EXECUTIVE SUMMARY

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"The IMD World Competitiveness Yearbook 2004 provides several customized rankings, whether global, by size, by wealth, by regions, etc. In the overall ranking, for example, the US ranks 1st, Singapore 2nd, Finland 8th, Switzerland 14th, the Netherlands 15th, Germany 21st, the UK 22nd, Japan 23rd, China 24th, Chile 26th, France 30th, Korea 35th, South Africa 49th, Russia 50th, Italy 51st, Brazil 53rd, Mexico 56th and Venezuela 60th. On the other hand, those whose position has improved the most are: Zhejiang 19th, Bavaria 20th, India 34th and Maharashtra 38th."

The World Competitiveness Landscape in 2004: Hot Issues

During the latest recession, the 10th since World War II, weak enterprises disappeared, larger ones consolidated, and business confidence was shattered by recurring scandals. Today, investors are back but cautious, consumers are more positive but indebted, and governments struggle with long-term reforms such as pension and health care. Going through a recession is like going through a tunnel. After the darkness, a new landscape appears. In 2004, the competitiveness landscape has changed because the markets are more buoyant. But there is more to it. The structure of the World economy is now different.

From recession to anemia

Economics is made up of cycles. At regular time intervals, the market corrects the excesses of a previous economic boom. However, the use of anti-cyclical policies by Central banks has considerably softened the impact of the latest recession. America's Federal Reserve has played a crucial role by regularly cutting interest rates. These are now at the lowest level for more than 40 years. Each time, this policy has provided the US and the world economy with some oxygen to survive the recession. As an unexpected premium, low interest rates have also fueled a housing and construction boom, especially in the US and the UK. It has allowed many households to re-finance their mortgages and use the excess cash for increased consumption.

The negative side of these policies is, surprisingly, how efficient they have been. The past recession, strictly defined by two consecutive quarters of a decline in GDP, lasted in general far less than the recessions of 1973 and 1981, which both lasted 16 months. Anti-cyclical policies thus succeeded in preventing the worst. On the other hand, they may have distilled "anemia" in the system. Many businessmen feel that the economy has not collapsed as quickly and as severely as it should have to "clean up" the system. Consequently, although the world economy did not undergo a long recession, it more or less "muddled through" many more months than expected. The fear today is that the recovery will be a soft one and is built on quicksand.

More caution about technology and oil

In addition, the technology sector is no longer acting as a locomotive for the world economy. During the past three years, it has undergone a severe period of consolidation. Many companies have disappeared. Those who survived the recession have been affected by a severe drop in market capitalization, in certain cases exceeding 90% of their value. The good news is that for some stronger companies this did not mean a similar drop in sales. They could carry on through the hard times. However, the market does not easily forget the excesses of the past years. Companies and stock exchanges are now highly sensitive to the quality of companies they deal with and to their return on investment. As a consequence, there are no more blank checks to the technology sector. It is no longer the driving force that will pull the world economy out of recession as strongly as it did in the mid-90s.

Nevertheless, the odds are in favor of the world economy improving in 2004. Capital investments are picking up, as well as oil prices. The West Texas Intermediate is now fluctuating around $35 a barrel. Economists always scrutinize oil prices carefully because of the negative impact they could have on corporate cost structures, further delaying any recovery. On the other hand, higher oil prices also indicate that the economy is heating up. For most countries, with the exception of the US, a higher price of oil is offset by the dollar's decline. In real terms, the oil price remains acceptable and should not jeopardize economic recovery.

Good news for stock exchanges, bad ones for security

Finally, stock exchanges are showing signs of life, which means more volume and transactions. Investors, who fled to alternative investments such as housing or art, are back. IPOs, a sign of confidence in the markets, are more numerous than before. The US presidential election should also contribute to an optimistic outlook for the stock markets. The Stock Traders' Almanac of 2004 has looked at stock performance in the US over 43 administrations since 1832. During the first two years of these administrations, the cumulative growth of the US Stock Exchange has been + 228%. During the last two years, it jumped to + 739%. Presidential election years in the US are always good for shares; there is seldom any bad news to rock the market…

The big uncertainty for 2004 remains the spread of insecurity. The proliferation of computer viruses and spams - 10.4 million unsolicited emails are sent every minute worldwide - terrorism, wars and epidemics disseminate a feeling of vulnerability that hinders the general level of confidence. Businesses are learning to deal increasingly with non-business issues, which can threaten the survival of a company as much as the downturn of the economy or the aggressiveness of competitors. The world economic system is now characterized by structural volatility, a new paradigm that consumers, companies and governments have difficulty coping with. Nobody knows yet how much it could hamper an economic recovery in 2004, but everybody knows that it could…

The uncertainties of day-to-day economics should not obscure the more fundamental trends, which are redefining the competitiveness landscape in 2004. So what is "hot" in World Competitiveness?

Japan is ticking again

The second largest economy in the world, with a GDP in excess of $4 trillion, has almost been absent from the world economy for the last 10 years. Japan, in the 1980s, used to be ranked first in our World Competitiveness Scoreboard, well in advance of the other nations. Japan's growth was stopped by the collapse of its financial sector, weaker small- and medium-size enterprises, missing out on the revolution in new technologies (PCs, Internet, etc) and a changing value system in society that has called for more reform of the state and the administration. Although all these issues have not yet been resolved (especially regarding non-performing loans), the Japanese economy seems to be more on track than any of the previous years with 2.7% GDP growth in 2003. This is good news for the world economy that badly needs as many "locomotives" for growth as possible.

Russia should be on the radar screen of investors

Between 1999 and 2003, Russia has been growing on average by 6% per year. This growth has been fueled mainly by oil and gas exports, however the economy is also picking up in other sectors. The reelection of President Putin will ensure more stability in the country and ongoing reform of the state, the administration and the business legislative framework. However, Russia will not develop homogeneously. Pockets of competitiveness will occur in many regions, while others continue to lag behind. Nevertheless, Russia represents a formidable potential and is becoming a player to be reckoned with. It has 1.8 times the land area of the US and has the largest reserves of raw materials in the world. Parts of the labor force, estimated at 72 million, are well educated, such as engineers and scientists, and they are competitively remunerated. Despite these assets, Russia attracts only 5% of the amount of foreign investments that China does, and has a GDP ($400 bn) comparable to that of Bavaria! It therefore has a tremendous potential for development.

India is becoming a magnet for services

In 2004, India has taken off with a GDP growth of 8.1%. Much of the economic activity is taking place in specific areas such as Maharashtra, Mumbai, Bengalore, New Delhi, Agra, etc. India thrives on qualified engineers, scientists, low wages, and especially an English-speaking work force. As a consequence, the country is becoming a hot spot for the "offshoring" of administrative and back-office operations. But India is also developing its competitiveness in software operations, manufacturing, entertainment and financial services. It is estimated that 2 million jobs in financial services will be relocated from industrialized nations to India up to 2008. The main challenge for India will be to maintain a steady and predictable competitive strategy, avoiding the wide fluctuations of the past. If it succeeds, it will emerge as one of the most attractive investment places on the competitiveness landscape.

China becomes the manufacturing place of the world

Over the past ten years, China has grown on average by 8.1%, and in 2003 alone, 9.1%. With a stock of foreign investment exceeding $400 bn, China is probably the most attractive location for new business today. Exports have grown on average by 17.3% per year and China is now the fourth largest exporter in the World, after Germany, the US, Japan, and ahead of France. 50% of these exports are produced by foreign affiliates. But China, having joined the World Trade Organization, is also poised to open its markets further. Average tariffs have dropped from 46.5% in 1992 to 6.9% in 2003. The trade to GDP ratio of China is now 44%, compared to 18% for Japan.

Europe expands to the East and attempts to become cheaper

On May 1st of 2004, the European Union expands to include 10 new countries, many of them in Central Europe. For the first time, new members have standards of living and operational costs that are significantly lower than existing members. Hourly manufacturing costs, for example, reach a high in Germany at $30. In most Northern European countries, such as France and the UK, they are around $20. However, only a few hours away from the wealthiest and most expensive European nations, the average hourly wage drops below $2 in the Baltic States and Slovakia, and below $3 in Poland and Hungary. This will mean that many foreign and European investments, which thrive on low labor and operational costs, may relocate from the West to the East of Europe. The countries that are most likely to be affected by this competition are Ireland, Portugal and Spain.

The "not so important" US deficit

The US has the largest and most buoyant economy in the world. As the most competitive nation in the world, it is still expected to lead the recovery. The odds are a good bet in this respect, with sound GDP growth of 3.1% for 2003. This intense economic activity has however triggered an even bigger balance of trade deficit, which is now reaching a record level of $581.6 bn. Nevertheless, it may not be as dramatic as it appears. Over the past 10 years, the US has always run a deficit in its trade balance, although not in such proportions. The reasons behind it today may be different.

Trade statistics only account for the country of origin for products entering the United States and not the ownership of the goods. Today, the explosion of foreign direct investments characterizes the competitiveness landscape. Companies use the globalization of the economy to have access to cheaper labor and operational costs, and thus to increase their productivity. This means that American companies (and indeed European and Japanese) increasingly manufacture abroad to serve their domestic markets. As a result, a significant part of the imports of the US and other industrialized nations are now the result of "national" companies shipping products (or services) back home that were developed by their operations abroad. The trade balance deteriorates but not necessarily the competitive position of the country.

And the more important one, the budget deficit

The US budget deficit is plunging. At the beginning of the new Bush administration, the US budget was running a surplus of 1.4% of GDP. In 2003, we are seeing a deficit around - 3.6% of GDP. The deterioration of the budget is the result of tax rebates (for example on dividends), the costs of wars and the economic slowdown. For the first time, foreign holdings of US treasury and agency bonds have exceeded the milestone of $1'000 bn. The US will increasingly be confronted with the rising costs of this debt and the necessity to reward foreign lenders. It should be noted that it is not only the Federal government that is concerned by the explosion of deficits but also the states and certain cities. For the moment at least, the US continues to attract most of the international capital in the world, which is available for financial investments. As a result, developing countries with weaker credit ratings have to compete for the rest of lenders' money, and probably at an interest rate premium. Today, the quality of the borrower prevails above the return on the investment; but for how long?

Meanwhile, the dollar remains weak

At the same time, the dollar has collapsed and is now, on average, 30% lower than its Euro rate in 2002. Foreign creditors of the US, increasingly found in China and Taiwan, are finding out just what a bad deal it is to hold securities in a depreciating currency and carrying low interest rates. They may become more out-spoken in trying to convince the US to be more receptive to the currency exchange and interest rates. Some countries, such as Russia, are trying to shift the sales of raw materials to a Euro base. On the other hand, foreign enterprises consider that a low US dollar creates real bargains for direct investment and acquisition of American companies. Finally, large fluctuations in the dollar's value will always create some distortions in evaluating the economic performance of nations or enterprises, especially if the dollar is the international measurement used for statistics or financial reporting.

Will the US Treasury or the Federal Reserve intervene? Probably not. The US is finding that a low dollar can boost economic expansion in 2004. In addition, it corrects some of the imbalances with China, which is criticized for keeping its currency artificially low. A low dollar also "locks" in a vast number of countries in Asia and Latin America, which depend heavily on the US market. This situation is well summarized by the comments of John Connally, the Secretary of the Treasury under President Nixon, who said in a similar situation: "The dollar is our currency, but it is your problem".

Europe's growth lags behind, again!

Economic growth in Europe has been weak throughout 2003, on average 0.9%, with some countries such as Germany or the Netherlands sinking into recession. Only Britain and Spain have performed relatively well. A weak economy means that corporate taxes and indirect taxes (such as VAT) bring less money to the State. As a consequence, the revenue part of the budget sinks, while the charges remain quasi-fixed costs. Meanwhile, Europe is not faring much better than the US on the deficit front. The cumulated budget deficits of the Euro area represent 2.6% of GDP with some big offenders such as France (-4.1%), Germany (-3.8%), Britain (-3.2%) and Italy (-2.5%). (The Maastricht treaty foresees that member states should not exceed a budget deficit of 3% of GDP). The cause of Europe's budget deficits is more structural than in the US. It is linked to the fact that European nations are getting marginally richer, but a lot older.

Europe and Wagner's Law

Europe is confronted with a declining demography and an ageing population, which is hurting its competitiveness. According to the United Nations, Europe's population, 729 million in 2000, will drop to 632 million in 2050. And this population will age quickly. In 1950, people over 60 years old accounted for 12% of Europe's population. In 2050, it will be 32%! Life expectancy in the industrialized world basically increases by one year every 10 years. A British citizen, for example, can now expect to live 78 years, 69 of which in good health. On the other hand, the younger population (under 14 years old) will shrink from 27% to 16% over the same period of time.

These demographic forces explain why two-thirds of the budgets of European nations are broadly directed to expenditures on education, health and pensions. When the population gets older, the objective of just maintaining the same level of benefits in health or retirement plans actually means an increase in the state's expenses. Can this tendency be reversed? Adolf Wagner, a leading German economist of the 19th century, and the advisor of Bismark in establishing the German social system, already underlined long ago that the more a country becomes wealthy, the more its social expenses increase and are difficult to reduce.

This so-called "Wagner's Law" is killing Europe's competitiveness. With growth under 3%, European nations simply cannot afford to maintain their welfare systems at current levels. Reforms prove almost impossible to enforce or, at the best, are adopted too slowly, as we are seeing in France, Germany and Italy. What will happen next? Public debt will soar.

A world of sinners

If one includes Japan, which also runs a budget deficit (around -7%), the overall pattern for developed nations in 2003 seems to be one of massive budget deficits. All together, the OECD nations, which were showing in 2000 a cumulative budget deficit of just - 1%, are now down to - 4.3%. This is the worst situation seen in over 10 years. Deficits can be temporarily acceptable if they are aimed at implementing a Keynesian anti-cyclical policy to revive the economy. However, in most cases, these deficits are no longer due to a deterioration of the economic climate. They are the symptoms of societal changes where wealth creation and social expenditures do not match anymore.

How long can this last? In theory, as long as a country can increase it debt, find creditors and repay interest and principal. Large nations have a huge potential to increase their debt level without much problem, simply because they are wealthy. For example, the National Statistic Office in Britain has calculated the country's entire wealth, that is, real estate, housing, infrastructure, etc. to be $8.8 trillion. Although this number is theoretical, since a lot of these assets cannot be sold, it means that creditors will probably continue lending money to Britain for some time. The same applies to the US, and most industrialized nations. They are a good risk! The real impact on the competitiveness of these nations is that the management of the debt redistributes some government revenues from productive investment to non-productive expenses (that is, interest and principal).

The good news for indebted nations is that interest rates have never been lower. However, it is a time bomb in the making. In classic economic theory, if the economy picks up and if creditors have to be rewarded with an attractive financial package to continue to lend money, interest rates should go up. This can have a damaging effect on the finances of many states, which will be confronted with a surge in the servicing of their debt.

But is this likely to happen soon? The margin of maneuver for central banks is quite limited. Not only states are running a high level of debt, companies are no wiser. In the US, corporate debt has increased fivefold since 1980 for long-term debt and threefold for short-term debt. This is the consequence of the "easy money" period of the exuberant Internet years. Usually, a corporation can expect that a part of its debt will be "eaten away" by inflation over time. But, tough luck, inflation, too, has never been so low.

In these circumstances, one can expect that central banks will keep interest rates low for as long as possible. Increasing rates could lead to falling prices for houses, shares and bonds; sharp rises could even shock the global economy into recession again. In any case, higher rates would be a poison pill for many indebted companies and severely deteriorate public finance in many large industrialized nations: a sure recipe to become unpopular…

But the rest of the world moves on

If the global economy contracts from time to time, the world, as a market, continues to expand dramatically. Every 12 years, the world population increases by one billion people. This explosion in demography will however slow down and between now and 2050, the world population will grow from 6.3 billion to 8.9 billion. But this expansion will not happen everywhere. India, China, Pakistan, Bangladesh, Nigeria and the US alone will account for 50% of the annual increase in world population, estimated at 38 million people. The US and Europe together, which represent 63% of world GDP today, will decrease from 11.2% to 7.7% of the world population.

The biggest development in world competitiveness is the emergence of Asia, globally, as a dominant force in world competitiveness. Asia, which accounted for more than 50% of world GDP in 1820, dropped to a mere 19% in 1950, but rose again to almost 40% in 2003. The longer trend is even more telling of the magnitude of this change.

Professor Angus Magnuson has studied for the OECD the evolution of GDP per capita of the world during the past 2000 years (see "The World Economy – A Millennial Perspective", OECD). In year 1, the GDP per capita of the known world was about $450. In 1950, Africa had moved to $894, India to $619 and China to $439. This means that in almost 20 centuries, there was practically no increase in the prosperity of Chinese individuals. In 2001, the GDP per capita of Africa had increased by an additional two-thirds to $1'489. However, over the same 50 years, India's GDP per capita increased threefold to $1'957 and China eightfold to $3'583!

In short, the individual wealth of one-third of the world population (India and China taken together) has increased more in 50 years than during the past 20 centuries. This means that purchasing power is being created in these markets, and a middle class is emerging with the ability to accumulate assets and with a new value system. This revolution is changing the face of the world economy.

The next new world,

According to the investment bank Goldman Sachs (Global Paper 99, 2003), China will be the largest economy in the world in 2050, with a GDP of $44'453 bn. It will be followed by the US with a GDP of $35'165 bn and India with a GDP of $27'803 bn. Three nations will be middle-size powers: Japan ($6'673 bn), Brazil ($6'064 bn) and Russia ($5'870 bn). Finally, Europe will constitute a cluster of smaller nations, where the largest ones such as Germany or Britain will have a GDP slightly above $3'500 bn. Altogether, Europe will account for a GDP of $25'000 bn.

Asia is thus becoming a highly attractive place for world investment. Already, more than 60% of the foreign direct investments directed to developing nations are going to Asia. China alone attracts 32.5% of these investments. In 2003, for example, China exported more goods to the US than to Mexico, which is part of the North America Free Trade Agreement (NAFTA). As a comparison, Latin American nations received 34.5% of the direct investments going to the developing world and Africa only 5.8%.

will create the next paradigm in competitiveness…

The strong emergence of the larger Asian nations will generate a major shift in world competitiveness. It can be described in three steps:

> In a first stage, China, India, and most Asian nations are considered as providers of economic inputs to American, Japanese and European enterprises. As a result, China has become the manufacturing center of the global economy; India provides back-office operations, Thailand third-party assembling, etc.
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> In a second stage, these nations build up some purchasing power and create a middle class, which develops and accumulates personal wealth. As a consequence, they become market providers. China is the fastest growing market in the world for mobile phones, but also for cars, steel, etc. India is keen on discovering more consumption goods, just as Malaysia and Singapore have done in the past.
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> In a third stage, Asia will move to become a world competitor in its own right. Asia is creating homebred global companies and will start to export local brands. The same pattern was followed by Japan after the war. It has quickly emerged from a nation manufacturing cheap production goods (often ridiculed by foreign nations) to one developing world-class brands and moving up the added value ladder.

Therefore, one can expect that larger Asian nations will emerge as strong players in world competitiveness. Japanese top brands such as Sony, Toyota, Nissan or Hitachi are now known all over the world. Chinese brands, for example, are less reputable, but they will follow the same pattern: Konka, Huawei, Haier, Huayi, Skyworth, Midea are names that will soon become more familiar to the rest of the world. TCL, another leading Chinese brand, has just bought the television division of the French company Thomson and has already become one of the leading manufacturers and vendors of TV sets in the world.

...that also leads to a structural change in productivity.

Since the industrial revolution of the 19th century, manufacturing has been the backbone of competitiveness. However, over time, the importance of manufacturing in the GDP of a country has been declining. The industrial part of American GDP is now 22%, 29% for Germany. China is at the top of the scale with 52%. Nevertheless, the trend is for a decline in importance, everywhere!

According to the author Jeremy Rifkin, based on a study by Alliance Capital Management, world manufacturing production increased by 30% between 1995 and 2002, but manufacturing employment shrunk by 11%. 31 million manufacturing jobs were eliminated in the twenty most important economies. It is perhaps even more interesting that a similar trend also affected China. During the same period of time, China lost 15 million manufacturing jobs!

Therefore, there is not a net transfer of manufacturing jobs from one part of the world to another, as one could have expected. On the contrary, there is a formidable boom in manufacturing productivity worldwide, implying a reduction in jobs. Manufacturing has simply become much more efficient. For example, during the past decade, steel production in the US has surged from 75 to 102 million tons. Meanwhile, the number of American workers employed in the US steel industry has fallen from 289'000 to 74'000!

The world is undergoing an unprecedented explosion in productivity based on new management methods, such as quality, automation and technology. But this is not all there is to it. Productivity gains are further boosted by the globalization of business, and especially by direct investments. Globalization has quickly spread the productivity revolution and techniques to developing countries, which now benefit from both lower labor costs and higher efficiency output. This combination could be lethal for traditional industrial countries and their workforce. Jobs will be lost, and companies' activities will move abroad. And the trend has just begun... The same paradigm now affects the service industry.

In summary...

Economic cycles should not obscure the most fundamental trends that are emerging in the world competitiveness landscape of 2004:

> Asia, and soon Russia and Central Europe, emerge as world competitors in their own right. They will brutally assail the competitiveness of the US and Europe, as Japan did over the past decades.
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> For governments, there are deficits and deficits: some are cyclical, but many are now structural. They are the result of a wealthy, ageing society that consumes more than it produces. Europe will suffer and may fail to reform itself.
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> World manufacturing explodes but manufacturing jobs implode. The productivity boom spreads via globalization into low cost areas. The next paradigm shift will affect the service industry.

As mentioned earlier, there is light at the end of the tunnel of recession. For some countries, this will mean unprecedented opportunities for success and prosperity, for others, the competitiveness landscape that unfolds may be too bright and blinding. The World Competitiveness Yearbook provides a glimpse of this new world. Some nations will adapt, some will muddle through, and some may be left behind. President Ronald Reagan summarized the situation quite well:

"There are those who make it happen, those who let it happen, and those who wonder what happened!"