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1. The End of Competitiveness?

Economic forecasts are going through multiple revisions in the face of major movements on the currency exchanges and the devaluation of the US Dollar, the Canadian Dollar, the English Pound, and a host of traditionally softer Euro-currencies relative to the Yen, the Swiss Frank, German Mark, and Dutch Guilder. Hard-currency countries are suffering from the sudden simultaneous deterioration of conditions for export and increased competitive pressure from inexpensive imports. Major exporting countries like Germany and Switzerland are particularly hard hit in this situation. For example, a firm that faces Italian competition has experienced a one-year competitive disadvantage of 25%, simply as a result of changes in the currency markets. Clearly, a disadvantage of this scale is not easily overcome, even with the best cost management program and the most flexible pricing policies.

It is no wonder that time and again the question is raised, whether in the long run, under these conditions, Switzerland, and indeed, Germany and the Netherlands as well, will be able to continue as sites of manufacturing and service-based industries. Considered carefully, the motivation for this unsettling question is revealed to have two parts. The first part stems from contemporary developments in the currency markets. The second, deeper - and presumably more important - motivation derives from concern about the overall economic structure. After all, it is not just the exchange rate that determines prices on the export market. Prices reflect the entire set of costs carried by producers in our area. The wage level, the maintenance of the social welfare state, the tax burden - these costs belong to a local cost-structure that is so disproportionately high in comparison to other countries that one can only marvel at this region's undisputed economic successes to date.

In addition, there is a clear shift of wealth creation out of the industrialized nations and into the so-called threshold countries. The days are past when raw materials were appropriated from one side of the globe so that on the other side they could be turned into high-cost finished goods. Today's perceptive world traveller is well aware of the changes occurring in regions where years ago one could only buy bananas, cotton, coffee, copper, or crude oil. These regions are developing manufacturing and service industries that produce products of a quality that rivals our own. Only the prices of their products are different: they're lower.

In our opinion there is no more pressing question than the question of what it takes to be competitive. In a world with such divergent local cost structures, what will it take for individual countries, branches of industry, and individual firms to maintain their competitiveness over the long run? Every investment mechanism, whether equity or fixed-income securities, are only as good as the issuing enterprise's prospects for generating cash flow with which to pay dividends and interest. Thus, in what follows, we attempt to provide an in depth understanding of the current economic situation. We then draw conclusions from this analysis which help shape our current view on economic matters.

2. Amazing Structures

Michael E. Porter, an American professor of economics, has given considerable attention to the issue of competitiveness. His publications (e.g. The Competitive Advantage of Nations, Free Press, 1990) have inspired serious reflection among business and public administrators. Porter researched a large number of successful business enterprises, and enterprise groups around the world in an attempt to determine the causes of their prosperity. His findings are quite remarkable. His research reveals that:

- successful companies are rarely operating alone in a field. Instead, they are most often experiencing intense pressure from a competitor in their immediate vicinities.
- business success is therefore often a combined function of the particular product and the characteristics of the space in which the product is being produced.
- the socio-economic framework in which a company operates plays an extremely important role.
- government programs aimed at economic structural-maintenance frequently end in disaster.
- currency divergences are of secondary importance, since otherwise the location of many successful enterprises could not be explained.

Interestingly enough, successful business enterprises are often found precisely where one would a-priori not expect them; they exist in locations which, when viewed superficially, appear to offer few advantages. Porter, for example, concerned himself extensively with the chocolate industry in Switzerland. In this our country, the only place cocoa beans might grow is in the botanical gardens. Similarly, the need for sugar (another basic ingredient of chocolate) does not provide an argument for choosing Switzerland as the site for chocolate production. Swiss Alpine milk is expensive. Wages are high. And yet, we have an extremely successful chocolate industry.

Another example is Holland and its flowers. Neither the relatively short periods of sunshine, nor the harsh climate have prevented Holland from virtually cornering the worldwide flower trade. Roses from Turkey are shipped to the airport in Schiphol, traded on the Dutch exchange, and eventually wind up in Athens. Although such transport routes appear absurd, they are apparently justified by Holland's monopoly on flower-marketing know-how.

One could cite numerous other examples: the Italian leather industry, Silicon Valley, the Japanese entertainment electronics industry, Basler chemical Industry, the Swiss presence in world trade. Porter's work clearly undermines the proposition that competitiveness is merely a function of the cost and availability of the traditional factors of production (raw materials, labor force, capital, and infrastructure).

3. The Ability to Innovate is Everything

The supposition that increased competitiveness requires increased business size also turns out to be false. The law of "economies of scale" holds that with increased volume the average per unit cost of production decreases and as a result profit margins are improved. However, this law only holds as long as size itself does not become a significant cost. The "dinosaur syndrome" has already claimed its share of large businesses. Presumably, managers in companies above a certain size find themselves expending the vast majority of their forces on issues that stem directly from the company's magnitude.

Of course the classical factors of production all have important roles to play. But they are not sufficient for economic success. Porter points out that the classical factors are typically constant. Thus, it is the dynamic factors which take on the greatest importance. The question becomes, to what extent can a company work with the static factors, adapt itself, and finally change the world. The ability to innovate is the key. There must always be the independent will to improve, to find advantages, to discover new technologies, to question and change methods, and to seek out new markets. Finally, there must always be the willingness to amend time-tested strategies.

The ability to innovate does not simply fall from the sky. But it is also not something that is easily organized. Innovation does not come about through orders or directives; this explains why large-scale enterprises often face losing the ability to rejuvenate themselves. Innovation is ultimately produced through the interaction of multiple distinct but mutually reinforcing factors. Porter captures this dynamic model with the concept of "clusters". The term intentionally invokes ideas of confusion, inconsistency, and malleability. This is horror for all the determinists who believe that the world, in all its complexity, can be subject to complete description.

4. The Cluster as a Success Factor

A business enterprise that is pressured by a very demanding clientele is, in the long run, more competitive than one that can more or less treat its clientele as it pleases. If a demanding clientele is so demanding that it anticipates the quality expectations of other client segments, then in this respect there may be nothing prohibiting a firm from succeeding on a world-wide scale. That is why a demanding local clientele fits in with the cluster concept.

Similarly, intense pressure created by local competitors has to be considered one of the factors of success. Monopolists are less prone to fail due to measures taken by regulatory agencies than due to their lethargy and complete lack of inclination to innovate. In today's global context there is no longer any place for monopolies. Their products are being substituted. The European radio and television monopolies were long ago marginalized by satellite television. They only survive (for the moment) through the tax-like fees they collect. It is sad that for so many years the lack of local competition prevented the emergence of credible media-electronics enterprises in Europe. The overwhelming presence of American film and television productions is not so much a consequence of American cultural imperialism. Instead, it is the result of European media socialism, which prevented the development of the necessary cluster or competitors.

The quality of the network of suppliers is also determinant of success. When a Japanese car company opens a new manufacturing plant in a developing country, it plans carefully the necessary expansion of its supply network. From year to year, the number of components supplied from Japan drops as the number produced in the developing country itself grows. In this way, the Japanese are building regional clusters of firms and people who know something about automobile production. In the long run, isolated individual firms will not be able to succeed, precisely because they don't have this critical pool of suppliers. The importance of this factor is underscored by the fact that innovations in the production of components are often more consequential than innovations in the assembly of finished goods.

Finally, the local socio-economic environment is also part of the cluster of factors necessary for success. Technical schools, a university, an active cultural environment, a free and world-embracing coexistence: one can hardly imagine any innovation without these elements. Ideas that really take us further seldom come from linear thinking. Typically, they result from an associative process of sideways thinking. The human mind needs the opportunity to range free. Thereafter it can better return to the discipline of logic and technical knowledge, as is promoted through teaching and research. A business enterprise that finds itself embedded in an environment of high intellectual productivity has all the prerequisites for expanded success.

5. If we look at ourselves in the mirror...

If these theses on competitiveness are, in fact, accurate - as the empirical evidence overwhelmingly suggests they are -, then several questions arise regarding developments and phenomena in our immediate and more distant surroundings.

A big question mark has to be attached to many of the so called competitiveness-policy initiatives that are currently being discussed in the European Community as well as in our country. Granted, some of the proposed laws are touted as aimed at improving the overall competitiveness of the market, e.g. those aimed at standardizing measurements, improving and standardizing the process by which goods are declared, and ensuring the uniform application of environmental regulations. However, it seems just as likely that once established, these standards will only serve to undermine the forces of innovation. Inflexible standards are unlikely to provide any incentives for progress and improvement. Current intervention in the law-making process by national associations in the federal capital, Bern, and international branch organizations working in the EC nerve center, Brussels, suggest that in most cases the result of competitiveness policies is likely to be protection rather than competition.

Another question relates to the maintenance of the cluster itself. To what extent are the strategic considerations (assuming they exist) of corporations, regions, and nations focused on these long-term aspects of economic success? Is the stage not often dominated by short-term profit-maximizing considerations? Are the Swiss people and their political representatives aware that the Swiss financial sector is an example of a cluster par excellence? Are we clear about the fact that the competitiveness of our financial sector depends to a large extent on the characteristics of our legal infrastructure? That security, trustworthiness, secrecy, efficiency of the courts, etc. belong to the success factors of this cluster?

Finally, there is a question that applies to each individual business owner. Does he or she truly take seriously the need to innovate? Or does he tend to be the imitator who, for the hundredth or thousandth time, offers the same thing as his competitors and tries to use cost management to achieve an acceptable return? We need to look at ourselves in the mirror. To what extent are we working to be different and better than the others?

6. Comforts for all those who are willing to compete

Internationalization, indeed globalization, has unmistakably encompassed nearly all the world's regions. It is thus tempting, as we indicated earlier, to assume that all production will shift to where costs are lowest. Presumably, the consequence of this would be a dramatic decline in the standard of living in the industrialized nations: a reshuffling of the deck. But what we have learned about competitiveness suggests that cost minimization is only a small part of the story. In the future, production will continue to be located where the necessary will and competence is present, and where an adequate legal framework is in place.

Without question, new areas of the world may gain in importance if they are able to develop the required capacities. India is writing computer software programs for the whole world. Large scale textile production has left Switzerland and Italy for the Middle East and China. Nowadays Chile offers numerous high quality agricultural products.

Globalization means that in the future real competence and actual innovative power will count for more. Political boundaries and regulations will steadily diminish in importance. Protectionism makes little sense in an era in which explosive growth in service industries is displacing physical products and there is a simultaneous multiplication of available communications technologies. Once again, the markets are growing in importance.

Hence, each person becomes the author of his own fortune. This appears to us a very weighty argument in favor of sufficient, carefully considered worldwide diversification of investments. In the end, intelligent participation in the globalized economy will be a less risky investment strategy than blind investment in government bonds, some of whose countries are nearly bankrupt. Furthermore, it will be less risky than a strategy to increase the already disproportionate stake in domestic property, the typical approach taken by Swiss pension funds. Property investments are only good for as long as one has tenants who are capable of keeping up their rent payments.

7. Not doing the wrong thing in the short run

Admittedly, all these considerations are primarily relevant to the long run. However, we should not allow the events of today to distract us from the larger trends. He who wanders in the woods without a compass will quickly lose his way after straying this way and that to avoid the trees...

This, of course, does not alleviate the necessity of having to learn as much as possible from short-term trends in order to increase profit or, at least, avoid making a mistake. The problem facing all investors in hard-currency countries is that any diversification can become costly. In previous commentaries we attempted to point out the reasons for the collapse of the US currency exchange rate. In particular, we focused on the connection to foreign and domestic debt and the inadequate rate of savings. In the last few weeks, the Dollar's retreat has slowed to a standstill and people have begun to adjust to the new exchange rate. This suggests a period of relative calm in the currency markets.

But the ice is still thin. If contrary to all current indications the US were to experience higher rates of price increases, then either the dollar would undergo further depreciation or the Fed would have to once again increase interest rates. One predictable result of such an occurrence would be losses on the bond market, a market which has experienced a relatively positive trend in the last few months. The worst-case scenario would be higher rates of price increases coupled with lower rates of growth. For the moment it is believed that there will be a "soft landing". If one uses the stock market as an indicator, then the prospects for this do appear quite good.

As hard-currency countries, Germany, the Netherlands, and Switzerland need to adjust their economic growth expectations downward. Those suffering the most from recent changes in the currency exchange rates are the suppliers to large export companies. The exporter can shield himself from losses by substituting less expensive imports for the supplier's products. The struggles of suppliers put downward pressure on the gross national product, even if the level of exports remains constant. Available data should thus be interpreted with care.

Firms should be similarly differentiated with respect to their prospective profitability. Disappointing performances are most likely from firms that are indirectly dependent on the export market and whose products face competition from inexpensive imports. Nonetheless, as the example of the pharmaceuticals company Hoffmann-La Roche has shown, significant success is possible despite shifts in the exchange rate.

Without question, the insecurity of the currency situation is casting a shadow over all of Europe's markets. Even the easing of interest rates is not producing any sizeable impulses. We don't expect this situation to change significantly in the near future. Our Bank has therefore consequently adjusted its equity investment. We retain certain exposure through structured products, but beyond that we are applying derivative techniques in order to take advantage of the flat trend.

8. Interest rates - already at their lowest point?

While accelerated by developments in the currency markets, macroeconomic data have for some time been announcing the recent downward shift of both short and long term interest rates in the hard-currency countries. So the long prophesied "interest rate-hump" has in fact arrived. The question is, will this friendly development (it has finally been possible to make money in bonds again!) continue for a while or is it already coming to an end?

The conservative growth prognoses for Germany and Switzerland suggest a continuation of both the easing of interest rates and the present currency situation. Of course, we must be aware that yields are once again approaching their historic lows. Currently the yield on a Swiss Frank ten year bond is approximately 4.3% and a German Mark ten year bond yields 5.5%. So there is not a lot of room for further downward movement.

In our previous commentaries we pointed out at length new patterns of interest rate behavior that we believe reflect the powerful disciplining force of the international bond markets. Very little room is left for monetary policy tinkering. That is the one, very good, side of the situation. The other side requires that we recognize the inevitability of negative surprises when discipline is maintained through the market. Thus, it is our view that interest rates are more likely to oscillate than to remain in a low level phase in the coming years. This changes nothing in terms of the long-term positive outlook, in fact quite the contrary.

As it became clear in the wake of the Mexico crisis that the US dollar would be used to compensate for Mexico's failed monetary and currency policy speculation, the value of the dollar sank. Once again, the markets rule the world! The punishment for economically questionable behavior is swift. When before their week was up, representatives of the G7 countries decided not to take any action with respect to the currency crisis, the currency markets also did nothing. Why? Because the markets know that intervening in currency policy promotes inflation in hard currency countries, and they would have responded accordingly.

We can't emphasize enough that the key to future investing lies in the new strength of market forces in the realms of interest rates and currencies. If in addition we recognize that the economically most successful firms will be found where competition is toughest, then we have discovered a signpost for future investing!
