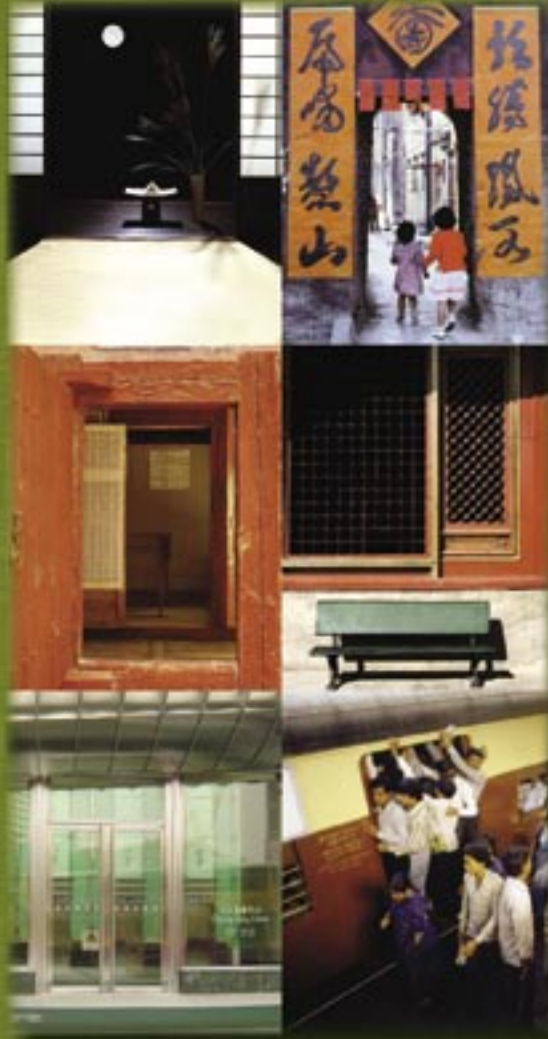


ASIA BUSINESS COUNCIL

ASIA BY 2010

Opening Tomorrow's Doors



Spring Forum

April 22-24, 2004

Island Shangri-La Hotel Hong Kong

FORUM REPORT

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ASIA BUSINESS COUNCIL

One of the hallmark features of the Asia Business Council is the time we spend listening to each other. Our members want to better understand the viewpoints of their business colleagues across Asia. We devote a significant portion of each of our Council Forums listening to each other's chief concerns and ideas regarding trends and changes in the region.

Over the past few years, two rather striking sets of issues began to arise. On the one hand, our members felt certain of the continued growth path of China and of the need to understand and benefit from it. On the other hand, an increasing number of uncertainties loom before all of us. Will the United States continue to be our key economic driver? Will terrorism and health-related issues derail our region's economic achievements? Can we work cooperatively with China? These and many other questions surfaced during our discussions.

Of course, we cannot predict the future, but we can prepare ourselves thoughtfully for a full range of outcomes. At our last Council Forum, we endeavored to just this — to give ourselves a set of tools and a framework to think about various scenarios that may affect our part of the world. This report explains our process and our findings. We hope you find it useful.



S. Dhanabalan

Chairman

INTRODUCTION

The Asia Business Council’s Spring Forum focused on deepening our understanding of Asia’s current and medium-term challenges and uncertainties. We sought to make better sense of the gray areas that help shape our extraordinarily complex world.

To realize this goal, we carried out a scenario-planning exercise. Scenario planning, first developed by Shell Oil in the 1970s, is now used by many companies and organizations around the world. The process allows participants to think expansively about what the future may entail. Scenarios are not meant to forecast or to fortune-tell the future, but, rather, to allow for better decision-making today.

Council members used a multi-part scenario-planning exercise to draw out their own perspectives on the future of Asia’s business environment while challenging their assumptions. First, 72% of our members took a 36 question survey; additionally, 12 of our Council members participated in in-depth interviews. The information culled from these two components pro-

vided a baseline set of assumptions — what we called the Council’s Official Future — that we tested during the scenario-planning workshop of our Spring Forum.



The pre-workshop findings enabled us to identify two critical determinants of Asia’s medium-term economic prospects: the political and economic vitality of both China and the United States. These two key determinants created the basis for a matrix with four plausible future scenarios for the Asia-Pacific region.

Before we could test the plausibility of these scenarios, we worked in a large group to gauge how robust the Council’s “Official Future” scenario is. The “Official Future” is the scenario that the great majority of Council members

thought would be the most likely outcome for Asia in the coming five to seven years.

One effective scenario-planning technique we used to help participants envision each potential outcome was to generate potential newspaper headlines. Throughout this report, the headlines precede discussion of each scenario in an effort to offer a more complete picture of each scenario's implications.



SCENARIO 1: THE COUNCIL'S "OFFICIAL FUTURE" FOR ASIA

"OFFICIAL FUTURE" TRENDS

China will stay the course over the next five to seven years: Well aware of the challenges ahead, members are generally confident that the Beijing leadership can manage the process of economic reform. They believe that the Chinese government can maintain growth in a way that will avoid dramatic boom and bust cycles and ensure relative social and political stability. China's emerging economic and trade clout represents a new competitive threat, but perhaps because of sheer realism, members

perceive that the opportunity of China dwarfs everything else. Moreover, members perceive that Beijing realizes that creating "win-win" opportunities will best serve its own interests, as well as the interests of the region.

Business in the region will develop smoothly during this period: Council members expressed striking confidence that the overall outlook for business is positive during the next several years, underpinning strong profits.

The US economic outlook is favorable and will contribute to economic growth in Asia: While many members expect US economic growth to slow down after 2004, there is a general consensus that expansion will nevertheless remain strong enough to help sustain growth in Asia. There is, however, significant anxiety about America's role in geopolitics and the potentially destructive side effects of US policy initiatives.

Prospects are poor for progress on the multilateral trade front: Members voiced great pessimism on the prospects for progress in the Doha trade round. The multilateral trading system may have reached its limit, due to a lack of political will. Multilateral trade negotiations have simply become too complex and time-consuming, involving too many players, to hold out much prospect of breakthroughs over the next 5 to 7 year period.

Bilateralism and regionalism will be more the norm in the next few years: Business leaders foresee that bilateral and regional agreements will reshape the trade scene. Many Asian countries are entering bilateral agreements with the US; ASEAN trade integration is developing, and an ASEAN-

China agreement is a realistic possibility. The value of intra-regional trade has grown explosively over the past five years.

Japan's future role in the region is unclear:

The current economic recovery has promoted confidence within Japan itself, but opinion among Council members is split on whether Japan's economic recovery will be sufficient to change the general perception that Japan's influence has declined in Asia. Memories of World War II and unresolved issues regarding Japan's war actions continue to bedevil relations between Japan and China, as well as Japan's ties with almost all countries in the region. Since China and Japan are the two main engines for regional economic growth, this tension will have to be resolved in order for Asia to achieve full stability and further economic integration. One related question is whether the "Asianization of Japan" will occur over the next seven to ten years.

The growth trajectory of the region, and its growing stake in globalization, will not be derailed by episodic diversions:

Council members are acutely aware that, while the region has been a net beneficiary of globalization over the last 20 years, it has to accept and cope with the growing side effects of globalization, such as SARS-type health epidemics and terrorism. As Asia is increasingly integrated in globalization, it faces turbulence and, perhaps, deeper shocks. Nonetheless, members are convinced that Asia is developing a greater ability to stay the course.

"OFFICIAL FUTURE" RISKS

China Shocks: No country has ever grown at rates approaching those of China's without experiencing

economic shocks. The Chinese economy presently shows clear signs of overheating and excess capacity.

China's Model of Economic Growth: The Chinese model is beginning to bump up against structural issues, including unequal income distribution, rural underdevelopment and unemployment. To generate enough economic growth for adequate job creation (7 to 8 percent per annum), China must expand its domestic market. Yet most policies to stimulate growth lead to inflation in the long term. Thus, sustainability of the economic growth model is a key issue for the future.

China/Taiwan: Confrontation is certainly possible, whether due to mismanagement by the mainland, by Taipei, or by a clumsy US government that stumbles in its handling of the issue. Similarly, political evolution in Hong Kong has the potential to create a crisis that involves the US, touching off a major Beijing-Washington row with potentially severe economic implications.

Terrorism: A high-profile terrorist attack, such as a destructive dirty bomb in New York or a major center in Europe, or a software attack on the Internet, both have the potential to snuff out global economic growth and severely impact the entire Asian region. Similarly, Muslim extremist groups in Southeast Asia could also wreak havoc in the region.

Major US Disruptions: These could stem from economic risks, such as a sharp slowdown in consumer spending due to weak job creation, the impact of high oil and commodity prices, or pressure from towering trade and budget deficits. There are also political risks, such as the fallout from America's failure in Iraq.

The very success of the “Official Future” scenario also contains seeds of problems. For example, commodity shortages and price inflation could become severe, with a net benefit to efficient consumers and producers of the raw materials. The use of artificial materials would surge; re-cycling and conservation would become far more important. Shortages of skilled human resources would only worsen, placing a premium on education and training in the longer term.

Further discussion of the three alternatives to the “Official Future” scenario allowed Council members to target strategic planning initiatives within their own companies and placed the “Official” scenario in a more nuanced light. A number of issues relevant to the Council emerged from this exploration:

- Non-linearity and turbulence lie ahead for the region over the next 5-7 years. We should expect at least one occasion when US or Chinese growth slows — or even goes into reverse for a while.
- The US remains the engine of global growth, so if the US stalls it will mean problems for China, Asia, and the rest of the world. Asia will recover eventually, however, because China is emerging as a regional and global growth engine.
- Shortages of skilled human resources are a priority concern for many Council members. They wonder where they will find the talent to manage their new operations in China, along with the company headquarters and other offices?
- Environmental degradation will also worsen, unless sustainable development is made a global priority.

Finally, Council members generally agreed that regional cooperation on global issues would be necessary to achieve the “Official Future” and a “win-win” solution. Council members also discussed how the Council might be instrumental in furthering that kind of cooperation. For instance, the Asia Business Council might bring together Chinese and Japanese business leaders to help ease long-held tensions and move dialogue and interaction to a new level of mutual regard.

SCENARIO 2: “CHINA SURGING”

China Surging

Scenario Headline & Five Whys

US ECONOMY WEAK

CHINA ON THE PATH

Headlines From This Future

2010: Three of Top Ten Global Brands are Chinese — Autos and PCs
Pudong Financial Journal

Five Whys

- Economy continues to grow
- Middle class expands rapidly, creating a huge domestic market
- China's manufacturing capacity expands and its technological prowess blossoms to the extent that Chinese corporations begin to outstrip American companies
- China succeeds in important image terms, e.g., the 2008 Olympics
- China and India create an economic union

The major determinants of Asia’s future are whether Chinese growth continues and if the US recovery can be sustained. Under the “China Surging” scenario, China’s growth continues, but the US recovery languishes. All of Asia — particularly India and Japan — rises under this scenario. “China Surging,” like “Official Future,” brings the risk of turbulent change that does not adhere to predictable cycles.

Corporations must have the resources to keep up with technological innovation, penalizing smaller companies. Companies must be resilient, lowering fixed costs to absorb market downturns, while remaining prepared to provide services immediately when the market recovers. Leadership will be critically important in a scenario in which China surges forward.

IMPLICATIONS

Economic and Financial

- An Asian currency is born; competes with the Dollar and Euro. A single Greater China securities market emerges, combining the Taiwan, Hong Kong and China A share exchanges; the Asian bond market flourishes; Asian property prices appreciate; commodity prices remain buoyant.
- China becomes the world's largest importer; brisk outward and inward flow of investment; Chinese are leading global tourists.
- Japan prospers; becomes Asian again. The Asian consumer emerges.

Environmental

Deterioration and then improvement in the environment, underlining the need to invest. Increasing use of non-fossil fuels; alternative sources of energy explored.

Political

- US no longer the global cop, making the world politically more unruly.

- China becomes more democratic; power is decentralized; comes to terms with Taiwan.

Social

- Birth rate rises in China; intellectual talent moves to China; Chinese universities are full of Western students; top grad school is Qinghua University.
- Income gap narrows globally; Asians return home in reverse migration.

Structural Changes

- Regional corporations merge for economies of scale; regional HQs of MNCs flock to Shanghai;
- Chinese State Owned Enterprises (SOEs) are all privatized; increasing integration between China and Asia.

Technological

Most digital devices are invented in China, a leader in innovation and standards, with positive implications. Internet III invented in China; digital divides reduced.

Winners

Asian economies, especially Hong Kong; service industries, property owners, logistics; Chinese domestic airlines, language schools (English and Putonghua); New York real estate (because newly rich Chinese will be buying).

Losers

US IT companies, Europe (except as a tourist destination), manufacturers with excess capacity.

SCENARIO 3: “GLOBALIZATION UNWOUND”

Globalization Unwound

Scenario Headline & Five Whys

Headlines From This Future

2009: US Slashes China Imports, Beijing Denies Dumping; Stock Exchanges Collapse Globally
Asian Wall Street Journal

Five Whys

- Fed gets it wrong; US inflates
- China overheats (real estate- led) and tightens monetary policy
- Excess Chinese capacity in key industrial products; credit is overextended and NPLs keep piling up
- IMF tells China to devalue, the RMB collapses; there is blood in the streets
- Weak Beijing Government threatens Taiwan

CHINA FALTERS

US ECONOMY WEAK

China’s economy falters due to lack of sustained economic reform, especially the reform of SOEs and the banking sector. Simultaneously, the US economy weakens after the Presidential election, the result of weak job creation and twin deficits that lead to much higher interest rates. Huge imbalances arise.

IMPLICATIONS

Economic and Financial

Whole of SE Asia affected by excess supply in China; rising trade conflicts and protectionism; regional blocs develop. Rising non-performing loans (NPLs) and credit tightening impact the entire financial system.

Environmental

No resources to improve the environment.

Politics

- High unemployment leads to more government intervention, rising protectionism and nationalism; governments cut more bilateral trade deals, shutting out some nations (such as China) and blocs.
- Japan goes nuclear; India becomes a first-tier nuclear power. Fundamentalists take over the Middle East.

Social

Rising unemployment leads to social unrest and “return to the farm.”

Structural Changes

Increase in M&A; SOEs acquired by other Asian players, such as Indonesia.

Technological

China’s rush into key technology industries like flat-panel displays and semiconductors leads to massive overcapacity and collapsing prices. The US government imposes license controls on exports of leading-edge technologies to China; China attempts to develop its own technology standards (wireless and voice), thereby raising costs and incompatibility.

Winners

Cash-rich, flexible, dispersed companies that pick up distressed assets and are able to leverage strong IT infrastructure. Basic industries such as agriculture, food processing and health care do relatively well. Private equity firms that astutely time recycling of bad loans and distressed assets. Companies that take the long view and hire the best talent right now.

Countries with large domestic markets and strong governments; India does relatively well and surges ahead; Europe bloc could shine. Defense spending flourishes.

Losers

Those with highly leveraged balance sheets, real estate, shipping, most services, luxury goods. Export-oriented countries suffer; the Chinese banking system is in crisis.


SCENARIO 4: ASIA REFOCUSED

Asia Refocused
Scenario Headline & Five Whys


Headlines From This Future
2009: Citi buys 51% Controlling Interest in China Construction Bank
Financial Times

Five Whys

- Economic growth slows
- Pace of SOE reform is too sluggish
- NPLs rise
- Government unwilling to stomach the political risk of rising social unrest
- Other economies (India, Brazil, SEAsia) become more attractive for FDI



CHINA FALTERS



STRONG US RECOVERY

The US recovery continues, but Chinese growth falters. The Chinese government fails to make tough decisions on how to manage the country's economy. Foreign corporations, aware of the tremendous long-term potential of the country, continue to invest. The Chinese leadership, focusing on the weak banking and financial sector, comes to terms with the idea of major involvement by foreign financial institutions.

An underlying premise of "Asia Refocused" is that anti-American sentiment does not derail globalization. This is not a foregone conclusion. One key to the continuation of the globalization trend is whether the US will have the leadership to stay the course and to combat protectionism around the world – first by preaching through example. It is not far-fetched to imagine a scenario where the globalization process is slowed or reversed just when countries such as China and India are climbing aboard. Under all scenarios planned by the Council, global business can make an important contribution by wresting back the initiative from anti-globalization forces.

IMPLICATIONS

Economic and Financial

Global downward pressure on prices; US Dollar strengthens, little impact on RMB due to inconvertibility; tension over lack of IP protection in China; real estate values fall in Beijing, Shanghai; foreigners snap up discounted Chinese assets; commodity prices ease; insurance premiums rise for China business.

Environmental

Increased degradation; continued US pollution permitted.

Political

- Slowing economy slows pace of reform (need 8% growth to create 12 million jobs annually); priority becomes "social and political stability;"
- China increasingly inward-looking.

Social

Friction between urban/rural leads to social unrest rises in China and other parts of Asia;

- Brain drain of Chinese talent moving abroad;
- Possible rise of nationalism/militarism in China;
- Globalization=Americanization triggers more anti-American sentiment.

Winners

International banks with rich China experience, which can pick up distressed assets; export-oriented manufacturers in China.

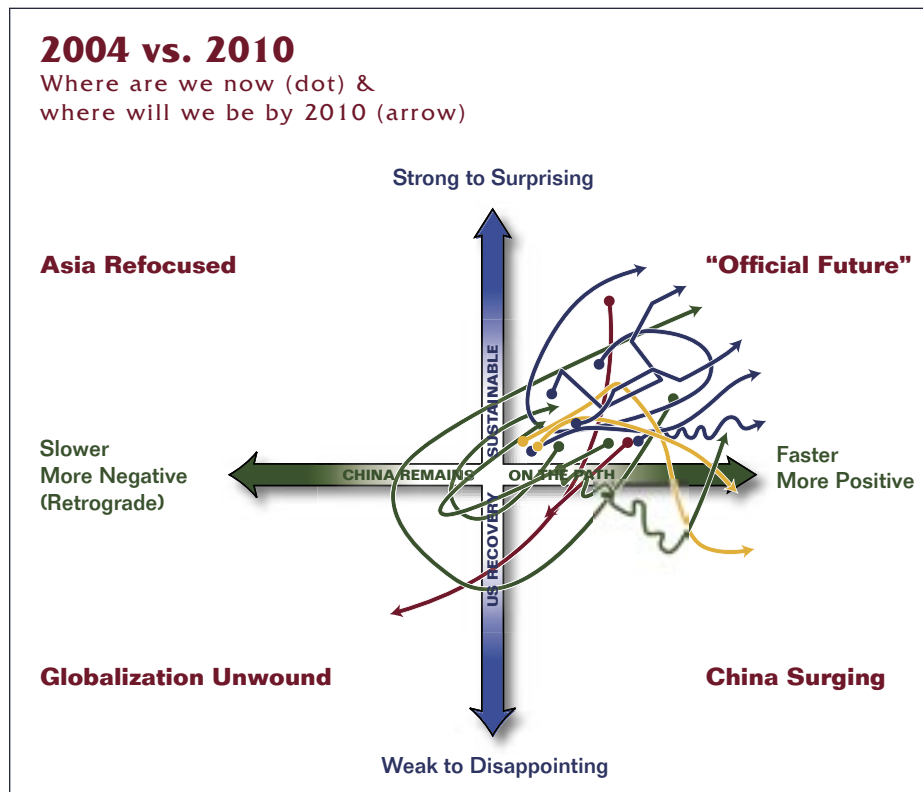
Losers

Japan would need to rethink its strategy in this scenario.

RETHINKING THE FUTURE

When asked to describe a trajectory for the Asian economy between now and 2010, a number of

Council members drew a path which passes through “Globalization Unwound” before returning to stronger and more positive growth. If this trajectory is realized, it will mean — at least in the downturn period — that agriculture, basics, and food processing are profitable, while real estate, luxury goods, services and shipping do less well. Also, this may be the one opportunity for Europe to truly recover and shine, as it would do well as a regional bloc in this world.



Technological

China attempts to set own standards; rising military investment in technology; Internet business negatively impacted; IT industries abroad do well.

IMPLICATIONS FOR THE FUTURE

A strong sense of inevitability about the rise of China and its growth — and the enormous impli-

cations of that dynamism — offset almost any reservations a chief executive might have. This view appears now to define the calculations and strategic outlook of business leaders in East Asia, forcing engagement in many dimensions of their businesses.

This was among the key conclusions to emerge in the scenario planning exercise conducted by the members of the Asia Business Council during their spring meeting in Hong Kong. Still, within this positive view of China's growth and its helpful impact on the region, the scenario planning process allowed for a more nuanced understanding of movement within the official future.

Strikingly enough, India — in each of the four scenarios that the discussions helped to crystallize — would also come out as a winner.

Other important overarching conclusions came to light in the Council's Forum discussions:

- Vertical disintegration and horizontal integration is accelerating across Asia, from the micro, divisional/enterprise level through to national and regional economic systems.
- The global center of gravity of economic activity is shifting toward Asia in ways that have tremendous implications for the strategies of MNCs.
- An overwhelming consensus exists among Council members that even if there could be reversals and bumps on the road with respect to China's growth and economic ascendancy, the upward trajectory over the next five to seven years is

inevitable. The perception is strikingly the same regarding the US.

- The over-arching picture of the future which emerges for Council members is one of "US-China global condominium" — at least when it comes to the economic and business future. The logic here is that these two engines combined with the global network cannot be derailed from their secular path.
- The winners in all scenarios are the "highly educated"; either at the individual level, or with respect to corporations that are able through the leveraging of knowledge and innovation to achieve and keep a leading edge. In the same way, the winners are the corporations that manage to be truly global, with a strong balance sheets enabling them to navigate through turbulences and sharp shocks — and benefit from the opportunities such volatility would create.

THE BEST ROLE FOR THE ASIA BUSINESS COUNCIL

The scenario-planning exercise ended with a fundamental question: Given our understanding of the challenges, uncertainties and promise of the region, how can the Asia Business Council best help both its members individually and the region as a whole?

The answers fall into two categories — bigger picture concerns and more specific business issues and challenges. The macro picture is that the tremendous power and possibility of a more unified Asian region has become increasingly clear. In order to facilitate improved regional understanding and strengthen cross-national relationships, the

Council must seek out and involve more members from Japan, China and the West. Discussions can take place about how to best realize the full potential of the region as a whole and how to work out historical differences.

There was also considerable interest in discussing the balance between church and state, especially vis-à-vis the influence of Islam throughout the region. Other issues included the impact of health, the outsourcing of talent, and the impact — such as on pension systems — created by demographic changes in the region.

Another important role of the Council regarding larger issues is to provide a forum and opportunity to identify whether there is a pan-Asian view on regional and international issues. For example, is there an Asian business voice that could and should be heard on sustainable development and the environment?

On more specific business issues, members expressed interest in strengthening Asian brands, management leadership and succession and diversity within the workplace.

The Council will continue to consult with membership about important issues as these emerge globally and in the region, and will structure programs and research accordingly.

ABOUT THE ASIA BUSINESS COUNCIL

The Asia Business Council is a not-for-profit group of CEO-level leaders with operations in Asia. We share a deep interest in the continued economic development and competitiveness of the region and are committed to the short, medium and long-term viability of Asia as an influential player within the global marketplace.

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