

Tracking global trends

How six key developments are shaping the business world

Introduction: the new math 2

1	<p>Emerging markets increase their global power</p> <p>Today, emerging markets serve as the world's economic growth engine, and the far-reaching effects of their spectacular rise continue to play out. But their risks are often downplayed. Therefore, taking advantage of emerging-market opportunities requires careful planning.</p>	4
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2	<p>Cleantech becomes a competitive advantage</p> <p>Governments and organizations are announcing plans to shrink their carbon footprints. The move to cleantech may represent a second industrial revolution that will have effects as great as the first.</p>	8
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3	<p>Global banking seeks recovery through transformation</p> <p>The global financial system remains in flux. The uncertain landscape poses both opportunities and risks for financial institutions, alternative asset managers and other enterprises that need funding to meet growth objectives.</p>	12
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4	<p>Governments enhance ties with the private sector</p> <p>The past year has been one of readjustment between developed and emerging economies, between the public and private sectors and between global institutions and nations. These adjustments will continue as governments, organizations and institutions define their roles in the post-crisis world.</p>	16
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5	<p>Rapid technology innovation creates a smart, mobile world</p> <p>Smart technology offers the promise of remote access to health care and education, while blurring boundaries between industries. The power of the individual will grow and new competitors will emerge, disrupting industries and creating new business models.</p>	20
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6	<p>Demographic shifts transform the global workforce</p> <p>Never before has demographic change happened so quickly. Global employers face the challenge that, despite a growing global population, they will soon have to recruit from a shrinking workforce due to an aging population.</p>	24
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Conclusion: winners and losers 28



The new math: six global trends, three key drivers

Last year's global trends report, *Business redefined*, reflected the impact of the financial crisis. In 2010, the global financial system remained fragile, but economies around the world began moving toward recovery. Some, especially those in emerging markets, hardly broke stride, continuing their rapid growth.

Tracking global trends looks at six broad, long-term developments that are shaping our world:

- 1. Emerging markets increase their global power**
- 2. Cleantech becomes a competitive advantage**
- 3. Global banking seeks recovery through transformation**
- 4. Governments enhance ties with the private sector**
- 5. Rapid technology innovation creates a smart, mobile world**
- 6. Demographic shifts transform the global workforce**

Global economies are so tightly interconnected that companies, governments and industries will soon be forced to cooperate in ways we could not have imagined just a few years ago. In fact, Ernst & Young believes the six trends are themselves connected by three underlying drivers that have helped establish each trend and perpetuate it.

- 1. Demographic shifts.** Population growth, increased urbanization, a widening divide between countries with youthful and quickly aging populations and a rapidly growing middle class are reshaping not only the business world, but also society as a whole.
- 2. Reshaped global power structure.** As the world recovers from the worst recession in decades, the rise of relationships between the public and private sectors has shifted the balance of global power faster than most could have imagined just a few years ago.
- 3. Disruptive innovation.** Innovations in technology continue to have massive effects on business and society. We're now seeing emerging markets become hotbeds of innovation, especially in efforts to reach the growing middle class and low-income consumers around the globe.

As you read this report, you will notice the complexity of the interlocking systems that shape today's economic and social environments. Faced with such complexity, you may be tempted to watch passively as the trends unfold and wait for a clear picture to emerge. Unfortunately, by the time the picture snaps into focus, it may be too late to capture the most valuable opportunities.



Six global trends, interconnected by three key drivers of change

Often, overwhelming complexity can be tamed by asking a series of simple questions: What are the main opportunities that exist for our organization? What are the threats? What can we do that is new – or, conversely, what have we always done that we should stop doing? And above all, when is the best time for action?

The very act of posing these questions can help clarify the way forward. That's why we've included "Key questions for global companies" for each trend. These questions, and in fact this entire report, are meant to be used as a guide – one that sharpens the focus on issues that are most important to your organization and frames your perspective in a way that helps organize the complexity of today's world.

We also encourage you to read our complementary report, *Winning in a polycentric world*, based on a global survey of senior executives that we conducted along with the Economist Intelligence Unit. Our findings reveal that never before have opportunities – and competition – been so evenly distributed around the globe. Companies must now operate in a "polycentric" world in which there are various spheres of influence in both developed and emerging markets. Responding to this world requires fresh thinking and fresh strategies. We hope these reports help you achieve those goals. ▲

Emerging markets increase their global power

As the greatest hope for growth in the global economy for the past two years, the emerging markets have become the darlings of the financial press and a favorite talking point of C-suite executives worldwide.

Once attractive only for their natural resources or as a source of cheap labor and low-cost manufacturing, emerging markets are now seen as promising markets in their own right. Rapid population growth, sustained economic development and a growing middle class are making many companies look at emerging markets in a whole new way.

As the emerging markets rise, so do their companies. Many companies that had previously posed no competitive threat to multinational corporations now do so. These emerging market leaders represent a major shift in the global competitive landscape – a trend that will only strengthen as they grow in size, establish dominance and seek new opportunities beyond their traditional domestic and near-shore markets.

In particular, we see the following trends ahead:

Leading emerging markets will continue to drive global growth

Estimates show that 70% of world growth over the next few years will come from emerging markets, with China and India accounting for 40% of that growth. Adjusted for variations in purchasing power parity, the ascent of emerging markets is even more impressive: the International Monetary Fund (IMF) forecasts that the total GDP of emerging markets could overtake that of the developed economies as early as 2014.

The forecasts suggest that investors will continue to invest in emerging markets for some time to come. The emerging markets already attract almost 50% of foreign direct investment (FDI) global inflows and account for 25% of FDI outflows. The brightest spots for FDI continue to be Africa, the Middle East, and Brazil, Russia, India and China (the BRICs), with Asian markets of particular interest at the moment. By 2020, the BRICs are expected to account for nearly 50% of all global GDP growth. Securing a strong base in these countries will be critical for investors seeking growth beyond them.

Emerging market leaders will become a disruptive force in the global competitive landscape

As emerging market countries gain in stature, new companies are taking center stage. The rise of these emerging market leaders will constitute one of the fastest-growing global trends of this decade. These emerging market companies will continue to be critical competitors in their home markets while increasingly making outbound investments into other emerging and developed economies.

Working to serve customers of limited means, the emerging market leaders often produce innovative designs that reduce manufacturing costs and sometimes disrupt entire industries. A case in point: India's Tata Motors' US\$2,900 Nano, priced at less than half the cost of any other car on the market worldwide. A version is set to go on sale in Europe this year.

Many emerging market leaders have grown up in markets with "institutional voids," where support systems such as retail distribution channels, reliable transportation and telecommunications systems and adequate water supply simply don't exist. As a result, these companies possess a more innovative, entrepreneurial culture and have developed greater flexibility to meet the demands of their local and "bottom-of-the-pyramid" customers.



Key questions for global companies

- ▶ How are you balancing the need to focus on the BRICs against the investment required in the “next tier” of emerging markets, such as Indonesia and Thailand? Do you want to lead in this next tier, or do you want to follow?
- ▶ If your company is based in an emerging market, how do you plan to compete with Fortune Global 500 players that are also targeting these markets?
- ▶ Do you have the right talent, cultural understanding, age profile, experience and skills to create credibility and relationships with critical stakeholders (e.g., regulators, company officials, key business leaders) in your most important emerging markets?
- ▶ Economic development is distributed unevenly in most emerging markets. Does your emerging market strategy differentiate between first-tier and second-tier cities? Do your product lines fit their distinctive profiles?

Of course, emerging market leaders entering the global arena will have to grasp the rules of globalization and all the complexities it can bring to operations and investment. This is creating a new opportunity for East-West and South-North deals, as emerging market leaders buy up Western competitors whose management expertise, access to clients, branding and inroads into technology can help smooth their entry into the developed world.

Rising population and prosperity drive new consumer growth and urbanization

Between now and 2050, the world's population is expected to grow by 2.3 billion people, eventually reaching 9.1 billion. The combined purchasing power of the global middle classes is estimated to more than double by 2030 to US\$56 trillion. Over 80% of this demand will come from Asia.

Most of the world's new middle class will live in the emerging world, and almost all will live in cities, often in smaller cities not yet built. This surge of urbanization will stimulate business but put huge strains on infrastructure. Physical infrastructure, such as water supply, sanitation and electricity systems, and soft infrastructure, such as recruitment agencies and intermediaries to deal with customer credit checks, will need to be built or upgraded to cope with the growing urban middle class. Addressing such concerns in Asia alone will require an estimated US\$7.5 trillion in investments by 2020. Meeting these needs will likely entail public-private partnerships, new approaches to equity funding and the development of capital markets.

Emerging markets will become the new battleground

The BRICs are having a major impact on their regional trading partners and more distant, resource-rich countries, an increasing number of which are being pulled into their economic orbit. In 2009,

emerging-to-emerging (E2E) trade reached US\$2.9 trillion. This massive flow of investment among emerging markets is well on its way to creating a second tier of emerging market leaders.

As pressure for resources increases, we expect a battle for first-mover advantage among emerging heroes, global players and emerging market governments in regions such as the Middle East and Africa. In Nigeria, for example, the Chinese Government is helping to establish two special economic zones. China will invest US\$500 million in the zones, which will focus on manufacturing machines and mineral extraction. China is also involved in similar programs in Ethiopia and Egypt.

Global influence grows

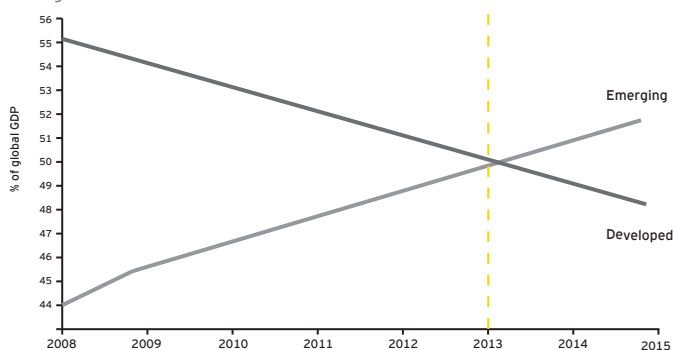
Inevitably, the BRICs' growing economic strength is leading to greater power to influence world economic policy.

In October 2010, for example, emerging economies gained a greater voice under a landmark agreement that gave 6% of voting shares in the IMF to dynamic emerging countries such as China. Under the agreement, China will become the IMF's third-biggest member.

Of course, it would be a mistake to see economic growth in the emerging markets as a winner-take-all contest, with developed countries on the losing side. Billions of new middle-class consumers in the emerging markets represent new markets for developed-world exports and companies based in developed countries. Emerging market corporations are another big new market: business-to-business sales to China and India, for example, are a key factor in Germany's strong export economy. ▲

Emerging and developed markets' share of global GDP

According to the IMF, by 2014 emerging markets will have overtaken developed economies in terms of share of global GDP.



Source: World Economic Outlook Database, International Monetary Fund, October 2010.

“To win in emerging markets, companies will have to reinvent themselves. Emerging markets will be not only a source of significant revenue growth for companies but also a source of talent, true innovation and ground-breaking approaches to business, which they will leverage on a global scale.”

– Emmanuelle Roman, Global Consumer Products Markets Leader



Howard Martin
Global Consumer Products Sector Leader

Capturing a billion new consumers

To win in emerging markets, companies will have to reinvent themselves

One billion people will enter the middle class by 2020, and 66% of them will live in emerging markets. Their spending power creates a huge commercial opportunity. To capture it, companies must rethink their business models; re-evaluate their approach to marketing strategy, R&D, branding and other core business functions; and focus carefully on getting it right.

Brand positioning

What are considered premium products in a developed economy may be viewed as luxury items in an emerging one. Tumi, for example, is known primarily for making luggage. But in China, it is positioning itself more broadly as a luxury brand for people on the move. Companies may benefit from repositioning some of the products they sell in the emerging markets, but must do so carefully to avoid eroding brand equity.

Urbanization and "city strategies"

The emerging middle class will live mainly in cities, many of which have unique market attributes. Instead of a "China strategy" or an "India strategy," companies will begin formulating strategies for particular cities, or for city clusters. They'll also extend their selling efforts beyond the first-tier locations that have absorbed multinationals' focus to date (the "megacities"), and begin tapping the profit potential of second- and third-tier cities, which are growing in importance.

Pricing

In many emerging markets, spending power is rising but still low by developed-world standards. In those locations, multinationals are competing on price in ways that will force them to innovate. Western companies traditionally have approached pricing by establishing their production costs and then adding a margin. In emerging markets, they start with the price consumers can afford to pay and work backward from there. This approach spurs innovation that drives down production costs in those markets.

Local competition

Emerging economies are characterized by fierce competition, not only from global players but from local ones. Home-grown businesses tend to deeply understand local consumer preferences. They enjoy additional advantages such as strong distribution capabilities, superior government relations, lower-cost business

models or a combination of all three. Smart, cost-efficient, well-connected local businesses can often get products to market faster, and at more affordable prices – an advantage that should not be underestimated.

Distribution

This is the name of the game in emerging markets. With modern retail underdeveloped and infrastructure poor, simply getting the product to consumers presents a major challenge. Some companies are responding creatively: Nestlé, for example, has converted a barge into a floating supermarket that can reach Brazilians living along remote tributaries of the Amazon. Successful companies will rethink and, when necessary, reconfigure their approach to supply chain management.

Emerging markets present a massive opportunity, but companies need strategic clarity in order to capitalize on it. This may require them to overhaul and perhaps reinvent certain basic functions, products or processes. Otherwise, 10 years from now they may look back at their investments in emerging markets and wonder what those expenditures really accomplished. ▲



For Ernst & Young's latest insights on the emerging markets, read *Growing in Africa: capturing the opportunity for global consumer products businesses*.



Key questions for global companies

- ▶ The global transformation to a more resource-efficient and low-carbon economy brings opportunities and risks for almost all industries. Is your business aware of – and actively monitoring – the far-reaching effects this transformation is likely to have?
 - ▶ Do you understand your competitors' cleantech-related strategies and are you equipped to compete with them?
 - ▶ Is your cleantech-related strategy optimized for both operational efficiency and revenue growth, and does it maximize the opportunities in both mature and emerging markets?
 - ▶ Energy challenges and the growing need to diversify the energy mix mean that many supply chains will require reconfiguration, with an emphasis on greater flexibility. Is your company ready to make this effort?
 - ▶ Are you prepared for the possibility of mandatory sustainability reporting?
-

Cleantech becomes a competitive advantage

The cleantech-enabled transformation to a low-carbon, resource-efficient economy may be the next industrial revolution. As this transformation accelerates, global corporations are increasingly realizing that they must understand the impact of cleantech on their industries and develop strategic plans to adapt to this change. *Going big: the rising influence of corporations on cleantech growth*, Ernst & Young's 2010 global survey of corporations with more than US\$1 billion in revenue, showed that cleantech is an organization-wide or business-unit-level initiative for 89% of respondents; 33% spend 3% or more of total revenues on cleantech, and 75% expect cleantech spending to increase over the next five years.

Governments also view cleantech as a national strategic platform for creating jobs, fostering innovation and establishing local industries. According to Bloomberg New Energy Finance, investment in cleantech surged 30% in 2010 over the previous year to US\$243 billion, double the amount recorded in 2006 and nearly five times that of 2004. But this is not enough. There is still a large gap between the capital required and the capital available to fuel the transition to a low-carbon economy. Primary energy demand is expected to grow by 36% worldwide between 2019 and 2035, with the bulk of that new energy use (93%) coming from emerging markets. By 2035, China alone will see its energy needs rise by 75%, according to the International Energy Agency (IEA) report, *World Energy Outlook 2010*. In the coming years, surging demand, energy prices, energy security concerns and scarcity of natural resources will encourage governments and companies to work harder to diversify their energy portfolio mix and to continue investments in clean energy innovation, deployment and adoption.

This inevitable move to a low-carbon, resource-efficient economy presents an opportunity to stake out and capture a strategic competitive position – not just for governments, but also for innovators, investors and corporations, too.

Looking ahead, we see a number of important changes:

The energy mix evolves

Renewable energy is still expensive in most places, which will limit its use in the short run. But as wind, solar and other renewable projects scale up, their prices will continue to fall. The IEA predicts that power generation using renewables will triple between 2010 and 2035. Fossil fuels such as oil and coal will lose market share over time, as natural gas and nuclear power contribute to the diversified energy mix. There has been a surge in construction of nuclear power reactors worldwide. Natural gas, a cleaner-burning fossil fuel, is expected to grow more important, serving as a bridge to a renewables-based economy.

Historically, corporations got their energy from a few select traditional sources, but today the energy supply options vary. For example, companies can have a renewable energy project onsite or offsite or procure it from a third party, and their corporate fleet can run on fuel, gas, electricity and (or) biofuels. Companies can also deploy sophisticated energy efficiency options, measure consumption in better ways, sell energy back to the local utility and use their waste to produce energy, as well as measure their carbon footprint and report it.

Clean energy is a national competitive advantage

Many governments are aggressively implementing clean energy policies, setting emissions targets and providing incentives for cleantech investing. China, Germany, India and Brazil are gaining leadership positions in solar, wind and biofuels. The US remains a cleantech leader because of its entrepreneurial culture and vibrant venture capital environment. Policy-makers are betting that cleantech investments will yield other benefits such as job creation and innovation-led economic growth. Notably, private investment is flowing to countries with comprehensive, clear and long-term energy policies aimed at incentivizing renewable energy use, promoting efficiency and reducing carbon emissions. New technologies are also being developed to capture, store and use spent carbon productively.

Companies make cleantech a strategic priority

Sensing commercial opportunity, companies increasingly are building cleantech into their growth strategies. Many are also “greening” their existing products in response to increasing consumer demand. Others are moving into growth areas that fall outside their traditional lines of business, hoping to achieve first-mover advantage as the landscape evolves. For example, Google and Cisco have both entered the home energy management space. In the past year, corporate activity in the cleantech marketplace has significantly increased through direct investments, partnerships and acquisitions of newly formed cleantech companies. This search for cleaner products will break apart many traditional industries. For example, the way that low-carbon and electric vehicles (EVs) are bought, sold, distributed and maintained could transform the utilities and automotive sectors. The global EV market is gearing up for large-scale EV manufacturing, and governments are setting needed EV standards. But questions remain as to who will “own” the customer – automakers, utilities or emerging integrators – and who will manage the data flows across the various entities.

Governments and companies move to secure valuable raw materials and to ensure energy security

Raw materials are strategic assets, especially in a time of scarcity. To secure them, some governments have turned outward. China, for example, is now deeply invested in Africa. One recent, typical deal: two state-owned Chinese companies received cobalt and copper concessions in the Democratic Republic of Congo in exchange for upgrading that country’s infrastructure. In 2009, the value of Chinese investment reached US\$17 billion, or 22% of all global mining M&A activity and 30% of the top 10 deals. At the same time, countries are becoming more protective of their natural resource supplies.

Companies, meanwhile, are reconfiguring supply chains, seeking greater flexibility in an effort to mitigate the impact of raw materials shortages, higher commodity costs and price volatility. Some businesses are protecting their supply chains by acquiring their raw material suppliers. Steelmakers, for example, have recently bought several iron ore and coal mines in different countries to guard against supply chain disruptions. The anticipated growth in energy demand, mainly in emerging markets, has forced governments to focus on long-term energy security and take actions such as diversification of the energy generation mix, investments in cleantech, encouragement of energy efficiency and acquisitions of energy sources overseas.

Organizations become more transparent about their sustainability practices

As concerns about resource scarcity, including energy and water, become more pressing, companies will face increasing pressure from their stakeholders to demonstrate that their businesses are sustainable. Companies will also have to disclose the social and environmental impact of their business activities. Although most sustainability reporting is currently voluntary, the broad trend is toward greater disclosure. More than 3,000 companies worldwide issue such reports, following such voluntary guidelines as the AA1000 AccountAbility Principles Standard and the Global Reporting Initiative Reporting Framework. These voluntary guidelines may soon become mandatory. ▲



Michael S. Hanley
Global Automotive Sector Leader

Beyond electric vehicles

To invest in the right clean technologies, companies in the auto industry will need to stay flexible

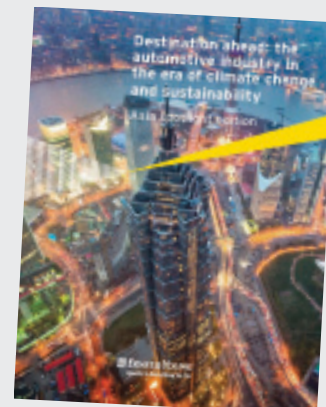
The automotive industry has made tremendous strides toward developing “advanced powertrain” systems – clean alternatives to the internal combustion engine that will power the next generation of cars and other vehicles. To date, EVs have captured the spotlight, and certainly they are important. But the terrain could shift abruptly, leading to rapid development of power systems based on fuel cells, compressed natural gas and a variety of other power sources.

With the stakes so high, companies cannot afford to under-invest in this area. But as any smart investor knows, it’s wise to diversify. Companies must stay flexible and adaptive across all of the next-generation powertrain alternatives and transition fuels, including natural gas, diesel and eventually fuel cells. By remaining flexible, businesses will be more able to anticipate changes in consumer preference, and to invest in the right technologies. For many companies, the real opportunities may lie in improving the fuel efficiency of the internal combustion engine. There are still many improvements to be made, and they could significantly affect the acceptability of the EV. Meanwhile, many companies are investing heavily in EVs and fighting hard to establish leadership in that sphere. Those that succeed will be those that get an accurate read on the tastes of early adopters, whose feedback ultimately will determine the size of the market.

And vehicles are only one part of the cleantech picture. Companies should be thinking hard about how they can operate their businesses in a sustainable way. Sustainability spans all areas of the business: R&D; manufacturing and assembly; sales and distribution; marketing; maintenance; and aftermarket services such as disposal. Cleantech is a broad term that refers not just to the end product, but to the operations and processes used to make it. Companies that re-engineer their facilities to use water, electricity and other resources more efficiently will save money and enjoy quicker payback on their cleantech investments. ▲



EVs are one of the most promising technologies for the dawning low-carbon economy. To get perspectives on this issue from Silicon Valley, Shanghai and Munich, please see *The electrification of transportation: from vision to reality*, part of our *Cleantech matters* series.



Additional perspectives on the auto industry’s response to climate change are available in the Asia spotlight edition of our paper, *Destination ahead: the automotive industry in the era of climate change and sustainability*.



Key questions for global companies

- ▶ Have you developed a growth strategy that synchronizes with changes you're making to your business models and geographic footprint?
 - ▶ Have you evaluated the impact of regulation on your capital requirements and determined how to manage them while getting the best possible returns?
 - ▶ Have you taken steps to ensure that you improve your data infrastructure so it is capable of producing consistent management, risk, regulatory and financial reports?
 - ▶ Are you assessing the impact of regulation on business models and reporting and disclosure needs? Are you providing valuable input to officials to help shape regulation?
-

Global banking seeks recovery through transformation

Three years after the financial crisis began, the global financial system remains in flux. Regulatory clarity is nearing, but many issues remain unresolved.

Initiatives of the G20, the Basel III global banking standards and the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) in the US have begun to bring some aspects of the new rules into focus.

While regulators have focused mostly on the systemic risk posed by some of the largest and most interconnected institutions, banks are concerned with their ability to compete and the resulting regulatory impact on returns.

The final shape of the global regulatory framework is still unclear, but it seems clear that international banking will change in fundamental ways, including:

- ▶ Limits on executive pay
- ▶ Heightened corporate governance
- ▶ Strengthened consumer protection
- ▶ More regulation and transparency of the over-the-counter (OTC) derivatives
- ▶ Restrictions on proprietary trading and investments in hedge funds and private equity (PE) funds in the US

More specifically, we believe:

Emerging market financial institutions are gaining global stature

In the developed world, many financial institutions continue to recover from the financial crisis, and, in many cases, emerging market banks are in better shape. Many rose from the crisis with hardly a scratch. While the traditional top two international financial centers – New York and London – remain secure in their status, capitals of finance in Asia are rising in the rankings. In The Global Financial Centres Index's September 2010 ranking, Hong Kong rose to third position, while Singapore was fourth. It is growing increasingly apparent that the banking sectors and institutions of emerging markets – particularly those of China, India and Brazil – will make a strong move toward increasing their presence on the global scene.

As 2011 unfolds, emerging market banks are well positioned to continue to benefit from strong credit growth in their local economies. Their focus on the traditional retail and commercial banking business, combined, in some cases, with government-mandated lending targets, has fueled the rapid rise of emerging market banking institutions in their local markets. However, traditional banking is capital-intensive and emerging market institutions are now looking for options to diversify into other businesses. While many emerging market banks have the scale to consider expanding into other emerging or developed markets, there remain a number of barriers to entry, including the lack, in many cases, of robust investment banking capabilities.

Demand for bank credit has been strong in emerging markets in the post-financial crisis period, as certain governments have set lending targets to stimulate economic growth. While there are no guarantees that state policies will continue to drive lending, a number of factors point to significant opportunities for banks in emerging markets. A significant pool of unbanked or underserved consumers exists in emerging markets. In addition, with GDP per capita in emerging markets expected to increase considerably, it is likely that demand for better and more efficient financial services will increase.

G20 initiatives, as well as the Dodd-Frank Act, will require increased regulatory oversight

In the US, the Dodd-Frank Act mandates that OTC derivatives, for example, be regulated by the SEC and the Commodity Futures Trading Commission (CFTC). Similar rules are also expected in the EU and the UK. At the same time, new consumer financial protection agencies have been created and proposals to strengthen consumer protection authorities have been proposed.

New rules limiting executive compensation are a major regulatory focus affecting the sector. The goal is to ensure that excessive risk-taking is not rewarded. These measures include an agreement to lower 2010's aggregate bank bonuses in the UK from the previous year, increase transparency, and reduce clawbacks and deferred shares subject to vesting periods.

Regulation will drive up the cost of business for many large financial institutions

The substance of the new rules creates challenges. For instance, Basel III requires banks to boost capital and liquidity levels, implement a leverage ratio, increase risk coverage for certain assets and activities and raise standards for supervisory review. In the US, the Dodd-Frank Act is more than 2,300 pages long and will require agencies to write 353 new rules and conduct 68 studies.

Not surprisingly, large financial institutions cite regulatory uncertainty as the biggest challenge they face. Their uncertainty is compounded by the fragmentation of regulations, as individual countries set out to make their own rules. Banks, which have already spent the past two years deleveraging and building capital and liquidity, now face the probability that their cost of doing business will continue to rise, margins will shrink, return on equity will decline and the pace of innovation may slow.

Financial services will realign

As a result of the enhanced regulatory environment and the higher costs of doing business, large financial institutions will likely need to modify their business models. Morgan Stanley Research recently estimated that the top 12 wholesale banks will sell off, reduce or shut down about US\$1.3 trillion of their risk-weighted assets under Basel III. Banks will look to emerging markets for growth opportunities, but their success will very much depend on their ability to build critical mass and successful operations in these economies.

Alternative asset managers may be positioned to benefit from realignment of the financial services industry

As commercial and investment banks are compelled to scale back their businesses, alternative asset managers, including PE firms and hedge funds, are positioned to benefit. Complex products will not disappear; instead, they may simply move to less-regulated segments of the industry.

Alternative asset organizations are moving into both the investment banking and proprietary trading spaces. Entire trading and banking teams have moved into the alternative funds areas. We expect this trend to continue. Increasingly, innovation in the capital markets may originate in this space. ▲



William Schlich
Global Banking & Capital
Markets Sector Leader

Four burning issues redefine the banking world

Today's banking and other financial institutions are focused keenly on four main areas: growth, capital, data and regulatory issues. This is true for all financial institutions, large and small.

1. Growth, a perennial concern, has become even more important. Where is it occurring now, and where will it come from in the future? One answer is the emerging markets, especially Asia-Pacific and Latin America, which are critical to financial services companies worldwide. Banks have to establish and maintain successful operations in these regions. Existing customers are another source of growth. Banks must know who their customers are, how to communicate with them and how to cross-sell to them. Some customers want high-tech services – “mobile money” – while others want relationship banking that may be low tech. Issues related to growth are forcing banks to ask the critical questions, “What businesses should we be in? In which geographies?”

2. Capital, how to raise it and manage it effectively, is another key concern. Banks are thinking about where capital is moving and where investment is taking place around the world. They're also considering their own internal capital needs. With new regulatory changes they need to hold more capital. Where should they put it? How might new capital requirements determine which countries they should operate in? How can banks manage capital to get the best possible return? These are some of the questions banks are asking now.

3. Data is another big issue, and banks are budgeting large sums to achieve improvements in this area. In this context, data includes management, risk, regulatory and financial reporting. The trick is making sure that the information used in all reporting can be reconciled. Ideally, banks want to generate reporting from a single source of data. Systemically important financial organizations, such as large banks or insurers, need to be able to supply regulators with real-time, transaction-level data, but most struggle to do so today. Some have dozens of different ledgers using systems that may not communicate well with each other. A single source of clean data is imperative to provide management the information it needs to effectively run the business and respond to all regulatory requirements.

4. Regulatory issues are also in the forefront as governments worldwide are changing how they regulate financial institutions:

Systemic risk analysis and focus on market stability. The financial crisis has led regulators to focus on identifying systemically important financial organizations. In the past, all large banks have been highly regulated; in the future, insurance companies, hedge funds and securities exchanges may be as well. Much effort is going into determining which institutions are systemically important and how to regulate them.

Enhanced prudential supervision of systemically important organizations. Capital, liquidity and solvency requirements are tightening. Resolution and recovery plans (i.e., living wills) have now been mandated by multiple regulatory authorities. In addition, more rigorous scenario planning and stress testing are becoming widespread. As a consequence, the ability to provide real-time information has taken on even more importance.

Greater transparency and disclosure. Regulations aimed at stabilizing financial markets will restrict financial services companies in new ways. For example, OTC derivatives trading will move onto exchanges, and in the US, banks will be prohibited from engaging in proprietary trading. There is also new legislation aimed at protecting consumers through greater disclosure and transparency.

The transformation of the world's financial landscape in the years ahead will be significantly influenced by changes in the above areas. ▲



To manage these forces of change, banks and other financial institutions will need to adapt their strategies and the technologies they use. You can read more about how they'll adjust to the new realities in *Bank Governance Leadership Network: ViewPoints*, November 2010, published by Ernst & Young and Tapestry Networks.

Governments enhance ties with the private sector

The global recession left many developed countries with falling tax revenues and rising expenses. Key emerging market countries did not experience the disruptions caused by the financial crisis, but they face the need to develop infrastructure, educational institutions and social safety nets for their fast-growing middle classes.

To meet those needs, governments of both mature and developing countries have three priorities: to strengthen their finances; to deliver their services more efficiently, effectively and economically; and to make sure that the private sector grows in an economically sustainable manner and ensures better employment.

To achieve those goals, many governments are trying to further their national interests through diverse vehicles and activities, including state-owned corporations, sovereign wealth funds (SWFs), industrial planning and regulation.

The challenges are serious enough that we see governments taking an extremely active role in the economy.

Looking ahead, we believe governments will increasingly take the lead in five key areas:

Developed countries rebalance their finances

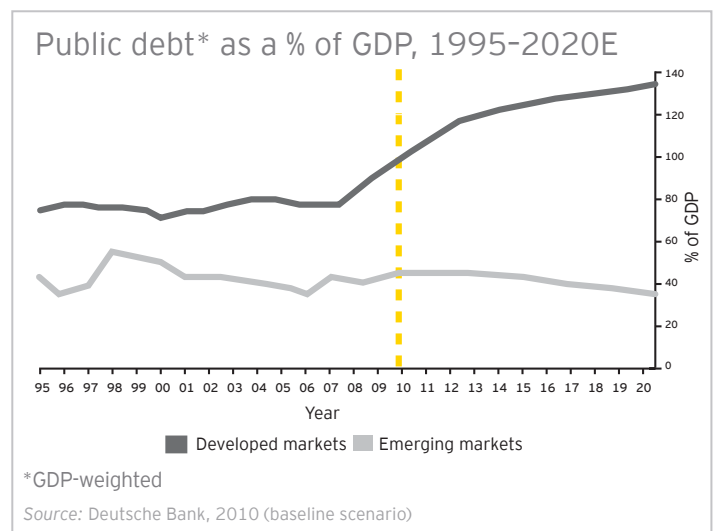
After several years of rising debt-to-GDP ratios, most developed countries are now struggling to put their finances in order.

From 2006 through 2009, the overall developed country market debt-to-GDP ratio rose from less than 80% to 95%. In 2011, the debt ratio is expected to break the 100% mark. Deutsche Bank projects that the debt-to-GDP ratio for developed countries will reach 133% of GDP by 2020.

Alarmed by these numbers, developed economies at the G20 Summit in Toronto in June 2010 committed themselves to reducing their deficits by 2013, and to stabilizing or reducing government debt-to-GDP ratios by 2016.

Deficit-reduction plans differ by country. Among the largest developed high-deficit countries, the first preference is to make spending cuts. Roughly 75% of deficit reduction in European countries is projected to be achieved through expenditure reduction.

Governments are also focused on trimming workforce numbers and salaries. The US, France, Italy and Greece are deferring pensions, while Spain and Greece are freezing payments. The US, Australia, Portugal, Spain and Italy have all announced measures aimed at reducing health care expenditures.





Key questions for global companies

- ▶ If you already supply goods and services to governments, do you have ideas about how to expand your relationships and provide more value?
 - ▶ Significant government investments are needed in pensions, social security systems, infrastructure and education. In many cases, this requires greater funding from the private sector, driving possible public-private partnership opportunities and other creative funding deals. Have you identified opportunities in this space?
 - ▶ Is your long-term strategy aligned with government investments, pensions, social security systems, infrastructure and education?
 - ▶ Are you positioned to meet government green-purchasing requirements?
-

Spending cuts on this scale will be challenging to deliver, and significant groups in society will assuredly lose out. Reaching consensus will be difficult and governments should expect friction.

Emerging markets countries expand their social benefits

Emerging markets countries with a surplus need to boost social spending on pensions, health care and infrastructure.

In some markets, a stronger safety net is intended to promote economic growth. Most Chinese, for example, essentially insure themselves through extraordinarily high household savings rates. To strengthen its consumer economy, China must first convince consumers that it is safe for them to spend.

Emerging market countries also need to improve the effectiveness of their tax administration, and to invest in infrastructure, telecommunications, transportation, education and housing. Public-private partnerships (PPPs) are likely to become important investment vehicles in these markets.

Aging populations and immigration inflows pose new spending challenges

By 2040, Japan, Germany and Italy will have some of the oldest populations on the planet. Brazil and Mexico will have populations nearly as old as those in the US, and China's elderly will be even older than the average elderly American.

Meeting the needs of people who are living longer, healthier lives will have a tremendous financial impact. Standard & Poor's reports that the median age-related public spending for developed economies (including health care, pensions, long-term care and unemployment) is expected to rise from 17% of GDP in 2010 to 27% in 2050, versus 11% to 17% for emerging market countries. Median public spending on age-related health care in developed economies is expected to grow from 6% of GDP in 2010 to 11% in 2050, versus 4% to 11% of GDP for emerging market economies.

Increased immigration flows are also expected to put upward pressure on future government spending. Between 2003 and 2009, over 60% of population growth in Organisation for Economic Co-operation and Development (OECD) nations was accounted for by migration, some of which was spurred by the recession. Higher levels of cross-border migration can supply an aging economy with younger workers, but they also create a greater need for public infrastructure in housing, public education and security.

Governments direct their economies

Against the backdrop of uneven economic recovery around the globe, governments continue to be active in economic life. An enormous amount of wealth remains concentrated under state control in the form of SWFs. Although SWF assets fell in value after

the recession, they are set to grow again. The total assets of SWFs are expected to climb from roughly US\$3.5 trillion in 2010 to US\$8 trillion by 2015, making SWFs powerful sources of capital for years to come.

State-owned enterprises (SOEs) will remain important to defending strategic industries and guaranteeing the adequacy of critical infrastructure in some countries. SOEs are becoming larger and more globally competitive. Sixty-two percent of Indian companies on the 2010 Fortune Global 500 list are SOEs. Forty-six Chinese SOEs (excluding Taiwan-based companies) are on the 2010 list, up from 34 in 2009. Three of China's state-owned energy giants are now in the top 10.

In this era, however, state-owned doesn't necessarily mean sleepy and inefficient. Think instead of a fast-growing company backed by an investor with very deep pockets. SOEs are increasingly acquisitive, while their improved stability and transparency are increasingly attractive to employees and investors.

Governments balance global cooperation with pursuit of their national interests

Greater globalization necessitates a new agenda for international economic cooperation, but at the same time, diverging domestic needs are creating conflict. The G20 agree in principle that global rebalancing is desirable to create long-term economic growth and financial stability. Developed economies have to save more and spend less to get their financial houses in order. Key emerging markets need to reduce their reliance on exports and stimulate domestic demand. Meanwhile, the need for faster economic growth is fueling new rounds of trade protectionism and stimulus plans.

Trade and currency issues were high on the agenda at the G20 Summit in Seoul in November 2010. Debate centered on varying perceptions of China's valuation of its currency to drive exports, as well as quantitative easing in the US and its potential to increase capital inflows to emerging countries and fuel asset bubbles. Despite fragmented views, the G20 Seoul declaration managed to reaffirm the notion of working together, with a focus on moving toward more market-determined exchange rate systems, refraining from competitive devaluation of currencies and pursuing a full range of policies conducive to reducing excessive imbalances.

Diverging speeds of economic recovery have caused some level of fragmentation among the world's leading countries. In particular, the need for faster economic growth at home is fueling new rounds of trade protectionism and stimulus plans that can hurt trading partners. But in the long run, the growing interconnectedness of nations and their economies should drive greater levels of global cooperation and coordination, despite the bumps along the way. ▲



Philippe Peuch-Lestrade
Global Government & Public
Sector Leader

Public-private synergy: making the best of both worlds

Around the world, citizens are demanding that governments manage their tax revenue with efficiency and thrift. Some government leaders have come to believe that a greater reliance on the private sector is the remedy for inefficiency in the public sphere. Others support sticking with the status quo, pointing to boom-and-bust cycles and other evidence of private sector recklessness. Neither option is satisfactory. We believe it is necessary to transcend this conflict by combining the best of both worlds. One possible route is a public-private synergy. This concept of synergy implies more than a PPP, which often connotes a procurement option for public infrastructure projects. When working in synergy, the government entity contracts with a private supplier to deliver specified services, such as transportation or water, under highly regulated conditions.

Separating the executive function from the operational entity improves governance and operational outcomes by letting each sector play to its strengths. The operational dynamism and efficiency of the private sector is combined with the steadiness and social focus of the government. Roles are clearly divided: strategic decision-making, executive control and pricing are government functions, while operations and service delivery are handled by the private contractor. The government retains final responsibility, acting as a controlling shareholder, similar to a holding company, that monitors the performance of businesses entrusted with delivery of particular services.

Such structures have already been adopted by many countries and are likely to become even more common in the future. As governments labor under fiscally difficult conditions to deliver the services that citizens demand, carefully governed public-private synergies increasingly will have the potential to resolve tough political and economic problems, both in emerging and developed countries.

For example, in emerging markets, public-private synergies bring in advanced expertise without risking a governmental loss of control over how the technology is used. At the same time, the fact that operations are executed by a profit-driven private entity circumvents the issues that might arise from possible government inefficiencies.

In more advanced countries, public-private synergies can help assuage concerns about stability and continuity in a changing world. Concerns about economic, environmental and social stability have made the public more receptive to an ongoing government role in certain strategic services and industries. Public-private synergy

approaches combine the public sector's dedication to meeting citizens' requirements with the cost and performance advantages of the private sector. After the massive bailouts of the past few years, many taxpayers are wary of entrusting vital infrastructure or other functions to the private sector. Indeed, our surveys suggest that many citizens want their government to take a more direct economic role in a variety of areas.

For years now, public sector policy-makers have tried to evaluate programs in terms of the "Three Es": economy, efficiency and effectiveness. Public-private synergies offer a way to enhance all three by incorporating the best of both worlds. ▲



For more about the opportunities in public-private synergy, read *Government as best in class shareholder*, a special report by Ernst & Young. Drawn from a survey of 12,000 respondents worldwide, the report looks at attitudes toward government-owned enterprises.



Key questions for global companies

- ▶ Are you developing innovations faster than your competitors? If not, how serious is the risk of losing your competitive advantage if a competitor provides a disruptive offering?
- ▶ Are you satisfied with your ability to leverage newer technologies such as social media and cloud-based services, analytics, security and privacy and virtualization solutions?
- ▶ Are you confident you have the right level of investment in intelligent data-mining capabilities, such as business and behavioral analytics? Do you have a strategy for gaining competitive advantage through better data use?
- ▶ Are you developing products and services for multiple mobile platforms? If so, are your stakeholders aware of the added financial and operational costs involved?
- ▶ Have you reassessed your training tools and requirements to make sure that your people understand how technology affects operations, marketing and strategy?

Rapid technology innovation creates a smart, mobile world

Over the past 25 years, the digital revolution has changed the way we work and play almost beyond recognition. Yet the smart, interconnected world we live in now is still neither as smart, nor as connected, as we would like it to be.

Consumers want more powerful devices and applications, while businesses seek more cost-effective technology to cope with increasingly complex challenges. Satisfying these demands will lead to explosive growth in data and analytics, to new competition in almost every field, and to the disruption and realignment of many industries.

Specifically, we expect to see the following changes:

Businesses will compete on analytics to differentiate themselves

The growing number of embedded sensors collecting information about the world, and the rise of social networks that store the data people share, will generate immense quantities of information. IDC, a market research firm, suggests that the amount of digital information created each year will increase to 35 trillion gigabytes by 2020, requiring 44 times more data storage than in 2009.

For example, telematics applications, similar to global positioning systems, will allow organizations to send, receive and store information via telecommunications devices while controlling remote objects. Although commonly associated with the automotive industry, telematics applications are being developed for use in medical informatics, health care and other fields.

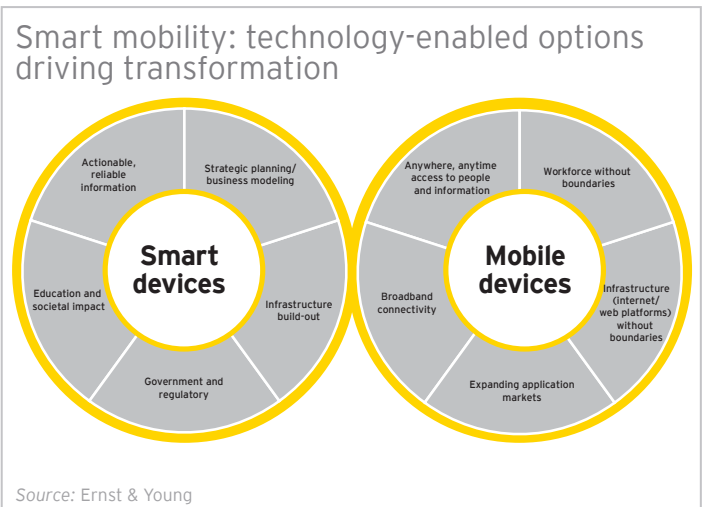
Despite these advances in technology, simply collecting and managing the massive volumes of data will provide minimal value. The real payback comes when business intelligence is applied to

enable companies to make better strategic decisions. Business intelligence, which enables organizations to gather quantifiable data on each area of the organization and analyze it in a way that yields information they can act on – helping them enhance decision-making, improve performance, mitigate risk and sometimes even create new business models – is growing in importance.

Smart mobility will change the way people interact

Increasingly, smart devices – portable tools that connect to the internet – have become a part of our lives. In the last quarter of 2010, sales of smartphones outpaced those of PCs for the first time, according to data from IDC. By 2014, more smart devices could be used to access the internet than traditional computers.

The move to an increasingly mobile world will create new players and new opportunities for a variety of industries. We expect that new emerging market companies will be significant competitors, growing rapidly in part because a lack of legacy systems will enable them to profit more quickly from new technology as it becomes available.



Emerging markets will create plenty of opportunities related to smart technology, and they will not be limited to for-profit enterprises. In Kenya, for example, mobile phones are being used to collect data and report on disease-specific issues from more than 175 health centers serving over 1 million people. This technology has reduced the cost of the country's health information system by 25% and cut the time needed to report the information from four weeks to one week.

Technology blurs boundaries

Many industries will be disrupted by the consequences of technology innovation. The "blur" created by digital technologies will intertwine geographies, economies, industries, products and even private and business lives. Technology insiders have long spoken of "true convergence," and this is it.

As smart devices become increasingly accepted, companies will move into adjacent markets to exploit new revenue models such as mobile commerce and mobile payment systems. Already, a number of data and tech giants are jockeying for position.

As these waves of disruption continue, whole new markets will be created even as long-established businesses are destroyed. In this changing environment, network providers, for example, will be faced with a choice: either evolve into the role of innovation provider, or be content simply to serve as a utility.

Over the long term, the ultimate blurring of boundaries might take the form of Web 3.0 – often called the "semantic web" – a term that refers to functions and activities involving the integration of machines, the web and human beings. Currently the stuff of science fiction, the semantic web is nevertheless an area to watch.

Cloud computing takes off – finally

Analysts have been talking about cloud computing for years, but cloud-based services are finally starting to take off.

By 2016, Gartner, a consultancy, expects all *Forbes'* Global 2000 companies to use public cloud services, transforming much of the current IT hardware, software and database markets into infinitely flexible utilities.

When cloud computing becomes widespread, it will transform businesses and business models, potentially reducing both initial and recurring costs for IT buyers, increasing their flexibility and lowering their risks. What's not to like about an infinitely scalable, pay-as-you-go business model?

Despite concerns related to data security, privacy and business continuity, its value proposition makes the success of cloud computing inevitable. Over time, cloud-based services will grow

increasingly sophisticated and evolve into full-scale business processes as a service.

The power of the individual will spur innovation

Google, Facebook, Twitter, smartphones, tablets and e-readers – technologies that originated in the consumer space – are now reshaping the way companies communicate and collaborate with employees, partners and customers. Through the new possibilities for "social listening," businesses are able to better understand what their customers and employees need and want.

More change can be expected when the generation that has grown up with new technologies and instant information gratification joins the workforce. For example, by 2014, Gartner forecasts that social networks will become the main form of business communication for 20% of employees worldwide.

Government's role in innovation grows

Governments will increasingly become involved in technology, investing in a broad range of applications – from home-grown innovation incubators to local manufacturing sites that create jobs and manage geopolitical risk.

In cloud computing, for example, governments are taking the lead, much as the US did in the development of the internet. In China, the Beijing Academy of Science and Technology has built the country's largest industrial cloud-computing platform, designed to serve small- and medium-sized enterprises in government-supported industries, including biotech, pharmaceuticals, new energy and knowledge-intensive manufacturing.

At the same time, governments haven't forgotten their regulatory role. As citizens share more personal data on websites such as Facebook, many governments are considering regulations to protect citizens' privacy and corporations' data. The EU is developing stricter privacy rules, including an "online right to be forgotten," which would require websites to delete data permanently at an individual's request. However, the public pressure to strengthen privacy protection through legislative means is likely to vary by region. Consumers in regions such as North America, for example, seem willing to trade some privacy in return for customized service. ▲



Patrick A. Hyek
Global Technology
Sector Leader

All companies are in the technology business

Ten to 20 years from now, we may look back on the present as the dawn of the Smart Era: a time when rapid and continuous innovation changed almost everything about the way we live.

Much of that change will originate with smart devices – digital tools that connect to the internet. These devices will give individuals constant access to information, regardless of location, anytime. They'll also provide broad social benefits such as remote access to education and health care information.

Smart devices will help trigger an information explosion that blurs the traditional boundaries within, and across, industries. They will empower consumers and create huge opportunities for businesses. And they'll pose a disruptive threat to some established industries.

Here are a few things to look for:

- ▶ *Industry boundaries are blurring, forcing new innovation.* Information makes up an increasing percentage of the business value in any given product or service. That includes research reports, health care records and sensors embedded in cars, appliances and even clothes (to monitor the wearer's vital signs). In a Smart World, all industries will start looking like the technology industry. This confluence will stiffen the competition that companies face and put them under enormous pressure to innovate.
- ▶ *Smart mobility fundamentally reorders the way society interacts.* Mobile sensors, handsets and tablets provide users with growing access to "cloud-based" applications. The result: unprecedented real-time access to information for individuals and corporations.
- ▶ *"Consumerization" reigns supreme.* More widespread access to information blurs the lines between technology's home and business uses. It raises consumers' expectations, sharpening their desire for personalized information that's tailored to their specific needs. The collective wisdom of the crowd directs the pace of future change and product and service development.

- ▶ *Computing-as-a-service transforms business.* Businesses worldwide will be captivated by the vision of information technology delivered with the same reliability, flexibility and scalability as a public utility service. They'll be attracted to the promise of cloud computing, which offers a flexible, pay-as-you-go business model for managing costs, freeing management to focus on delivering business value. That switch will enable organizations to achieve increased business agility, enabling them to respond far more nimbly to rapid market changes than was possible using in-house IT.

Along with these opportunities, the Smart World poses risks. A high degree of interconnectedness invites breaches of security, misuse of information and overreaching by governments. But the good outweighs the bad. A Smart World promises solutions to some of society's biggest problems, including a lack of access to health care and education. Continuous innovation is the key to unlocking these treasures. Today's leaders will be gone tomorrow if they fail to innovate. ▲



To learn more about the ways in which smart mobility will change your business, read our report, *View from the top: global technology trends and performance*.

Demographic shifts transform the global workforce

Despite a growing global population, the availability of skilled workers is actually shrinking, and no longer just in advanced, aging countries such as Japan and Italy. Now, some emerging markets, such as China and Russia, are also feeling a demographic pinch.

The data suggests that this is only the beginning. A “demographic divide” will soon arise between countries with younger skilled workers and those that face an aging, shrinking workforce. The war for talent will become increasingly acute in certain sectors, especially areas requiring high skill levels and more education.

More specifically, we expect:

Labor force demographics will shift profoundly

Despite projected growth in the global population from 6.9 billion in 2010 to 7.6 billion in 2020, the working-age population is expected to decline in many countries. Japan already has more people exiting the workforce than there are workers prepared to enter it. In the European labor market, 2010 marked the first time more workers retired than joined the workforce. While this labor gap is a relatively manageable 200,000, it will surge to 8.3 million by 2030. By the end of this decade, other large economies such as Russia, Canada, South Korea and China will also have more people at retirement age than are entering the workforce.

Other, younger countries stand to profit from those trends. One-third of India's population is now under the age of 15. Other emerging market economies with young labor forces such as Brazil, Mexico and Indonesia may benefit from a demographic dividend, a surge in productivity and growth as those workers join the labor pool. But the dividend pays off only if the country provides its youth with adequate educational and economic opportunities to develop their skills.

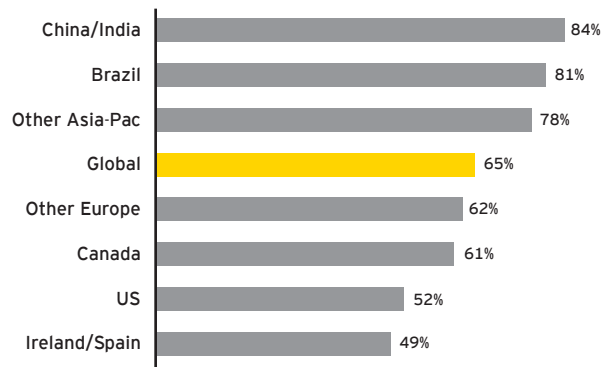
There is a growing mismatch between the skills employers need and the talent available

An estimated 31% of employers worldwide find it difficult to fill positions because of talent shortages in their markets, reports the *2010 Talent Shortage Survey* from Manpower, an international employment agency.

When it comes to attracting employees with critical skills, the task becomes even more challenging. Today, 65% of global companies and more than 80% of companies in fast-growth economies are having problems finding employees with the skills they need, according to Towers Watson, an HR consultancy.

Problems attracting critical-skill employees

Sixty-five percent of companies around the globe are having problems sourcing critical-skill talent. In the fast-growth markets, the problem is particularly acute.



Source: Towers Watson



Key questions for global companies

- ▶ When you make location and investment decisions, do you take into account the shift in demographic factors such as the percentage of working-age population, education level and skills base?
 - ▶ Are you developing strategies to better tap the intellectual capital of older, more experienced workers?
 - ▶ Are you satisfied with your efforts to promote diversity and inclusiveness, particularly in the emerging markets?
 - ▶ Do you have a strategy for skills development that includes coaching and exposure to a variety of experiences?
-

Why can't companies find the right talent despite the growing ranks of college-educated workers and the high unemployment in some of the best-educated markets? Part of the answer has to do with the rising skill level needed in the evolving global economy. Another element is the failure of educational systems to produce an adequate base of talent to meet these changing needs. Although educational access is growing worldwide, not enough students graduate with the skills desired by global employers.

“Generation U” and women to fill the skills gaps and create a new focus on broader segments of the talent pool

Desperate for workers, many companies will become more accepting of diverse employees, particularly older workers and women. The leading US advocacy group for retired people, the AARP, believes that 80% of baby boomers will keep working full- or part-time past their current retirement age. The Pew Research Center predicts that Generation U (unretired) workers will fuel 93% of the growth in the US labor market through 2016.

Women, an increasingly well-educated source of talent, have entered the workforce in ever greater numbers in recent decades. However, their talents are still often underutilized. This is particularly true in societies with traditional views of gender roles, including many fast-growing economies.

Beyond simply filling desks, such diverse hiring may pay other dividends as well. Recent research from Harvard Business School shows that companies operating in countries that traditionally discriminate against women can gain advantage by recruiting and hiring well-qualified female managers. ICICI Bank in India, for instance, has long hired many women executives and now has a woman CEO.

The talent market is increasingly global and mobile

Economic development and greater integration across markets in the past few decades have caused many talented people to explore career opportunities overseas. Cross-border migration has grown 42% in the last decade, from 150 million to 214 million, with most of the traffic directed toward OECD countries.

Higher unemployment in developed markets has discouraged many migrants recently. Between a lack of opportunity and local hostility to migrant workers, more would-be migrants are staying home. New legal restrictions also have created a disincentive. As the economy recovers, however, demand for labor is expected to bounce back – and migration along with it. Some countries have

taken initial steps to soften or reverse restrictive policy changes that they implemented at the height of the recession.

The dramatic growth of emerging market countries is also beginning to change migration patterns. Although developed markets are still a top choice for economic migrants, we are increasingly seeing reverse migration as well. According to the World Economic Forum, “The return migration of highly skilled workers to their home countries is a growing trend for emerging countries.”

Employees gain more bargaining power

Over the past 20 or 30 years, the bond between company and employee has weakened, even in corporate cultures where loyalty was once prized. Fast-changing company needs and a desire to cut costs led first to more frequent layoffs, and then to nontraditional relationships where the expectation was not decades of service, but only a few years.

In a period of high unemployment, this new social contract is an advantage for the employer. But as the market turns, skilled employees should benefit. They will want a better understanding of their employment options and a greater say in how work is assigned, assessed and rewarded.

The employer will no longer define the workplace; rather, employees' priorities and preferences will dictate what the future workplace will look like, particularly now that technology makes it easier than ever to design a variety of flexible arrangements. Companies operating in aging societies will have to craft methods to engage or re-engage the experienced base of talent. Companies that fail to respond to this change and do not succeed in redefining their employee value proposition will fail to attract, retain or develop talent effectively. ▲



Carolyn Buck Luce
Global Pharmaceutical
Sector Leader

Difficult conversations: the cost of life in an aging world

As the world's population ages, the cost of treating disease is becoming unsustainable

As people around the world live longer, the cost of health is increasing, particularly at the end of life. Health care spending in some countries now accounts for 9% to 20% of GDP. There isn't enough money in the world to support systems that care for patients who live longer and longer, and are susceptible to more and more diseases, as standards of living and longevity increase. The focus of health care systems must therefore shift from treatment to prevention.

That shift will be necessary but not sufficient. To stem the rising cost of health care for an expanding and aging population – to “bend the cost curve,” in the jargon of policy analysts – societies also must have a series of difficult conversations about the cost and quality of life.

No mere rhetorical phrase, the *cost of life* is a line item on every government's balance sheet. The Medicare Modernization Act of 2003, for example, a US law enacted under President George W. Bush, increased government reimbursement for the cost of medicine taken by Americans on Medicare. Passage of this bill turned the US Government into a major customer of the pharmaceutical companies, one that reimburses 40% of the cost of medicines purchased in the US, up from 10% previously. This change has added billions of dollars to the already swollen US deficit. Health care reform legislation passed under President Barack Obama shifts the cost burden even further to a public payer.

This growing burden means that soon the US will start having conversations similar to those already taking place in Europe, where most countries have a national health care system. There, the debate is about how much the government will pay for “health,” and how to define the health outcomes that are worth paying for. Should the government pay for drugs that don't extend life but improve its quality, for example? For this reason, the UK developed the quality-adjusted life year (QALY) index to combine the quantity and quality of life. The basic idea of a QALY is to measure the benefits gained from various medical procedures and express them in terms of patients' survival and life quality.

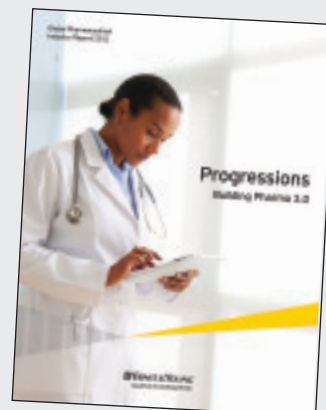
Given the advancement of many treatments that can greatly extend life, this issue is crucial. Equally important is the need to manage costs to national health systems.

Beyond the difficult questions at the end of life, the cost of health care has driven both families and health systems to become “super consumers” and to demand more information about the benefits of competing drugs – particularly since many blockbuster drugs developed for chronic and lifestyle diseases are coming off patent and being replaced with quality generics.

Innovation on life support?

Another big question is: Who pays for innovation? In the past, pharmaceutical companies vied to patent the next blockbuster drug that improved quality of life for millions of people. Companies knew it could take 10 years and US\$1 billion to get their drugs to market; but they also knew that once the drug was approved, it would pay for itself and then some. Today, companies must ask, “Will the payer reimburse us? Is this drug sufficiently better than others that are already in the market? Is it worthwhile to develop a drug that enhances the quality of someone's life – especially if the patient may not live much longer?”

These are hard questions, but economic and budgetary pressures make answering them unavoidable. In the past, massive improvements in public health have resulted from advances in sanitation (clean water, clean hands) and curative treatments (antibiotics, vaccines). The next advance must center on behavioral change, as health care systems shift their focus from treatment to prevention. Individuals must take responsibility for eating better, exercising more and breaking harmful habits such as smoking. This is the only way governments will bend the cost curve and stave off the looming crisis posed by the cost of living in an aging world. ▲



To cope with the changes of an aging global population, drug companies will have to shift from being product-focused to being patient-focused. Instead of manufacturing the best pills, their job will be to deliver the best outcomes. It's a shift Ernst & Young calls Pharma 3.0. Read more about it in our global pharmaceutical industry report, *Progressions: building Pharma 3.0*.

Winners and losers

As the trends described in this paper change the ways in which businesses operate, grow and compete, winners and losers inevitably will emerge. The winners will be easy to spot. They'll be the organizations that constantly monitor broad trends in the external environment, embrace technology and look for talent everywhere, especially among previously neglected segments of the workforce such as women, minorities and older workers.

Regardless of what industry they are in or where they are headquartered, these organizations are looking outward. In so doing, they are navigating multiple jurisdictions and regulatory frameworks while adapting to local environments and attempting to create global workforces. They are modifying supply chains to leverage shifting labor cost structures and mitigate raw materials' price fluctuations. They're figuring out how cleantech fits into their growth plans and making it an integral part of their future strategy. National governments, meanwhile, are seeking ways to meet growth agendas while reducing cost structures and future debt obligations.

As businesses and governments look to the future, they would do well to remember that executing on their existing strategy may no longer be good enough. They must think more deeply about the opportunities and risks presented by the evolving trends, and the driving forces behind them. With a different mindset, they can re-imagine what is possible, discovering what they can do that is new, and how best to do it. Those that succeed may find themselves not just navigating tomorrow's global trends, but actually shaping them. ▲



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