the UK, the Bank of England has already hinted that it may be getting towards the end of this process. At some point, interest rates and tax rates will have to rise. It is likely that there will be further currency stress. With the Chinese holding their currency steady against the dollar, most of the pressure will be in the movement between the euro and the dollar. Another interesting sight in the UK has been that of politicians getting tough on public spending ahead of a general election.

Policy-makers are making tough demands on banks. At the same time, they are asking them to boost capital bases, return to profits, increase their lending and restrict bonuses. It is likely that there will be plenty of pain still to come. Regional US banks are still failing at a rapid rate and there are plenty of bad debts yet to emerge. During the crisis, corporates have been very successful at cutting costs, but they are not yet increasing revenues.

Mr Coggan summarised by saying that the US and European economies may look better in 2010, but they are still far from perfect. Even if we manage to avoid a W-shape recession, lingering problems will remain for some time to come.

Mr Micklethwait then asked Robin Bew, editorial director and chief economist of the Economist Intelligence Unit, to add his views. Mr Bew thought that a V-shaped recovery was unlikely, even if the short-term outlook was now better than most people assumed back in spring. In some sectors, there have been marked improvements compared with 12 months ago, when the atmosphere was universally negative. This improvement has been driven in large part by restocking, particularly in Asia, and has even benefited those sectors that were among the worst hit by the crisis, such as automotive.

Policy measures that have been implemented are very ambitious and aggressive, said Mr Bew. But ultimately, they are transitory. Policy ambition on this scale cannot persist over the next few years. It must come to an end at some point, with an exit from quantitative easing and an increase in interest rates.



A balance sheet recession

Of similar concern are structural issues in the economy. Mr Bew characterised the current downturn as a “balance sheet recession”. We have seen this most obviously in the financial services industry, but also in the private sector, with mortgages and credit cards. What these balance sheet problems have in common is that they take time to work through. One likely outcome of this is that growth is likely to remain depressed for some time to come. This explains why many companies are looking beyond their traditional markets to other parts of the world, particularly emerging markets.

Looking ahead, Mr Bew said that there were a couple of issues that caused particular concern. One of the key challenges will be public sector finances. Problems are likely to persist for a long time and imply the need for higher taxes and higher long-term interest rates. Quantitative easing, while it has certainly played a prominent role in preventing financial Armageddon, has unfortunate side effects. It has, for example, encouraged a carry trade into high-yielding assets.

This raises the spectre of asset price bubbles. In a number of markets and asset classes, such as property or equity markets in China, flows do look very speculative. Mr Bew concluded by saying that there were still big systemic risks out there, and current policy responses may inadvertently be creating new ones.

One delegate suggested that there was a comparison that could be drawn between China and Japan in the 1980s. He suggested that the significant growth currently being seen in China could be interrupted, for example because the currency had been kept artificially low. Just as the west acquired bad habits in the run up to the crisis, so China could be doing the same now. It is a problem that is often seen in economies that are in good shape.

Consumer behaviour

How are consumers behaving in the US and Europe? One delegate felt that there was a gap between reality and psychology. If you were to ask people about their financial situation, they say that it is stable and not getting worse. That is a clear shift from a few months ago. But the psychology is rather different. We see groups of society – those that are still employed – that now have higher disposable incomes than prior to the crisis because of low interest rates. Although they may be better off, they are not behaving like it. Large sections of society are downshifting their spending and there is a culture of “make do and mend”.

Another delegate highlighted how consumer behaviour varied widely from one European economy to another. In general, there is a lag between economic recovery and changes in consumer behaviour. In many economies, consumers are very value-oriented and price-led. If they are offered a good deal, they will take it. Prudence and thrift have become virtues for many consumers.

At the same time, people have learnt how to be smart with their money and are being far more selective about how they spend it. They are prepared to pay for quality. There is, however, a general lack of confidence that is rooted in unemployment or fear of it. Until we see an improvement in the employment picture, it is unlikely that we will see a bounceback.

The challenge of knowing when there will be an increase in consumer confidence poses a conundrum for companies about when to invest again – particularly those for whom fixed investment is a long-term process. As one delegate explained, you need to invest ahead of the curve, but it is difficult to know precisely when that should be.

Another delegate questioned whether putting up taxes would be the right approach at a time when consumer confidence needs to be rebuilt. Surely a better alternative, he suggested, is to work out how to encourage growth in the economy and thereby increase the tax base? The danger of simply putting up taxes is that it could result in a negative spiral.



Prospects for employment

The long-term employment picture in Europe troubled some delegates. The worry that jobs would simply not return along with economic recovery could be plausibly argued.

Another delegate felt that public sector employment was bloated, and that most job losses should and will come from the public sector. More generally, there were opportunities to think more carefully about how the government delivers public services. This may mean looking to outsourcing as a way of improving efficiency and productivity.

This prompted one delegate to consider whether it was time for the UK to reconsider an industrial policy aimed at creating new jobs in revitalised sectors. Not everyone agreed that an industrial policy was a viable solution, however. This required government to “pick winners” and one delegate doubted that this would be possible because the process would inevitably become politicised. As he put it, the government is always looking out of the back of the bus, rather than focusing on the road ahead. Another delegate preferred the term “industrial activism” – a term also used by Peter Mandelson in his speech at the Annual Trade and Industry dinner.

What next after cost-cutting?

Some companies are saying privately that they could have a good year, said one delegate. They are reluctant, however, to say this in public because there is a danger of talking things up too quickly and because they do not want expectations to run ahead.

Others thought that the overall situation was overwhelmingly bearish for European and North American economies, particularly as interest rates and tax rates increase, which is bound to happen. This does not mean, however, that all businesses will suffer. Clearly, there will be some that will be able to thrive as a result of growing demand in Asia as well as the shifting pattern of world income and wealth.

Companies operating in the Eurozone are struggling because of the high value of the euro, while the US and UK are benefiting from dollar and sterling depreciation. The reason we do not see more complaints about the situation in Europe, said one delegate, is that German companies have traditionally been very good at taking costs out of the business. Companies in countries that are less able or willing to do this will come under enormous strain.

One delegate wondered about the long-term effects of cost-cutting as companies start to plan for an eventual upturn. Would a retailer re-open branches that they had closed on a high street? Or would they instead see this period as an opportunity to shift towards an online model? Would companies try to grow without re-hiring any of the staff that they have shed during the recession? Or, if they did hire, would they seek to recruit outside Europe, possibly in lower-cost regions of the world? There are worrying implications of this trend, particularly when one considers the enormous ambition shared by many young people in countries such as India and China.

Climate change and technology

On the topic of climate change, one delegate worried that technology, whether carbon capture, renewables or nuclear power stations, would not be the solution for reducing emissions. The only way in which emissions could be cut, he argued, is through reduced consumption and improved efficiency. Yet the drive to reduce emissions is set against a world in which populations are increasing, and in which prosperity and expectations are on the rise in many countries – including the most populous on the planet. He also pointed out that the large amount of money set aside by the Obama administration for energy and infrastructure had barely been touched. Surely it would be better to spend this money in order to kick-start investment in the sector?



The future role of technology in the European economy prompted some debate. One delegate bemoaned the fact that no disruptive innovation in recent years had emerged from Europe. He also pointed out that there was ongoing downward pressure on prices, with a continuing reluctance among consumers to spend that had been aggravated by the economic crisis. The industry needed to restructure, but at present there was little sign of this, believed the delegate. In particular, the industry was shifting its centre eastwards as Chinese and Indian companies developed increasingly sophisticated offerings.

Overall, it was felt that there was still some way to go before a sustained recovery would be seen in the US and Europe. Many companies continue to find it difficult to access credit. Although confidence has improved, corporates and consumers are still not spending. The year ahead will continue to be fragile and it is almost inevitable that unemployment will rise. The mood, said these business leaders, was not likely to improve for several quarters.

HOW FAR CAN CHINA AND INDIA LEAD THE WAY?

Chaired by: Simon Long, Asia Editor, *The Economist*

Throughout the last five years, virtually all emerging markets boomed, but from this point forth, their fortunes will diverge considerably. How badly are emerging markets' long-term prospects being hurt by the global financial crisis? What does a collapse in global demand mean for export-led economies? How will Gulf and Far East countries manage their surpluses in future?

The relative lack of confidence in the growth prospects for the US and Europe led into a discussion about China and India. These two largest emerging markets continue to grow at a rapid pace and are often cited as providing the best hope for leading the global economy to a recovery.

Simon Long, Asia Editor of *The Economist*, noted that when the history of the crisis came to be written, the emergence over the past 30 years of China and India into the global system would be one of the most prominent themes. But this rapid development has led to unfortunate side effects – not least global imbalances of excess Asian savings and excess Western consumption. These have been one cause of the crisis, and fixing them should be certainly seen as part of the solution.

Mr Long described how Asia seemed to have sailed through the crisis relatively unscathed. Earlier this year, when industrial production and exports in East Asia appeared to be falling off a cliff, there was an expectation that the region would be very badly hit. Yet fast forward a few months, and China is expected to achieve growth of 8% this year. India, despite facing far greater fiscal constraints and the worst monsoon in 80 years, will grow by 6%. Other countries in the region, such as Indonesia and Vietnam, are also doing well.

Rebalancing the economy

This year, China will offset three-quarters of the decline in G3 GDP. It will achieve this via a massive fiscal stimulus – which, unlike in the US, has actually been spent – along with a huge expansion in credit. China also seems to understand the need to rebalance its economy – indeed, this has been made explicit in its current five-year plan. It is therefore reasonable to think, said Mr Long, that this region is one bright spot in the global economy.

And yet this rebalancing of the economy appears to have stalled. The World Bank forecasts China's current account surplus at 5.5% this year and expects it to remain steady next year. The reason for this, said Mr Long, is that it is far harder for China to stimulate spending than for the west to stop spending. The reasons why people save so much in China are very deep rooted and relate to a dysfunctional healthcare system, inadequate pension provision and the need to save for dependents' education. Even though the government has pledged to increase its spending on healthcare, the level of available coverage will remain relatively low.



One way in which China could rebalance its economy is to allow its currency to appreciate. This would be the easiest way to boost imports and increase domestic consumption. But the Chinese authorities are reluctant to do this, said Mr Long, because the basic dependence on G3 demand is still essential to their model of social and political stability. They are also worried about the impact of an asset bubble bursting, particularly in urban areas. The comparison with late 1980s Japan is an interesting but worrying one because the consequences of a decade of stagnation in China – as happened in Japan – would be truly catastrophic.

Prospects for India

Turning to India, Mr Long said that it was a far smaller economy than China and far less exposed to the international system. But there are concerns here too, particularly because India's key advantage – huge amounts of cheap labour – is simply not being used effectively. Although India has famously succeeded in building an IT sector from scratch, the number employed in manufacturing has not changed since 1991, when the country began its reforms. There are 40m people joining the labour force every year, said Mr Long, and it is not clear what they are going to do. There continues to be a 45% malnutrition rate among the under fives, there is an insurgency in central India to which the government is about to send 100,000 troops, and there are many parts of the countryside where there is a widespread perception that all the wealth goes to the cities.

Mr Long said that one of the hopes for the crisis was that it would be a catalyst for greater economic integration in Asia. At a recent summit in Thailand, there was a lot of talk about pan-Asian free trade and of the region as a whole becoming an engine of its own economic growth. Mr Long thought that, while these discussions might serve a political feelgood factor, they would have only a limited economic impact. There continue to be tensions in the region, with countries such as India and Japan feeling unease about China's rapid growth. This made the concept of an East Asia free trade zone unlikely in the medium term.

Operating in China and India

The discussion then opened up, with delegates describing their experiences of running businesses in India and China. One felt that the two countries had little in common, apart from corruption at all levels, which technically made it illegal for a UK company to trade there!

He pointed to the strong control that the Chinese authorities exerted over the economy, which even included mandating a slowdown in production if they felt it necessary. Western businesses were only allowed to compete there, thought the delegate, if it served China's goals. It was possible to do niche work, but little more, and the barriers to entry were extraordinary.

Another delegate, however, was more optimistic. China is a challenging place to do business, he admitted, but western companies have to understand the opportunities of operating there. A changed mindset was required. Otherwise, asked the delegate, what other solution was there? Another attendee agreed, saying that the more western companies work with the Chinese and gain a better understanding of the business culture, the better they will fare.

An undervalued currency

One delegate commented that China had studied closely the models of countries that had made the transition from underdeveloped to developed – such as Japan after World War II – and decided that the best route to growth was to create an export-driven economy linked to an undervalued currency. Despite the impact this might have on the rest of the world, they were prepared to live with this undervalued currency for the medium to long term. The question, said the delegate, was how the rest of the world accommodated this problem, which was likely to endure.



An undervalued currency would also have negative consequences for China, suggested one delegate. It is a barrier to importing knowledge and capital, is likely to lead to bubbles and also raises the question of what to do with their excess liquidity. Another delegate was surprised that there was only limited discussion of the issue at the G20. Although the renminbi was revalued 18 months ago, it remains undervalued and it is puzzling that the Americans conceded that this point in exchange for co-operation on other issues.

The discussion then turned to the likelihood of Chinese companies seeking to buy companies in the US and Europe. Many delegates thought that this was inevitable, although one questioned whether the Chinese had sufficient experience of conducting proper due diligence. One delegate thought that the US government was more likely than ever to oppose such deals, as they did when a Chinese company tried to buy Unocal. American politicians were more sinophobic than before, said the delegate, in part because they sensed more than ever that economic might was shifting away from the US to China, but also because Chinese acquisitions raised a whole host of sensitivities, including concerns about defence, sustainability and religious tolerance.

India and innovation

Moving onto India, one delegate highlighted the vibrancy of the Indian workforce, and the joined-up way in which India thinks about conducting business. He cited as an example the business process outsourcing sector, which was only a few years old yet had achieved extraordinary growth already. India has enthusiasm, a can-do spirit and a massive network of Indian businesspeople around the world.

The innovation capacity of India was also highlighted. The country is well known for its business model innovation and has cornered low-cost technologies and services out of necessity to meet the needs of a less affluent customer base. India excels at “frugal engineering” – the idea of doing more with less. The rest of the world is still learning how to do this.

BUSINESS MODELS IN A POST-RECESSION LANDSCAPE

Interview and Q&A with Jorma Ollila, Chairman, Royal Dutch Shell; Chairman, Nokia

Chaired by: Tom Standage, Business Affairs Editor, *The Economist*

How are companies adapting their business models in the face of turbulent market conditions, disruptive new technologies and innovative, global competitors? Which companies will survive, and which will thrive, as recession gives way to recovery?

It is often said that a downturn is a good time in which to innovate or start a business. Recent research from MIT has found that, out of the Fortune 500 companies, more than half were created during times of recession. Did Nokia have the same view about the benefits of innovating in a downturn, wondered Tom Standage, Business Editor of *The Economist*?

Jorma Ollila, chairman of both Nokia and Royal Dutch Shell, agreed with the hypothesis that downturns were good for innovation. He pointed to an interview with Jeff Bezos, in which the chief executive of Amazon said that no innovation of substance took place in his company when there was plenty of money or time. On the contrary, everything innovative was created when they were short of money or in a hurry.

In the early 1990s, when Nokia transformed itself from a diversified industrial company into the mobile phone company of today, Finland was in the midst of its deepest post-war recession. The transformation was driven partly out of necessity, because Nokia's traditional businesses were mature and slow-growing, and partly because there were enough people in the company who saw opportunities for growth in mobile communications.



The transformation of Nokia took place during a crisis situation at the company and followed two years of major losses. The response was to sell off 80% of the business, which covered a diverse range of products including cabling, rubber and paper, and focusing on the burgeoning mobile communications industry. It was here that Nokia thought it could differentiate itself, said Mr Ollila. Initially, the company thought that its future lay in mobile infrastructure, but this later shifted to devices.

The challenge of picking winners

This raises an important point – namely that it is very difficult to pick winners, said Mr Ollila. While it is easy to sell off parts of a business, it is much more difficult to grow again and not only pick the right areas of focus, but to continue with innovation. In the early phase, it is not possible to know what will work and is a question of trial and error, said Mr Ollila. This highlights the difficulty of putting in place an effective industrial policy, which ultimately requires governments to pick winners. It is an unwise approach, and one should let the market decide. Nevertheless, there needs to be an element of picking winners as governments need to create a market and support innovation through technology improvements, as they currently are doing with environmental technologies.

Mr Ollila was hopeful that innovation and entrepreneurship had a good future in Europe, even if companies as successful as Nokia remained rare. Universities in countries such as the UK, Germany, France, the Netherlands and Nordic countries were stronger in innovation than in recent years. In addition, young people think differently about careers. Rather than seeking to work for government or large companies, they are increasingly interested in entrepreneurship and working independently. This is even more the case given the scarcity of jobs at the moment.

Innovation and renewables at Royal Dutch Shell

Moving on to discuss Mr Ollila's other chairmanship, Mr Standage asked how Royal Dutch Shell was responding to the recession. Had it changed the way that the company approached innovation?

Mr Ollila admitted that the recession had had an impact on demand for oil, but that the expectation was that there would be a fairly rapid return to growth. One surprising factor, he said, was that the market view of the future oil price was a lot more optimistic than the consensus of the delegates in the room.

In terms of innovation, Mr Ollila said that, for the past ten years, Shell had spent more on R&D than any other oil company. Today, the company continued to invest in its historical business of getting oil and gas out of the ground and to the consumer, but it also recognises that it cannot rely on hydrocarbons alone in the future. The industry and, in particular, Shell, has had to become more forward looking and increase its focus on innovation. This means investing in longer-term solutions, including renewable energy.

Transferable skills

Mr Standage asked how Mr Ollila had applied his experience as chief executive, then chairman of Nokia, to his new role at Shell. One skill that was definitely transferable, said Mr Ollila, was his background in innovation and technology. There was a sense that the oil and gas industry would need to be transformed through the adoption of new technology, so the experience of running a highly innovative telecoms business was certainly relevant.

One other aspect that was transferable was his experience of running businesses in India and China. Mr Ollila said that Nokia had always made at least the same margin on phones sold in China as in the rest of the world, so had been able to build a good business model there. A strong background of investing in India and building a successful business would also have been considered relevant by the board at Shell.



This is not to say, however, that running a business in China is easy. Within three or four years of being invited to set up operations in China, there was a move by the Chinese authorities to support local suppliers, some of whom were government-owned. These companies copied technologies that had been introduced by Nokia and other competitors, and there was a subsequent strong push to grab market share, including the use of students to sell door to door. The attempt to build market share for Chinese providers was unsuccessful, however. There were two reasons for this: first, the quality of the Chinese devices was not good enough, particularly the software, and second, they failed to keep up with the speed of technological change.

Was Mr Ollila more worried about Chinese competitors now, wondered Mr Standage. Yes, of course, said Mr Ollila, the whole industry is worried about competition from China. The Chinese have already made good strides with infrastructure and there is some progress being made on intellectual property.

Prospects for Copenhagen

One delegate asked Mr Ollila about his expectations for the forthcoming UN summit at Copenhagen. Would a deal be reached, or would the meeting turn out to be a failure? Mr Ollila was pessimistic about a deal being reached, suggesting that there was too much uncertainty and that agreement was still a long way off. Without a Senate Resolution in the US, it will difficult for President Obama to give a strong mandate to negotiators attending the summit. He did think, however, that because there was such a broad understanding of the need for an agreement, that some kind of framework would be agreed. In addition, there needed to be some way of improving the UN process which, despite being inclusive, was not very efficient.

There was then a discussion of the technologies that could help to mitigate climate change. New research into biofuels created from algae, currently being developed by ExxonMobil, was cited as a promising innovation, but one that would take 15 years to come to fruition. Mr Ollila said that, at present, there was no silver bullet in terms of new technology. Instead, the world should focus on what he termed the “low-hanging fruit” of improved energy efficiency. The second area of focus should be carbon capture and storage because of the huge amount of coal currently being burnt. A third area of focus needs to be biofuels. Without focusing on these three areas, it will be impossible to meet reduction targets, believed Mr Ollila.

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