EXECUTIVE SUMMARY

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"The IMD World Competitiveness Yearbook 2005 provides several customized rankings, whether global, by size, by wealth, by regions, etc. In the overall ranking, for example, the US ranks 1st, Hong Kong 2nd, Finland 6th, Switzerland 8th, the Netherlands 13th, Japan 21st, the UK 22nd, Germany 23rd, Korea 29th, France 30th, China 31st, India 39th, South Africa 46th, Brazil 51st, Italy 53rd, Russia 54th, Mexico 56th and Venezuela 60th."

The World Competitiveness Landscape in 2005: A higher degree of risk

The year 2004 will be remembered as one of economic recovery. Most of the large economies displayed a robust GDP growth rate: China 9.5%, US 4.4%, Japan 2.6% and the European Union (25) 2.3%. Of the 60 economies ranked in the World Competitiveness Yearbook, two-thirds of them posted a growth rate superior to 3%. This has been the best year since 2000!

After such robust growth, scholars who specialize in economic cycles usually forecast a period of consolidation, in other words, a gentle slowdown of economic activity. This is likely to happen in 2005. However, there is an unusual level of risk accumulating on the horizon: some concerns remain with regard to the capacity of the world economy to manage a slowdown in an orderly manner without slipping into another recession.

Benign neglect for deficits in the US

Once again the US is the most competitive economy in the World Competitiveness Yearbook 2005. The vitality of entrepreneurship, the abundance of technology, the size of the capital market, the mobility of the workforce, and the quality of infrastructure are just some of the formidable competitive assets which have so far maintained the US at the top of the competitiveness ranking. Given this remarkable performance, the US seems to be surprisingly unconcerned by the persistence of its twin deficits… but for how long?

The deficit in the balance of trade remains around 6% of GDP. Although the US has had a deficit in its balance of trade for the past 15 years, the gap between exports and imports is widening, in spite of a weaker dollar. Objectively, imports in the US are boosted by the fact that many US companies are now manufacturing their products abroad, in order to benefit from lower production costs, and then shipping them back into the US. Statistically, they appear as foreign imports, but in reality they are US products. This is one of the many consequences of globalization, and it probably concerns 20 to 25% of US imports.

On the other hand, the same globalization affects exports. Companies tend to replace exports from the US by direct investments in local markets. The US remains, by far, the largest direct investor abroad, and the rapid expansion of Asia has accelerated the process. As a consequence, the overall performance of US exports tends to be disappointing since it is no longer the only means for companies to serve international markets.

The budget deficit, which runs at 3.4% of GDP, should be a far more serious matter of concern in the US. Such a persistent deficit, which is unlikely to be reduced in the near future, has a number of enduring effects: the least of which is the explosion of debt. It is now estimated that some $1'650 bn in US Treasury and Agency bonds are being held by foreigners, an amount that has doubled over the past three years. These creditors are mainly in Japan, China, Taiwan and the Arab world. This debt does not constitute, per se, a major problem for the US economy, which can easily confront such an obligation. It is more disquieting for the world economy in general since it puts considerable strain on the capital market. It will have two major consequences:

Interest rates will continue to increase – slowly

In order to continue to attract foreign investors, the US Federal Reserve is bound to slowly increase interest rates to reward creditors. Until now, the Fed has been limited in its action by a weak economy and a high level of corporate debt that was inherited from the exuberant Internet years. After some "cleaning up", companies are again generating cash flow and, with economic growth above 4%, the time is ripe to increase interest rates again.

The Fed's margin of maneuver is, however, limited by the persistence of high levels of household debt and a buoyant real estate market. An abrupt increase in interest rates could be very damaging to the financial situation of many families and could depress the housing market. In a country of spenders and home owners, it could have a devastating impact on final private consumption and stall the US economy.

Internationally, a rise in US interest rates would have a limited "domino effect". The European Central Bank, the Bank of Japan and the Bank of England have shown a certain degree of independence in their decisions that is likely to continue. The real issue will be how much of world money will be consumed by the US in order to carry on running such large deficits. Obviously higher interest rates will attract more money into the US, maintaining its reputation as a first class creditor. Consequently, other nations, especially developing ones, will encounter more difficulty in attracting capital. In 2005, one can thus expect that the cost of borrowing money will increase for developing nations.

The US dollar will remain weak, but not weaker

It is a strange fact that the most competitive nation in the world has one of the weakest currencies in the world. The dollar, which was exchanged at 0.90 to the Euro in 2002, is now running as low as 1.30 to the Euro. This is a normal depreciation mechanism that traditionally takes place when there is an excess of offer in a currency on international markets, usually triggered by deficits. However, the dollar is not any kind of currency. The dollar zone spans Asia, the Arab world and Latin America where numerous national currencies are pegged to the dollar. In addition, most international commodities are priced in dollars.

It was therefore in the best interest of everybody to let things go. Even the Euro zone, where exports have been negatively affected by the Euro's appreciation, could somehow benefit from a currency discount on its supply of raw materials. In addition, China, which has been confronted for some time with numerous demands to re-evaluate the Yuan, benefited from a significant boost in exports by keeping its currency in line with the dollar's fluctuation. The explosion of textile exports, also due to the end of the Multi-Fiber Agreement, shows how quickly China can turn a low exchange rate opportunity into a huge competitive advantage.

A weak dollar is likely to trigger a surge in foreign mergers and acquisitions in the US. Today, the total assets owned by foreigners in the US are in excess of $10'000 bn (about the size of the US GDP). US industrial assets are thus becoming increasingly attractive to foreign investors.

The era of the weak dollar is nonetheless reaching its end. History has shown that there is a point in the depreciation of a major currency when the market turns around and investors come back in the hope of a currency gain. It is possible that the dollar has now bottomed out. Relative stability over the past few months and even some marginal re-appreciation support this theory. Therefore, even if only a small appreciation of the dollar should materialize in 2005, it could still become a year of many dangers.

Madonna was right!

It is indeed a material world. The Internet years of 1997 – 2001 seem very distant. In those days, companies that were not Internet savvy were doomed to failure. Those days are gone. The world economy is now all about raw materials and commodities.

In 2004, the price of rolled steel went from $300 a ton to $590 a ton. Almost every raw material price has undergone a 50% to 100% increase in 2004. Oil has followed the same pattern. In 2000, the West Texas Intermediate was trading at $10 a barrel. Nowadays, it is above $50. Huge demand for raw materials has implied a surge in the shipping industry, in addition to the surge in off-shore manufacturing. The Baltic Dry Index, which monitors cargo prices around the world, has practically doubled in 2004.

Thanks to the formidable Asian (particularly China) appetite for raw materials, high prices for raw materials are likely to persist in 2005. It has been estimated that China consumes 31% the world production of coal, 27% of steel, 19% of aluminum and 33% of fish. It is however worth underlining that China "only" consumes 7.7% of the world production of oil. If China would consume the same proportion of oil as other raw materials, i.e., 15% to 30%, then the price of oil would explode on world markets. Currently, Asia, all together, consumes 23mil barrels of oil per day, almost as much as the 24mil barrels of North America. However Asia is ten times more populated than North America…

The prices of raw materials will remain high in 2005, although one should keep in mind that it is a volatile, and sometimes speculative market, where prices can fluctuate significantly. The time bomb is the dollar exchange rate. Despite some unsuccessful attempts to quote raw materials in Euros (for example Russia and Iran), the dollar remains the currency of reference. If the dollar should appreciate in 2005 and beyond, the main victim would be Europe.

Vulnerability and private consumption in Europe

The performance of the European economy remains slightly disappointing despite the better performance of the Nordic nations such as Finland (3.7% GDP growth) and Sweden (3.3%) and, of course, the United Kingdom (3.2%). The various attempts to revive the competitiveness of Europe seem to have failed so far and the Lisbon program, which aimed to build Europe into the most competitive region in the world, has not yet produced any tangible results. In general, the competitiveness of Europe is also dragged down by the weak performance of three of its largest economies, France (2.1%), Germany (1.6%) and Italy (1.2%).

Although the competitiveness problems of Europe are largely documented – labor market rigidities, lack of domestic competition, inadequate technological cooperation between research institutes and companies, high taxation, etc. – it appears that a key determinant of Europe's future will lie in its ability to revive domestic private consumption.

Anglo-Saxon countries are in general characterized by a higher degree of private consumption that leads to higher levels of household debt. On the contrary, Continental Europe practices lower levels of private consumption and higher savings. For example, the growth in private consumption is above 2% in the US and the UK while it is practically flat in Germany and Italy. In addition, gross domestic savings are around 14% of GDP in the US and the UK, while they run above 20% in most European nations.

This trend is also reflected in the performance of European companies. In 2004, German or Swiss companies reported excellent performance on international markets despite the appreciation of their currencies. In contrast, purely domestic companies have shown disappointing results, which are also reflected in the overall GDP growth rate. The difference between an Economy of Globality and an Economy of Proximity, as it is explained in the Annex on the Fundamentals of Competitiveness, is becoming increasingly acute in Europe. Therefore, one of the main objectives of many European nations should be to revive domestic private consumption to sustain competitiveness as a whole.

Cutting Taxes: The Magic Formula?

Since the US and the UK have lead the way in reducing taxes, many governments or political parties have put taxes on the top of their agenda. In 2004, for example, both Germany and Austria reduced their level of corporate taxation to sustain competitiveness. A few years ago, President Bush implemented a proposal to reduce the taxation of dividends in the US, thus leading in 2004 to one of the largest distribution of dividends in American corporate history.

The new members of the European Union, especially the Baltic and Central European nations, have been quick to use low corporate tax rates as a key instrument to attract foreign investments. In the past, Ireland has demonstrated how successful such incentives could be for the competitiveness of a nation. However, this "tax competition" has also generated a heated debate in Europe and beyond. Should it be assimilated to unfair competitive practices?

The relationship between taxation and competitiveness is a minefield. It is interesting to underline that there is no clear correlation between the total tax pressure incurred in a country and its overall competitiveness or growth rate. For example, Luxembourg, Finland, Sweden, Norway and Belgium simultaneously display the highest economic growth rates in continental Europe and the highest overall tax pressure (above 42% of GDP). On the other hand, Ireland, the US, Estonia and the Slovak Republic have had remarkable growth rates in 2005 while relying on a much lower tax pressure (between 27% and 34% of GDP). In the middle, Japan and Switzerland have both shown very weak economic growth during the past ten years while at the same time showing a relatively low total tax of 27% and 31% respectively!

Competitiveness distinguishes between the various types of taxes that are levied. It seems that a direct impact is more easily established between corporate taxation and competitiveness than with personal, social or indirect taxes. Although many business and political leaders would intuitively argue that a lower level of social or personal taxes boosts the economy by supporting a higher degree of personal spending, it is not clear from the evidence. In continental Europe, it appears that a tax cut often results in more savings rather than more consumption (as would be the case in Anglo-Saxon countries).

A decrease in taxes is often associated with the need to restrain government spending. Here again, no evidence for a strict correlation with competitiveness can be shown. Sweden, Denmark, Finland or the UK display high levels of government spending, in excess of 20% of the GDP, as well as good competitiveness performance. At the other end of the spectrum, Singapore and Hong Kong also perform very well with only 11% of GDP in government spending. One can assume, as a rule of thumb, that government spending can be broken down into 50% transfer payments and 50% investments. When government spending relates to investments, it is not necessarily contrary to competitiveness. The quality of such government expenditure should be taken into consideration as much as the tax pressure.

The real impact of taxes is on employment. For example, a high level of labor tax induces enterprises to automate production and to replace the human factor by machines.

This explains why the general level of production may increase while manufacturing employment decreases in many highly taxed nations. The other consequence of taxes on competitiveness is that it exacerbates the "relocation factor". Companies operating in a high taxation environment are less inclined to conduct painful and lengthy restructuring strategies in their domestic market if relocating activities abroad can produce more rapid and significant gains in productivity. This trend partly explains the increasing gap between domestic and global performance of advanced economies.

In short, the taxation debate in 2005 highlights a complex relationship with competitiveness, with the exception of corporate taxes. It shows that, in addition to tax rates, the efficient and appropriate utilization of tax revenues has a direct impact on competitiveness. Government spending is not necessarily bad for competitiveness if it is efficiently directed to investments in infrastructure. Singapore and Malaysia are good illustrations of government spending that supports competitiveness through the creation of advanced infrastructure. In Europe, Finland is perceived and ranked (PISA study of OECD) as having one of the best education systems while spending far less money as a percentage of GDP than in Sweden or Switzerland, whose performance is less impressive.

Cost competitiveness

The debate on tax competition is part of a wider trend, which thrives on using globalization as a means to increase company productivity through the reduction of operating costs.

Over the past two decades, three trends can be identified:

- In the 1980s, productivity increased through a strategy of "working better". This lead to the introduction of quality techniques, mainly imitated from Japan, and reengineering policies, which were a more abrupt way of radically redesigning a company. This strategy has proved to be highly efficient. Between 1995 and 2002, the production in world manufacturing has increased by 30% while jobs decreased by 11%. It can be summarized as "doing more with less…"

- In the 1990s, productivity gains were obtained through a strategy of "working cheaper". Outsourcing was the name of the game and, as a consequence, companies multiplied partnerships with suppliers, distributors, etc, to offload non-performing business entities.

- Since 2000, productivity gains are achieved by taking advantage of the differences in operating costs that can be found in international markets. The exploitation of globalization as a means of cost competitiveness has become a key element of the strategy of international companies, whether it is to supply the home market or a third country. Off-shoring is just one of the manifestations of this trend.

A key element in cost competitiveness is labor cost. In the developing world, total hourly compensation in manufacturing (i.e., including compulsory supplementary benefits) varies between $10.70 an hour in Korea to $0.75 an hour in China. On the other hand, the same hourly labor cost in industrialized nations would be in a bracket between $35.40 an hour in Denmark and $16.40 in Spain. Sometimes, countries in the lower bracket are not necessarily geographically distant from countries in the upper bracket. This is the case with the Baltic and Central European nations, which are now in the same economic union as their main markets (such as the Scandinavian countries and Germany), while enjoying a labor cost advantage that makes them 5 to 10 times cheaper.

A labor cost advantage combined with an aggressive tax policy and attractive conditions for foreign investors can prove to be an almost "unbeatable" proposal to induce companies in expensive countries to relocate their activities. In addition, this cost attractiveness applies not only to standard assembly operations but also more and more to services, back office operations, financial activities and sometimes, even research.

The potential to tap low labor cost resources in the world is quite significant. According to the International Labor Organization, 700 million people will join the labor market in developing countries over the next 10 years. Moreover, it is estimated that today 850 million workers earn less than $2 a day and 550 million less than $1 a day.

Competitiveness based on low cost does not however last very long. History shows that successful nations have a tendency to close the labor cost gap relatively quickly with their competitors. For example, in 1980, the total labor cost in manufacturing was $5.52 in Ireland and $6.03 in Japan. In 2004, it reached $21.02 and $21.54 respectively. The same trend is likely to occur in Central Europe, especially in the Baltic States that show high growth rates. Within the next decade, these nations will probably see their labor costs aligning with their neighbors. Therefore, where will competitiveness come from?

Leading edges in competitiveness

Competitiveness is not necessarily incompatible with an expensive operating environment. It even appears that the most competitive nations in 2005 also rank among the most "expensive" nations. In many cases, the explanation is that nations first tend to be competitive then, with success, become expensive. The relationship between costs, productivity and competitiveness is a subtle one. A low cost competitiveness strategy gradually leads to the development of other competitive advantages. Within such an approach, the following competitive priorities can be highlighted for 2005.

- *The ease of doing business:*
  The advantages of a low cost environment can be destroyed by complex legislation, obscure administrative procedures, lengthy authorization processes, and in certain cases, improper practices. On the contrary, several nations have worked on the simplification of investment procedures, such as in Denmark or the Netherlands, on the efficiency of foreign investment approval, such as in Malaysia and Singapore, or on a simpler tax system such as in the Baltic States, Slovakia or Russia who have recently adopted a flat tax approach.

- *Technological infrastructure:*
  The globalization of the value chain implies that companies have acquired the ability to manage and control its various components on a worldwide basis. Large companies are thus relying on advanced technology, such as IT and communications to keep track of their assets and customers. Therefore, nations do not only need to invest in traditional but also in technological infrastructure to provide the necessary environment for companies to operate. In developing nations, the cost of such investments is reduced by concentrating these infrastructure investments in special economic zones such as in China, or in regions such as in India (Bangalore, Misore, etc..)

- *Logistics infrastructure:*
  The rapid development of outsourcing and off-shoring in the past few years obliges companies and nations to give special attention to their logistic strategies. Planes, boats, trains and trucks transport considerable quantities of raw material, components or finished products from one location to another. The cost advantages of such global activities can disappear if logistics are not efficient. On average, companies spend between 7-10% of their costs on logistics today.

- *A sound financial system:*
  Many developing nations are focusing their competitiveness on assembling and manufacturing. Indeed, the world is eager to consume products, if possible cheaper ones. However, the rapid development of industrial activities should not mask the importance of developing in parallel a sophisticated financial system that can provide appropriate financial resources and corporate governance. Japan, in the past, has suffered from such an imbalance. The industrial competitiveness of Japan, at a certain stage, became disconnected from a weak financial system, which almost collapsed under the burden of non-performing loans and illegal practices. Today, the same concerns could apply to China. The sophistication gap between the manufacturing and the financial sector in China should be quickly addressed in order to avoid the risk of a major financial crisis.

- *A diversity of competencies:*
  Many nations still suffer from an over-dependence on one business sector or one market. The diversification of activities and thus of competencies should remain a priority. Failing to do so leads an economy to suffer unnecessarily high levels of volatility in their growth rate. This has been the case for many years in Australia (overly dependent on raw material production and trade with the Commonwealth), and South East Asian nations (focusing on IT components for the North American markets). More recently these nations have succeeded in diversifying their approaches, with excellent results on competitiveness.

- *A science culture:*
  A sound environment for competitiveness can be defined by taxation or business legislation. It is not however sufficient. The real engines of competitiveness and economic success remain science, innovation, technology, education and entrepreneurship: all are intertwined. Nevertheless, a Science Culture plays a central role. In the end, science, supported by education, is at the core of competitiveness for a nation. The Western nations continue to have an enormous lead in scientific knowledge and applications, such as patents, on the rest of the world. However, following the success of Japan, many industrializing nations are now building a scientific base that should be acknowledged. This is the case in Russia, India, China, Brazil, Singapore, and Israel. Such a policy is more successful if it also focuses on bridging the gap between fundamental and applied research and business applications. This approach is central to explaining the long lasting competitiveness of the United States.

Conclusion

To conclude, a higher level of risk and many imbalances characterizes the World Competitiveness Landscape in 2005, perhaps too many…

In summary:

- The uneven growth rates between Asia, the US, Latin America and Europe, (but also inside regions such as between Eastern and Western Europe) continue to create economic and political tensions.
- Persistent deficits in the US maintain a weak dollar and exacerbate the instability of currencies now divided into three main monetary zones: Dollar, Euro and Yen.
- Asia's strong appetite for raw materials and the US need for capital increase the prices for commodities and money.
- A rise in interest rates, especially in the US, can in turn jeopardize economic growth and hamper the borrowing capacity of many emerging nations.
- As a consequence, inflation that had completely disappeared because of the intensity of global competition resurfaces as a source of concern.
- A growing gap is also developing between the performance of the global economy, which is good, and the domestic sector, which is less buoyant, especially in Europe.
- A similar disparity occurs between Anglo-Saxon economies, which thrive on consumption, and sometimes debt, and other nations mainly in Continental Europe and Asia, which prefer to thrive on investment and saving.
- A significant disparity in labor costs among industrialized and emerging nations continues to be the main factor for the relocation of activities worldwide.
- "Offshoring" no longer affects only assembling or manufacturing activities but increasingly services, back-office operations and now research. Value added activities are also becoming mobile.
- As a consequence, and in order to attract or retain enterprises, competition on corporate taxes is ever more a key weapon in world competitiveness, both in developing and developed economies.

These challenges are, per se, quite significant for any nation. They imply however more than just an additional volatility in the World Competitiveness Landscape. Globalization impinges on the very core of competitiveness of advanced economies through the formidable mobility of their enterprises. For most companies today, a rise in productivity can be the direct consequence of an optimum location, or re-allocation, of assets worldwide. Enterprises often find it easier to close a business entity "somewhere" and to move "elsewhere" rather than to spend the energy and the time for restructuring and reviving a flagging operation.

The capacity of many advanced nations to reform and adapt to new requirements in competitiveness is thus hampered by the fact that many of their own companies are less involved in the process at home. It partly explains the difference in adaptability between the domestic and the global economy in many nations. This "all or nothing" approach also poses a major challenge because of the social consequences involved. As a result, the margin of maneuver of many governments in 2005 to maintain or develop their competitiveness has never been smaller.