

thebigpicture

guideposts for the private investor

Week Commencing 21 July 2003

Publishing and Subscription Information

thebigpicture guideposts for the private investor is published by *thebigpicture* Economics (ABN 71 040 787 936). The author, John A Robertson, while working in Australia, London and New York, has over 20 years experience in international financial and commodity markets, corporate strategy, financial and business evaluation and government policy. He has been Chief Economist and a director of a leading Australian investment bank. He has been a top-rated institutional equity analyst and has marketed investment advice in all the major international financial centres.

To subscribe to the newsletter, go to www.thebigpicture.com.au or send an e-mail to: admin@thebigpicture.com.au.

Newsletter subscribers may also subscribe to *thebigpicture* premium content which includes tailored analysis and seminars on economics, business and policy issues affecting investment decision-making. Further information can be seen at www.thebigpicture.com.au.

◆◆◆◆◆◆◆◆◆◆

thebigpicture Economics
ABN 71 040 787 936
PO Box 333, Malvern
Vic 3144

LOSING THE COMPETITIVE EDGE

Is there such a thing as national competitiveness? In arguing that there was not in its recent annual outlook, the Asian Development Bank (ADB) has signaled a growing sophistication in the region's approach to economic development and a challenge for Australian companies.

One message in Asian Development Outlook 2003 is that national competitiveness is a misnomer. Analysts and policymakers sometimes attempt to create summary measures of national competitiveness but nowadays competition only really occurs at the firm level. Nations do not compete.

Attempting to translate influences and issues important to an individual enterprise into a national measure of performance misunderstands the decision making behind successful businesses. Trying to make the jump can hinder understanding of what policies should be applied to achieve better outcomes.

Too often governments try to pump up their reputations by alluding to one study or measure at a point in time. Most often the measure has something to do with costs and quite frequently has something to do with wages being low. A low rate of wage increase is seen as good for national competitiveness. However, competitiveness in the modern world needs to be seen as a process rather than a condition at a point in time.

The best indicator of being competitive is a capacity to sustain a business in the longer term while being able to adequately compensate employees and provide an adequate or superior return to the providers of capital for the business.

Cost reduction might be an element of this outcome but is unlikely to be a major ongoing component. Similarly, in this sense, competitiveness may not necessarily involve doing better than comparable firms in terms of sales or market share. A sustainable business might be able to co-exist with peers. It might occupy specialized niches along a global value chain. It is characterized by its capacity to add value.

Favourable outcomes for the sustainable business are achieved through strategic initiatives dealing with product quality and innovation. In this world, doing something at the lowest imaginable cost might not be valued by customers if someone else has a record of being able to deliver a paradigm change to product quality or the way in which a product is viewed by consumers or other business buyers.

It also follows that longevity cannot be assured unless the culture of innovation is well established. Without innovation failure looms no matter what the cost structure. This is a dynamic process which is continually repeating: there are companies which are continually failing and others which are growing to replace them.

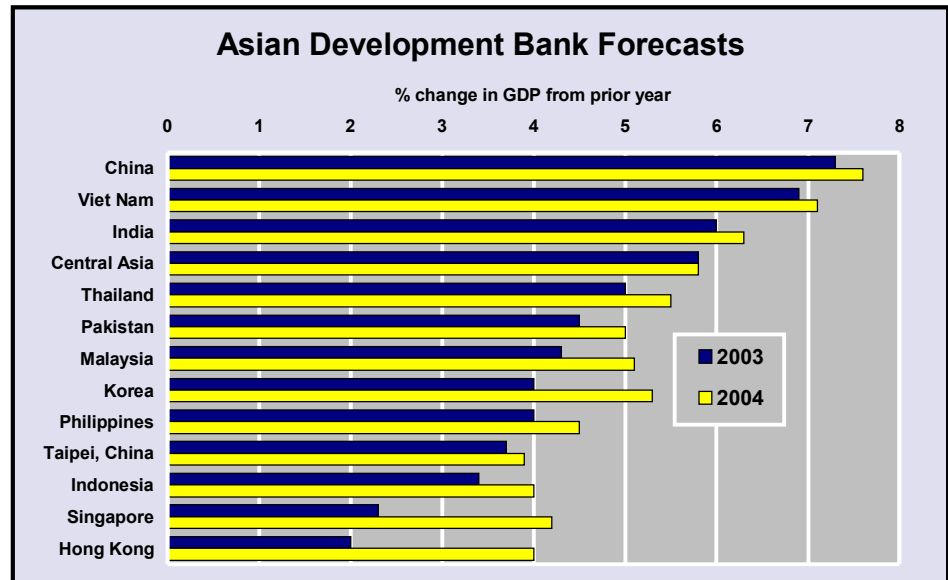
From a national perspective, a company failure itself is not such a bad thing and does not necessarily flag a poorly performing economy as much as the inability to generate the replacements.

Having a body like the ADB consider what determines commercial success shows that there is an important transition occurring in the way in which the region is beginning to

“Better entrepreneurial and technical skills, speedier adaptation to new technology and prudent risk taking will be the necessary attributes.”

(Continued on page 3)

THE WEEKLY CHART SPOT



Source: Asian Development Bank

“China’s increasingly consistent growth performance signals an influence which is binding the broader region to its fortunes and compensating for the absence of Japan as a driver of growth in the region.”

China remains the largest and most quickly growing economy in the Asian region according to the most recent forecasts produced by the Asian Development Bank. Growth in the region covered by the bank is expected to stay above 5% during 2003 (5.3%) and 2004 (5.9%) after reaching 5.7% in 2002.

This relatively sanguine outlook indicates little lingering effect from the problems which caused activity in the region to decelerate so dramatically at the end of the 1990s. Nor is there a significant ongoing influence from the outbreak of the SARS virus whose effect seems likely to be short-lived.

Significantly, a recovery in the growth prospects of Hong Kong and Singapore, which had been lagging, are expected to occur in 2004. That said, the ADB has identified recession in the developed economies, volatile energy prices and disruption to tourism as risks to the forecasts.

Such a promising outlook is emerging without any significant additional contribution from Japan something which might have been unthinkable once. China’s increasingly consistent growth performance signals an influence which is binding the broader region to its fortunes and compensating for the absence of Japan as a driver of growth in the region.

The newfound role of China as regional economic hub represents a chance for the region’s growth to become more self-sustaining. China is still too small to have an effect outside the region on general economic conditions. However, this is likely to come with time. With a growth rate so much above the global averages, it should eventually take over from Europe and Japan as a global driver of economic activity.

Losing The Competitive Edge cont’d

(Continued from page 3)

That these matters are being contemplated in Asia is a warning for Australian companies of the relatively sophisticated way in which the region is thinking about itself. Against this, traditional notions of cost competitiveness will not facilitate penetration of the regional markets. Better entrepreneurial and technical skills, speedier adaptation to new technology and prudent risk taking will be the necessary attributes.

Company fortunes will be more dependent on the capacity to create new products or services or innovations leading to new generations of existing products.

Reducing costs might be important from time to time but, if that is all that a company is capable of giving, there cannot be any sustainability of effort and, in focusing on cost reduction, it will lose its competitive edge.

US ECONOMY: WHERE TO? CONT'D

(Continued from page 4)

worse. After sharp output falls, at an annual rate of 7% in March and April, output is 1% lower than a year earlier. A red flag here too.

Personal income is a critical building block for consumers as they take their spending decisions. In May, personal disposable income was 3.7% higher than it had been a year earlier. This is a deceleration from the prevailing rates of growth during most of 2002 but still sufficient to maintain consumption spending at around 4% a year or better. We will leave this flag green.

Business sales fell sharply during the war months. Relatively buoyant pre-war growth in excess of 4% gave way to no



Losing The Competitive Edge cont'd

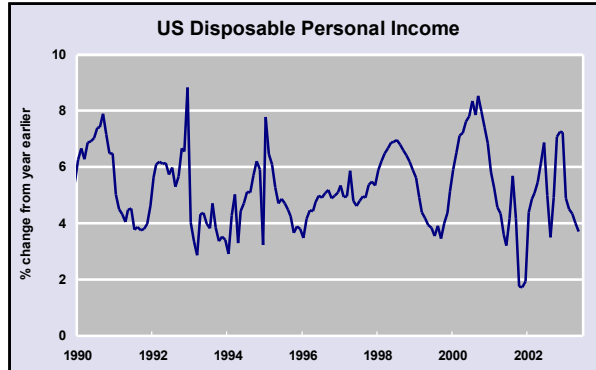
(Continued from page 1)

think about itself and what constitutes successful policy.

Only recently, Asia was viewed widely as a location for low cost production. For most western companies, going to Asia was a tactic in their cost management repertoire. Subsequently, Asia began to loom larger as a market in its own right. Now, with China as a hub for activity in the region, there is an increasing proportion of intra-regional trade and countries are less dependent on fortunes outside the region.

Meanwhile, Asian companies are also becoming integrated into the global value chains in which production is increasingly organized enabling them to play an ongoing role in global industry even though their production costs might be rising and, based on costs alone, production would have moved on to another location by now.

change in May for only a 2.0% increase over the year. The momentum here has also changed for the worse and, even if war-affected, needs to be given a red flag



for the time being.

Despite a desire to be positive and the hope, based on conventional economics, that the affects of the stimulus should be showing soon, the growth risk is still very evident.

No wonder that Greenspan has made it clearer than ever that growth is now the top priority with his fellow governors "prepared to maintain a highly accommodative stance of policy for as long as needed to promote satisfactory economic performance" an aim which could be pursued "for a considerable period without ultimately stoking inflationary pressures".

"Among the four key indicators which help distinguish between recession and growth in the US economy, the balance has turned less optimistic."

The first lesson for Australia is that it is not possible to generalize about its own position in the world: that it can produce high value added products while low value added product comes from Thailand, say, or that falling Australian unit labour costs will necessarily translate into improved economic performance by Australian companies. These are assertions which can only be tested at the enterprise level if there are sustainable businesses to support them.

This growing reality is being reflected in the national debate. Wage agreements, for example, are now far less a political matter. Once, unions were blamed for high wages. Gradually, wage levels are being seen as the responsibility of business management as are virtually all aspects of a firm's culture and success.

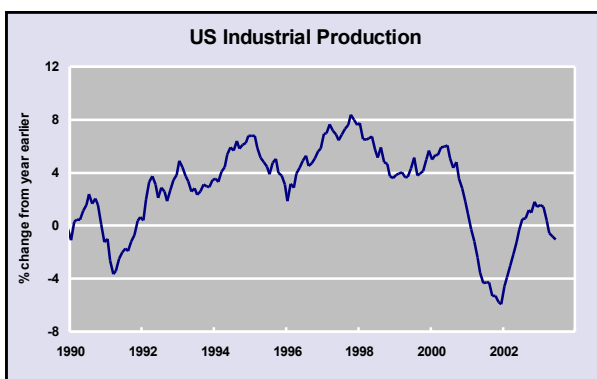
(Continued on page 2)

US ECONOMY: WHERE TO?

The world needs a driver for its growth and is watching the USA as the only available alternative. That makes Alan Greenspan the chief policy maker for the planet. Meanwhile, there are more red flags against some of the key indicators.

Chief policy maker Greenspan told the US House of Representatives in the past week, in the Federal Reserve Board's semiannual monetary policy report to the Congress, that there was cause for some greater optimism about the US economic outlook:

- some of the residual war-related uncertainties had abated;
- monetary policy was more supportive of growth;
- yields across maturities and risk classes had declined;
- higher profits, discounted with significantly lower longer term interest rates, have boosted stock prices;
- improved household balance sheets from higher asset prices and the restructuring of existing debt are helping to support consumption;
- recently passed tax legislation will increase households' cash flow in the third quarter by US\$35 billion; and,
- businesses have taken advantage of



low interest rates to shore up their balance sheets with a move to longer term and cheaper financing alternatives.

According to Greenspan, if the past is any guide, these factors should bolster economic activity over coming quarters. Although characterizing forward-looking indicators as "mostly positive", Greenspan did caution that a rebound in energy prices and weakness in demand in Japan



and Europe could sap the strength from any incipient US upturn. He also observed that there appeared to be "a pervasive sense of caution reflecting, in part, the aftermath of corporate governance scandals" which has left business reluctant to spend on capital or new hirings.

It appeared that the FOMC was confronted at its last meeting, therefore, with the hope of a turnaround but the reality that conditions remained weaker than could be countenanced without action.

Since *thebigpicture* last reviewed its key US indicators a quarter ago the balance of available evidence seems to have fallen against recovery persisting. Among the four key indicators which help distinguish between recession and growth in the US economy, the balance has turned less optimistic.

Non-farm payroll numbers, down 0.3% over the year to June 2003, are lower than at any time since October 1999. Employment does tend to lag other performance indicators. Nonetheless, this represents a red flag for the US economy.

At best one could say that industrial production has stabilized. More pessimistically, the momentum has turned for the

(Continued on page 3)

"Although characterizing forward-looking indicators as "mostly positive", Greenspan did caution that a rebound in energy prices and weakness in demand in Japan and Europe could sap the strength from any incipient US upturn."