THE WORLD COMPETITIVENESS LANDSCAPE IN 2006

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Competitiveness thrives on two capabilities:

- *The management of a broad spectrum of competencies* within a nation or a firm, with the objective of fully exploiting their capital of resources and knowledge. The World Competitiveness Yearbook, with its 312 criteria, describes how nations and firms perform in creating and utilizing their wealth. Thomas Edison summarized the idea well when he said: "If we did all the things we are capable of, we would literally astound ourselves".

- The management of change, with the objective of adapting better and faster than competition to an ever-changing competitiveness landscape. The world today is open, online, and transparent. As a consequence, nations, firms and individuals have become more vulnerable. There is no place to hide anymore… The pace of change has accelerated and the world is in constant evolution. Thus, the rules of competitiveness are changing all the time. Mark Twain summarized this state of fact: "In the real world, the right thing never happens in the right place and the right time".

So what can we expect in 2006 and beyond?

1. The US will continue to over-consume money

The competitiveness of the US is a paradox: the economy is still the most competitive in the world, although its lead on other nations is shrinking: it grew by 3.5% in 2005. On the other hand the US is accumulating massive debt—in excess of US$ 8,000bn—that is increasing by US$ 2.1bn every day. How is it possible?

The US balance of trade remains in chronic deficit, some US$ 828bn last year, which amounts to 6.6% of GDP. A growing part of this deficit is generated in Asia: Wal-Mart, for example, bought more than US$ 20bn worth of Chinese goods last year. However, this deficit needs be put into perspective. Off-shoring and outsourcing are a key feature of the globalisation strategy of firms. Thus, a significant share of imports entering the US—estimated slightly over 20%—originates from US operations abroad. As logistics and transport become more cost efficient, firms now manage their value chain globally and do not hesitate to develop sourcing strategies with nations all over the world. As a consequence, US enterprises abroad are becoming key exporters to the United States, a fact that is not reflected in trade statistics.

The US budget deficit remains worrisome. It has now reached US$ 318bn, which represents -2.5% of GDP. This deficit is a result of spending on military conflicts in Afghanistan and Iraq, on security measures against terrorism and a reduction of tax revenue (on dividends, for example). Although the budget situation in the US has rapidly shifted from a surplus of 1.4% of GDP under Clinton to a permanent deficit under the Bush presidency, it is not proportionally worse than many other nations. In Europe, the rules of economic convergence imposed by the Maastricht treaty, limit the maximum deficit allowed to –3% of GDP. In Japan, the budget deficit runs at almost -7% of GDP. The US deficit is worrying not only because of its absolute size but because it is financed with foreign money.

Foreign ownership of treasury bonds has exploded. It is now estimated that more than US$ 2'200bn of bonds are held by non-US citizens—essentially foreign central banks. Among these, the largest holders of foreign currency reserves are Japan with US$ 847bn, followed by China with US$ 819bn. Then come Taiwan, Korea, Russia and Hong Kong… As a consequence, China now owns US$ 247bn in US treasury bonds. It is a quite remarkable fact that the largest communist nation in the world may soon become the first creditor of the largest capitalist nation in the world!

2. A Time Bomb?

The US budget deficit is thus a source of concern for two reasons:

- its absolute size, which drains capital from the US government, and

- the government needs to rely on foreign savings to finance it.

As a consequence, the US Federal Reserve has embarked on a strategy of gradual increases in interest rates—so far 12 increases in a row—in order to attract foreign savings, but also to avoid a sharp drop in the value of the dollar! This strategy has worked well so far. Countries running a budget surplus, such as Asian nations, but also Germany, Russia and Switzerland, have transferred some US$ 744bn towards countries running a budget deficit: mainly the US and the UK. It is estimated that 2/3 of the world current account surplus is now re-invested in the US. But, how long will it last?

A rise in interest rates increases the cost of money for firms and individuals. Firms are less vulnerable than individuals because they have different sources for capital, such as the stock exchange. Individuals, however, are more vulnerable, especially in the US, since they have actively been involved in the housing and property boom, where the price of real-estate increased by 14% last year. A rise in mortgage prices could trigger a massive readjustment of the property market and lead to numerous personal bankruptcies. It is important to underline that the cheap money of recent years has also triggered a property boom in Asia (except Japan), most of Europe (except Germany and Switzerland) and, of course, the UK and Ireland. All of these nations could therefore be exposed to a sharp turn-around in the property market with severe repercussions on the economy as a whole.

The biggest uncertainty for the US government depends on the willingness of surplus nations to continue to invest in rather dull investment vehicles such as treasury bonds. China has embarked on a strategy of diversification of its investment portfolio, in particular with increased direct investment abroad to secure sources of raw materials and commodities. Africa is increasingly a prime recipient of Chinese investments: for example, offshore oil in Nigeria.

Despite these developments, the US will remain the best debtor in the world, with sound collateral assets, a strong currency and a reliable government. However, the US administration has probably reached the end of its policy of "benign neglect" for the budget deficit – once so well described by President Reagan "The deficit is big enough to take care of itself…" In the short term, cost control is likely to become a top priority for the US administration.

3. China will continue to over-consume raw materials – India is next.

China represents 20% of the world population and the economy has grown by 9.9% in 2005. The combination of size, rapid growth and rather low energy efficiency in China has triggered a surge in the demand of raw materials and commodities on world markets. China currently consumes between 20% and 30% of most key raw materials such as aluminium, steel, copper or coal, and more than 40% of world cement production. As a consequence, steel, tin, nickel, copper, aluminium, lead, zinc and gold are breaking record prices on a regular basis. The world economy has entered an era of expensive raw materials, commodities and energy. Very few experts see a possible ease of tension on prices in the near future, especially since a similar "Indian syndrome" may now complement the "Chinese syndrome". The Indian economy is indeed larger in size than China and has grown by 8.1% in 2005.

The most visible consequence, at least for the public, is the surge in the price of oil. At the time of writing, the West Texas Intermediate has been trading above $70 a barrel. Most OPEC producing countries had set a target price of $30 a barrel in their budget previsions for 2005. For 2006, the target price was set at $50 a barrel: at this stage, even this assumption appears conservative. Nevertheless, it is important to underline that taxes represent about 2/3 of the selling price of fuel or gas in most industrialised nations. Thus, the rise in oil price has also been quite beneficial for most western governments, notwithstanding the large petroleum companies.

Several factors indicate that a high oil price will continue to define the competitiveness landscape in the near future. China is only responsible for 7.7% of the world consumption of oil, in stark contrast with its massive consumption of other raw materials. Experts believe that the Chinese share of oil consumption will gradually grow in the future thereby putting increased pressure on oil prices. India and other emerging nations such as Vietnam or Indonesia will also play a role in this process.

Pumping and refining capacities seem to be stretched to a maximum. The spare capacity is perhaps no more than 2.5 million barrels a day worldwide while the world consumption exceeds 80 million barrels a day. Most of the spare capacity is in Saudi Arabia. In these circumstances, any potential instability in the Gulf region will create additional price tensions. Moreover, "external factors" such as the nuclear crisis with Iran, riots in Nigeria or hurricanes in the Gulf of Mexico could also add to price instability.

Thus, these conditions are likely to prevail in 2006 and beyond. The large resources available in Russia, the central Asian nations or Iraq have yet to be fully developed, while the "populist" regimes in Latin America will probably continue to use energy as a political weapon on international markets. The world economy should be prepared for a roller coaster experience on oil, with quite some volatility on price, at least for the near future.

4. A World economy in Teflon?

Conventional wisdom considers that rising interest rates, persistent deficits and expensive raw materials and commodities do not support a buoyant economy. Yet, despite this combination of potentially adverse conditions, the world economy has been booming in 2005, as if these trends had no affect at all on business.

Of the 61 economies covered by the World Competitiveness Yearbook in 2005, 22 had a growth rate above 5%, 39 above 3% and 48 above 2%. This growth performance is the best the world economy has known since the year 2000. In fact, Italy was the only country that did not post any economic growth last year.

The reason the world economy is so robust is that the sources of economic growth have changed during the past decade.

Traditionally, growth has been limited to the industrialised world and was linked to increases in the purchasing power of the population. This is still partly the case today. When the US economy grows by 3.5%, it means that some US$ 434bn is added to the world economy—the equivalent of 2/3 of India's GDP… In such a "closed" economic system, any decrease in purchasing power, such as a rapid surge in oil price in 1973, creates a worldwide recession.

In 1998, a second source of growth emerged with the explosion of new technologies. Personal computing, mobile telephony and the Internet radically changed the business models and the purchasing patterns of customers. Companies embarked on massive investment spending to renew their technological infrastructure. Nations did the same. Customers changed their buying habits, shopped around and became more price conscious. As a consequence, productivity increased massively, first in western enterprises, then worldwide.

Today, the largest source of economic growth is the emergence of new markets. Asia, the former Soviet Union, the Gulf countries and Latin America are contributing far more to world economic growth than ever before. Africa is still on hold, but also represents a formidable growth potential. The World population, which is estimated today to be at 6.4bn people, will increase by 1bn people every 15 years until 2050 when it will stabilize. The most significant augmentation of the population during the next 45 years, according to the United Nations, will be an additional 500 million in Latin America, 950 million in Africa and 1.6 billion in Asia.

If population growth is matched by economic growth, as can be expected in China or India, the world's largest markets will be quite different in 2050. By then, four very large markets will dominate the world: the US, China, India and a United Europe, followed by 3 medium-sized markets: Japan, Brazil and Russia.

Of course, population growth alone is not enough to create economic opportunities. The most interesting change in the world economy will be the creation of a middle class in previously underdeveloped markets—mainly in Asia—where 600 million people already reached this status over the past five years and thereby generated an explosion in consumer goods sales. This new middle class represents a combined GDP in excess of US$ 4,000bn. Some experts estimate that it will double in size every 10 years and not necessarily only in Asia.

This "growth effect" doesn't exist in Europe anymore. United Nations forecasts predict a population loss for Europe, in the order of 100 million people over the next 45 years, mainly because of a decrease in the birth rate. This situation has two consequences:

- Most of the fast moving segments of the economy in Europe can now be found in the so-called "economy of globality", i.e., large international firms or smaller companies focused on exports, that have direct access to world markets and can rely on the "growth effect".

- The domestic economy will increasingly rely on structural changes in the local population such as the aging factor. By 2050 in Europe, one person out of three will be over 60 years old with more than 10% of the population older than 80 years of age. When the compulsory retirement age was set at 65 years of age several decades ago, most people had a life expectancy of just 5 more years. Today, they can expect more than 15 additional years, most of them in good health. This dramatic change in the population structure will create additional costs for society but will also generate numerous business opportunities for firms.

5. Some governments have become a burden for competitiveness

The remarkable economic performance of many countries in 2005 is not necessarily matched by a similar government performance. For example, there is a striking contrast between the achievements of the US economy over the past few years and the fact that the central government (and indeed some states) has accumulated budget deficits and debt. These discrepancies appear very clearly in the chart shown on page 51.

The Overall ranking is calculated by combining four factors of competitiveness: Economic Performance, Government Efficiency, Business Efficiency and Infrastructure. This year, we have studied which governments contribute less than the economy to the overall competitiveness of their country. In other words, which governments help and which governments hinder overall competitiveness in their countries?

Latin American governments (Venezuela, Argentina, Brazil and Mexico) and Italy significantly lag behind their economy. They fail to perform on several fronts: budget deficits, debt, taxes, bureaucracy, etc. In some cases, like Venezuela and Argentina, the economy still performs well for external reasons, such as oil prices or exports. On the other hand, Brazil and Mexico remain weak for growth. Italy is the only country in this year's ranking that does not show any economic growth at all.

France and the US are the two industrial nations that show the most significant differences between how their government and their economy perform. Both governments are running significant budget deficits and debt thus leading to questions about the efficiency of the State. At the same time, the US and France are still the 2nd and 5th largest exporters in the world thanks to very competitive enterprises.

India and China face a similar gap between government and economic performance, but for different reasons. With growth rates respectively of 8.1 and 9.9%, both governments face the challenge of keeping pace with rapid economic expansion. Their task now is to meet the standards and expectations of a buoyant economy. Failure to do so may create economic and social imbalances that could jeopardize what has been achieved so far. Success also has a price!

Competitiveness is a matter of balanced policies. Too many governments have not yet mastered the economic imperatives necessary to support and stimulate the competitiveness of their country. Such governments become a hindrance to growth. Others, such as Finland and Denmark are more proactive. The government and economy need to remain in sync in order to contribute durably to the competitiveness of a nation. A growing gap in performance between the government and the economy is a bad omen for the future competitiveness of a country.

6. Location is essential…

As we have seen earlier, a key determinant to global economic growth is the emergence of new markets. Such markets in Asia, the former Soviet Union, the Gulf countries, Africa and Latin America, don't just offer prospects for revenues; they also offer unique opportunities for firms to relocate assets and processes. In summary, during the past two decades, productivity has been thriving on three main strategies:

- Quality and Reengineering, with the objective of working better
- Outsourcing, with the objective of working cheaper
- Globalisation, with the objective of using the best comparative advantages worldwide.

Globalisation has created the possibility for enterprises to increase their productivity while relocating their assets and processes to various parts of the world. One of the objectives of the World Competitiveness Yearbook is precisely to provide all of the necessary information to determine which nations provide the best comparative advantages and the greatest opportunities to attract assets and processes.

As a consequence, the management of a global value chain with scattered assets all over the world has become a daunting challenge for firms. In the process, the nature of assets and processes has changed. They are now:

- Traditional assets and processes that are generally owned and located in the home market,
- Off-shored assets and processes that are still owned but located in a foreign market,
- Outsourced assets and processes that are not owned but accessed from a third party in the home or foreign markets.

Off-shored and domestic assets and processes are naturally prime candidates to be relocated according to the competitive advantage of various locations. However, domestic assets are not immune either to be relocated, although the social and political consequences of such a decision are usually higher. One way or the other, a firm's competitiveness relies on its ability to connect and manage all these assets. From a nation's point of view, it implies investing in advanced transport, technological and communication infrastructure to help firms link up their assets. Competitiveness also thrives on the ability to be part of a global network of infrastructure.

Beyond the obvious risk of making the wrong location choice, there are a number of issues that need to be kept in mind:

- Comparative advantages among nations can change rapidly. For example, labour costs in Ireland, which used to be among the lowest in Europe a decade ago, are now about the same as in the UK (above US$20 an hour).

- Globalisation brings complexity, and it is a hindrance to business and customer satisfaction. Nations add to complexity through complicated administrative processes, bureaucracy or slowness. The ease of doing business is a competitive advantage that is just as critical as the cost of doing business.

- Vulnerability increases in such an environment. An extended, global value chain, based on the networking of partners implies that more corporate proprietary information is freely shared inside the system, and thus can be copied or stolen. In such an open environment, friends can quickly turn into enemies.

As a consequence, global firms, which transfer assets and processes abroad, run a real risk in creating their own competitors for tomorrow. The proliferation of powerful new local enterprises and brands in China and India illustrates how quickly the world is producing new actors and competitors on the competitiveness landscape today.

7. And competitive people are everything!

The competitiveness of people, whether part of a nation, of a firm, or as individuals is the most fundamental competitiveness factor for creating wealth. The eagerness to succeed and the willingness to work hard are irreplaceable qualities to attain higher levels of competitiveness. Such an attitude is epitomized in the provocative statement of Kamal Nath, the Indian minister of commerce: "In India, a 50 hour working week is considered part-time."

Reasonable labour cost and appropriate working hours are, of course, important determinants for the location of firms. It is obviously more difficult to attract investments to Germany with labour costs of over US$30 an hour in manufacturing and a 1,674 hour working year, than to India where labour costs are 10 to 20 times cheaper according to the industry sector and where people work 2,347 hours each year.

However, there is another dimension to the problem that is often underestimated: how many people are actually involved in the labour force in comparison to the total population? In Switzerland, the proportion is almost 60%. In Canada, Denmark, Japan, Singapore and Hong Kong it is still above 50%. The workforce accounts for only 48% of the total population in Germany, 47% in Spain, 42% in India and Italy and 34% in Turkey.

For developing nations, competitiveness also implies including as many people as possible in the labour force to create and distribute economic prosperity. In developed nations, it is a matter of financing the future. In Germany, the smaller working population (48% of the total) combined with increased part time employment (20% of those employed) indicates that the full-time working population in this country is eroding. As a consequence, the tax base is getting smaller and many countries, such as Germany, are now suffering structural budget deficits, as we have seen earlier.

Cost and working hours are important, but quality is paramount. A major revolution is now underway: emerging economies are not competing any more with cheap manpower but also with cheap brainpower. Russia has one of the largest R&D personnel worldwide; India is renowned for its scientists and Central Europe for its engineers. It is estimated that there are 33 million university educated young professionals available today in developing nations compared to only 14 million in the industrialized nations (where they are a lot more expensive…).

The war for the best talents, globally, has gained unprecedented importance in firms. It can also create some problems for nations. Young Chinese, for example, are eager to study in foreign universities and work in foreign firms. There are usually considered as very attractive employees because of their hard-working attitude and eagerness to succeed. However, their homeland China is now suffering an acute shortage of skilled professionals and educated managers. Will they ever return home?

Conclusion

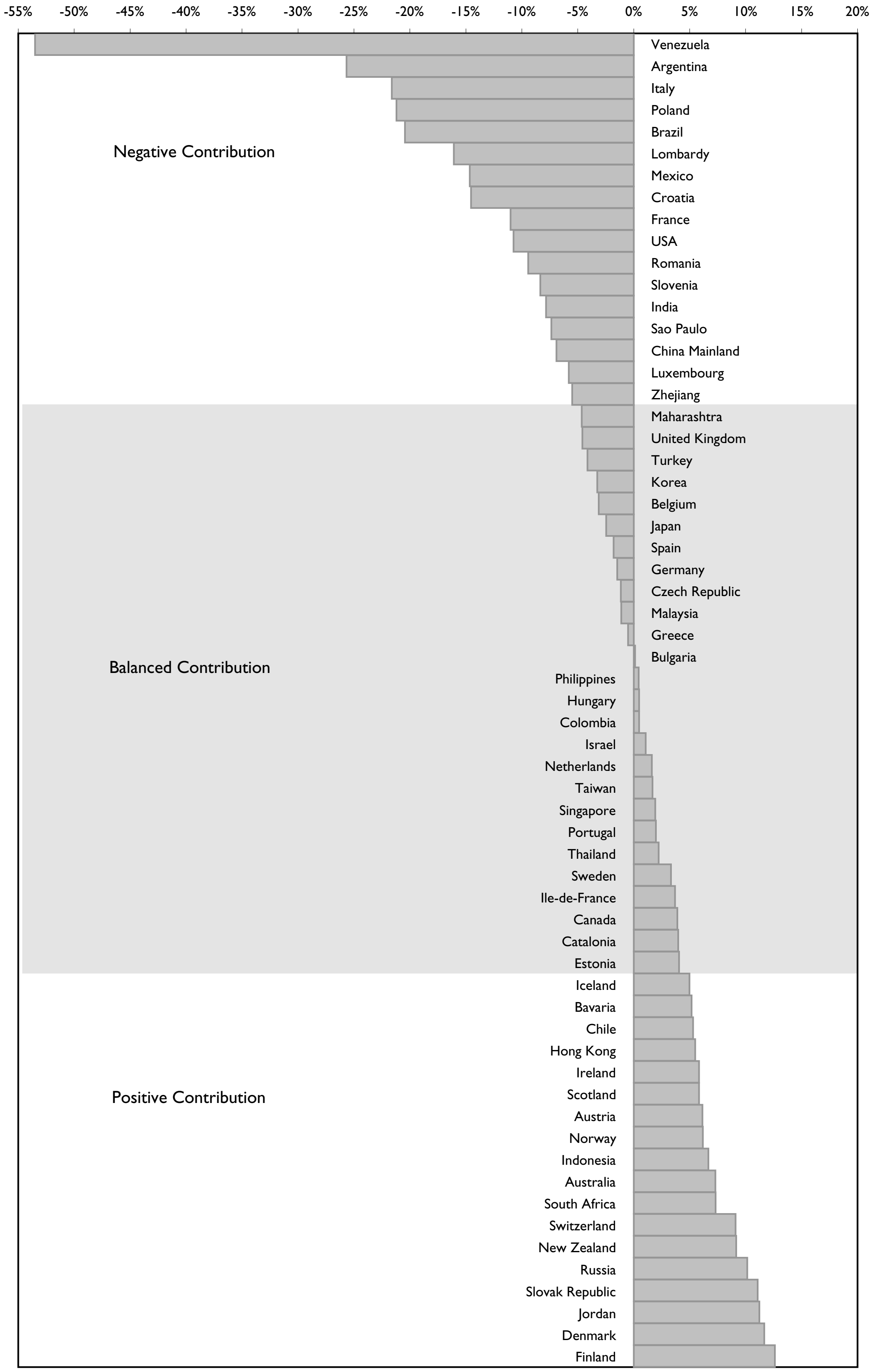
More than ever, competitiveness thrives on the ability to manage a totality of competencies and to capitalize on the vast amount and diversity of skills available in a nation or a firm. Attitude also matters. In this respect, competitiveness can also greatly depend on the willingness to be, precisely, competitive. There are a number of nations today where the predominant value system seems to be the preservation of what people have, rather than the achievement of higher levels of prosperity. "Quality of life" prevails over "standard of living".

Ambition is thus fundamental to competitiveness. In short, successful nations and firms have the ability to raise the general level of ambition everywhere and for everybody. Such an attitude may very well be the ultimate engine for competitiveness. It was very well expressed in the words of the painter Salvador Dali:

"At the age of 6, I wanted to be a cook, at 7 I wanted to be Napoleon, since then my ambition has grown steadily!"

ARE GOVERNMENTS DRAGGING THEIR FEET?

(Biggest negative difference between the government's and the economy's contribution to competitiveness)



IMD's World Competitiveness Yearbook defines a nation's environment by the contribution of four Factors of Competitiveness: Economic Performance, Government Efficiency, Business Efficiency and Infrastructure. Here we show a comparison between the contributions of Economic Performance and Government Efficiency, calculating the biggest negative differences between the government's and the economy's contribution to the overall competitiveness of each country.