EXECUTIVE SUMMARY

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In Group I*, Australia (2) and Malaysia (4) increased their competitiveness in the 2003 rankings behind the US (1), which has shown more resilience in the crisis than expected. All the large industrialized nations rank in the first 10 places, with the exception of Japan (11) and Italy (17). The State of Sao Paolo (13) tops the list of the most competitive regions in this category.

In Group II*, Singapore (2) and Hong Kong (4) are making a strong comeback after a painful year 2001. However, this was before the SARS epidemic. Finland (1) remains in the lead while the Netherlands (8) pays the full price of political and social uncertainties. In general, smaller nations are more vulnerable to the economic environment. This is especially true for Switzerland (5) and Ireland (11), both falling two ranks. Ile-de-France (15) is the most competitive region in the group.

The world competitiveness landscape in 2003

Nations are painfully emerging from two years of economic doldrums, which went beyond a mere technical market correction. The following headlines will define competitiveness landscape in 2003:

- **I** **It is not a recession, it's "economic anemia"; it is more pernicious and just as bad.**
- **II** **The US is resilient, thanks to interest rate cuts and consumer spending. However, the current account deficit (4.8% of GDP), the expected budget deficit ($300 billion) and proposed tax cuts may push foreign debt up and the dollar down further.**
- **III** **Europe battles with deficits and the ability to reform governments. Overregulation and complexity hamper its growth. Joining members perform better.**
- **IV** **Latin America struggles to overcome the side effects of the implosion of Argentina and Venezuela. Brazil's new administration has been well received so far.**
- **V** **Asia was picking up again, but the SARS epidemic may jeopardize the recovery.**
- **VI** **Oil prices are back to reasonable prices ($24) after the Iraqi war.**
- **VII** **The collapse of stock markets has forced the financial sector, once a buffer in periods of slowdown, to restructure just as drastically as industry.**
- **VIII** **Pension funds have lost $2'800 billion worth of assets. A time bomb is ticking.**
- **IX** **Corporate debt has increased five-fold in the US in 20 years. If interest rates go up again, many companies could go bankrupt.**
- **X** **The IT sector continues to consolidate and is no longer the locomotive of growth in the world economy. What will be the next big hype? Wireless?**
- **XI** **Confidence in business leaders is at an all-time low. Trust in numbers and people has been destroyed. Legislation on accounting, auditing, and corporate governance will step in.**
- **XII** **Competitiveness key words for 2003: back to fundamentals, simple, solid, no-nonsense, adaptive, transparent, and honest.**

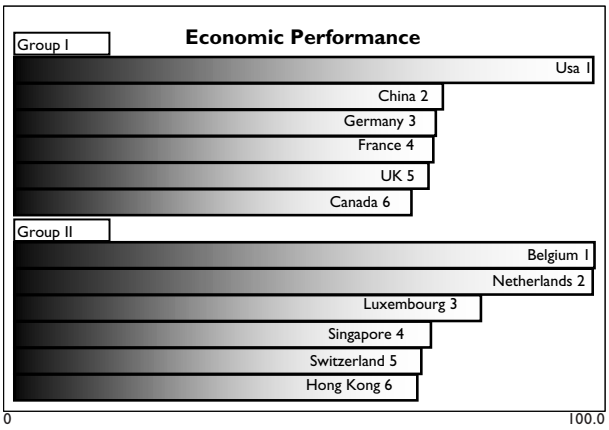
* In 2003, the World Competitiveness Yearbook highlights two categories: Group I, comprising 30 economies with a population greater than 20 million, and Group II, comprising 29 economies with a population less than 20 million. This distinction takes into account the very different nature of competitiveness in larger and smaller economies. In addition, and for the first time, some selected regions and local states are included in the rankings, thus underlining the reality of a new dimension in competitiveness.

A. Competitiveness and Economic Performance in 2003

The good news is that the world economy is not in recession. The bad news is that nobody believes it. Out of the 59 countries and regions of the world analyzed by the World Competitiveness Yearbook 2003, only four have seen a contraction of their GDP in 2002: Argentina (-11.2%), Iceland (-0.5%), Israel (-1.1%) and Venezuela (-9.6%). All other economies have been growing. China Mainland and Zhejiang Province lead the pack with staggering growth rates of 8.0% and 12.3%, followed by Turkey (7.8%), Korea (6.3%), Estonia (5.8%), Thailand, and the Philippines at 5.2%. The other economies are suffering continued sluggishness but growth is not shrinking. The general state of confidence in the economic future, nevertheless, remains very low and a "wait and see" attitude seems to prevail.

1. A never-ending soft landing of the US economy…

Since 1995, the US economy has contributed more than half of the growth of the world economy. As the leader in world competitiveness, the performance of the US economy has thus a strong impact on every other nation. In 2001, the US barely escaped a recession with 0.3% growth. In 2002, the economy did not experience the strong upturn that some would have expected. However, 2.3% growth last year, given the very volatile economic and political environment, is still quite an achievement.



In retrospect, perhaps it would have been better if the US economy had suffered a short abrupt recession to clean up the market after the eccentric years 1998 - 2001. A market correction was inevitable and expected. It would only have been the tenth since World War II, nothing unprecedented. However it did not happen. On the contrary, the US economy underwent a long, agonizing slowdown. Why?

- The US Federal Reserve has been extremely articulate in gradually lowering interest rates (12 times in a row and currently at 1.25%), thus preventing the US economy from entering a recession. The resulting boom in housing and construction in the US (as a consequence of lower mortgages, etc.) has sustained the economy probably more than would have been conceivable in Europe, Asia or Latin America where house owners are less numerous. It is also estimated that American homeowners raised $130 billion through home-equity loans in 2002 that were recirculated in the economy.

- Consumption did not fall as drastically as might have been expected. Despite all the bad news on the economic scene, corporate scandals and imploding financial markets, consumers continue to consume. The rate of consumption isn't as high as usual, especially during the critical holiday seasons, however it is still more dynamic than analysts would have expected.

- Companies were very quick to react to the first signs of economic slowdown. Costs saving measures were immediately put in place in 2001, especially after the shock of September 11th. New management tools, such as Enterprise Resource Planning, have helped companies react faster and more efficiently than in the past. Excess inventories, a traditional cause of recession, were slashed drastically. Today, inventories represent on average 1.38 months of sales.

Despite the terrorism threat, the war in Iraq, erratic oil prices and the collapse of financial markets, the US economy has not technically been in recession, thereby pursuing a period of expansion that has now lasted more than a decade. Moreover, it has demonstrated extraordinary resilience during this difficult and gloomy period. The IMF is forecasting 2.2% growth for 2003.

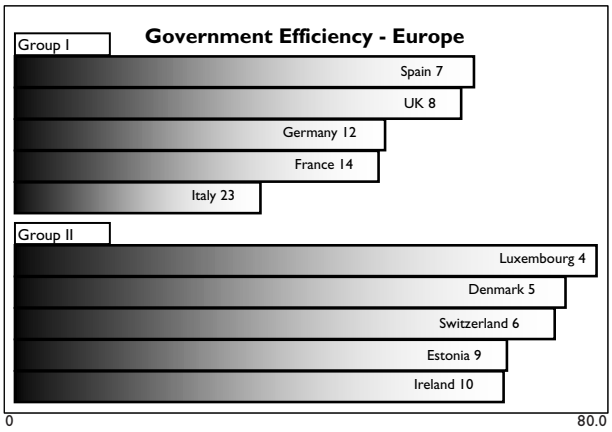
2. …and Europe is coughing.

The perspectives for European competitiveness are more divergent. The 15 European Union countries show a great diversity in performance. The adhesion of 10 additional nations, confirmed by the Athens treaty on April 16th 2003 and effective in May 2004 will increase the disparities in European competitiveness. Many of the newcomers have a significantly lower cost structure and salary basis than the European average. As a consequence, some transfer of economic activities, especially in assembling and manufacturing, is likely to take place *within* the European Union.

Companies located in countries with high cost structures, such as in Scandinavia or Germany, will certainly exploit the opportunities offered by the future membership of the Baltic States, Central European and Mediterranean nations. On the other hand, Ireland and Portugal, among others, could suffer from delocalization of some foreign investments.

Altogether Europe, in 2003, can be divided into three categories:

- Larger economies have encountered significant difficulties in adapting and reforming the role of Government to enhance their competitiveness. This is the case for France, Germany, and Italy, where slower growth places them on the borderline of recession. As a consequence, budget deficits are a source of concern since they exceed the limit fixed by the European stability pact (3% of the GDP as a maximum). In March 2003, the German Chancellor announced an action plan to correct this problem. One exception is the UK, which continues to show more dynamism, posting 1.6% growth. However, in 2002, the UK experienced a sizeable current account deficit, tension in the public sector and infrastructure problems.



- Smaller economies suffered not so much from inadequate domestic structures but from their vulnerability to the international economic situation. This is especially true for Ireland where the growth rate has been halved in two years to 5.1% (compared to 11.5% in 2000). The Nordic European countries, the Netherlands and Switzerland are also undergoing the fallout of a declining world economy. Their performance could be described as "flat". Even tiny Luxembourg, who seemed to be immune to economic downturns, has seen its economic growth plunge from 8.9% in 2000 to a meager 1.0% in 2002.

- Upcoming economies, such as Slovenia, the Czech Republic, Hungary, the Slovak Republic, or Estonia, benefited from strong growth rates (between 3.2 and 5.8%). Their low cost base will allow them to reap greater benefits from their entry into the European Union. They risk however some brain drain of qualified and young people who may be tempted to move to the higher revenues found in European countries. They will also have to monitor a certain loss of control over local industry, which, in open markets, could be bought out by foreign investors.

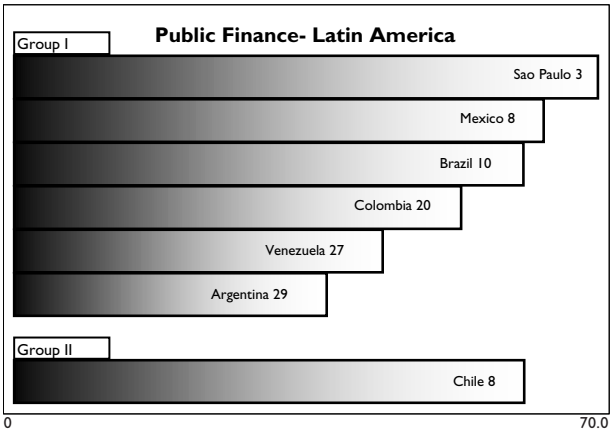
Russia is still considered from a different angle although its competitiveness is more and more linked to the European environment. Structural reforms are showing results coupled with a solid price in oil and gas that has sustained export revenues. Russia has been growing at 4.1% in 2002, a good performance following 5.0% growth in 2001. However, the considerable investments, which will be required to bring Russian infrastructure up to world standards, will probably be directed to selected industry sectors and regions of the federation. Only these will have the capacity to compete globally in the near future, while significant parts of the Russian economy will continue to struggle.

The competitiveness of Europe is plagued by overregulation and complexity. A recent IMF study has suggested that deregulation could add 10% to the European GDP in the medium term. The cost of doing business is a fundamental part of competitiveness. It is not only calculated in monetary terms (compensation levels, taxation, etc.) but it is also related to the complexity of doing business, the rigidity of structures, the fragmentation of decision-making and a lack of flexibility in changing direction. Cost is certainly part of the competitiveness problem of Europe. However, the ability to simplify structures and to increase transparency in policies is also a major challenge, which has to be tackled.

The 15 countries of the European Union are only expected to grow by 1 % in 2003.

3. Latin America struggles on...

This is not a good period of time for the competitiveness of Latin America. Argentina has suffered a massive -11.2% decline in its GDP in 2002. Venezuela, confronted by political instability and repetitive strikes, has shown a decline of - 9.6%. Both countries, which theoretically should be among the wealthiest of the continent, seem to have imploded, leaving their political and economic infrastructure in complete disarray. Their attractiveness to foreign investments has dramatically fallen. In addition, an exodus of qualified people is taking place, further damaging the future competitiveness of these nations.



Brazil has undergone a transition period with the election of a new president: Luiz Inacio Lulla da Silva. With a growth rate of only 1.5% in 2002, Brazil has certainly performed below its true potential. However, the fears of a "populist", free spending economic policy of the new government seem to have been overcome by a very pragmatic administration. A balanced policy adopted by the president between electoral promises and economic realities has moderately reassured international markets. Increased independence given to the central bank also has been well received. The next key challenge will be how the government tackles public debt.

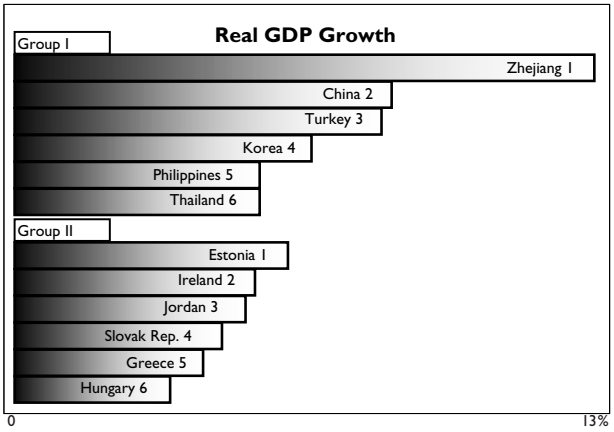
Colombia has avoided tougher times, with 2.5% growth, especially due to support from the IMF. Indeed, IMF policy, also in Brazil and Argentina, will determine to a great extent the future competitiveness of Latin America. Brazil received an IMF loan of $30 billion last year and should be able to secure more. However, Argentina defaulted on an $805 million repayment to the World Bank in November 2002. Argentina alone accounts for 15% of all IMF loans and 8% of total World Bank loans.

Latin America is in dire need of stability and predictability. Spending in infrastructure, and capital investment in general, has slowed down. Very few competitive industrial clusters are being developed, with the exception of Chile. Education, especially in primary and secondary schools, does not receive sufficient funding. The short-term pressures are harming the future.

4. Asia on the brink…

The competitiveness of Asia has always been characterized by a high degree of volatility and excessive dependence on IT technologies and the US market. 2002 was no exception to the rule.

The region has experienced higher growth rates than other parts of the world; these include Korea (6.3%), the Philippines (5.2%), Thailand (5.2%), Malaysia (4.2%), and even Indonesia (3.7%). However, Taiwan and Hong Kong are less dynamic with growth rates of 3.5% and 2.3%. Singapore, for a long time the beacon of the region, reports a disappointing growth of "only" 2.2%. All these nations have suffered, to different degrees, from the collapse of the IT sector worldwide and the slowdown of the US economy. South East Asian nations are trying to diversify their economies by focusing on more service-oriented activities such as financing or logistics.



China Mainland and Zhejiang Province stand out with formidable growth rates of 8.0% and 12.3% (9.9% for China during the first quarter of 2003). Despite all the economic turmoil, China is on its way to becoming "The" manufacturing center of the World. It received some $44 billion of foreign direct investment in 2001 and $52.7 billion in 2002. China has accumulated in a small period of time the 4th largest stock of foreign direct investments in the world ($395 billion). China already represents 25% of world steel consumption. With a well-defined cluster policy, especially on the Eastern coast, and a huge potential labor force (737 million people), China is emerging as one of the most formidable competitors on the international scene. The government's objective is to quadruple the GDP to more than $4,000 billion by 2020. Joining the World Trade Organization in 2001 should bring both additional benefits and an adaptation of business legislation, based on more transparency and equal treatment among enterprises.

India's relatively weak performance in 2002 at 4.4% growth (compared to 5.6% in 2001) is probably the result of a difficult year in the agricultural sector, which accounts for about one fourth of the GDP. However, India has "pockets" of competitiveness, which are not to be underestimated, especially the region of Bengalore, or the states of Maharashtra, Kerala or Gujarat. India has a huge reserve of qualified, English-speaking workers, who are more and more sought out by global companies for back office and processing activities.

The two "advanced" economies of the region, Japan and Australia, have experienced a very different fate. Japan continues to have disappointing performance of 0.3% in 2002 (0.4% in 2001). Economic activity was mainly sustained by international demand, especially from China, and domestic consumer spending supported by government incentives. However, the need to reform the competitiveness structure of Japan is as urgent as ever, especially in finance, distribution, competition regulations, and the revitalization of small and medium size enterprises.

Australia, with 3.8% growth in 2002, is one of the fastest growing nations in the OECD group. The perspectives for 2003 however, are dimmed by the reevaluation of the Australian dollar, weaker exports, and international political uncertainties. Even so, Australia is showing impressive resilience and has sustained growth over 3% during five of the past six years.

However, two non-economic issues will also affect Asia's competitiveness in 2003:

a. The containment of terrorism after the wars in Afghanistan and Iraq, which have significantly increased security and defense spending in the region.

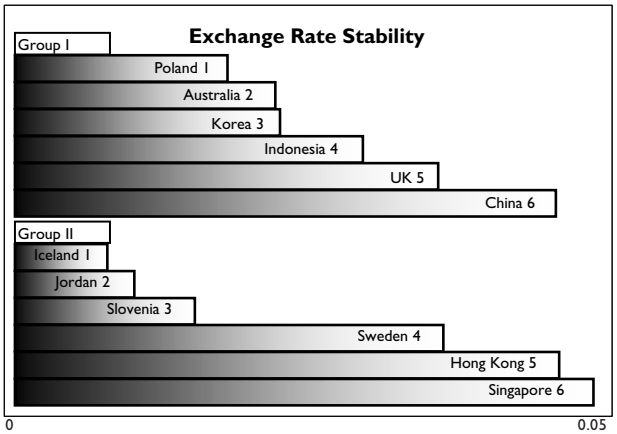
b. The spread of the Severe Acute Respiratory Syndrome (SARS) is starting to have an impact on the region. Morgan Stanley estimates that it may decrease growth by 0.5% in Asia (excluding Japan) and that a 60% drop in tourism revenues could be expected during the epidemic. Some analysts even venture that it could push Hong Kong into a recession during the first half of 2003.

5. Oil, money and the world.

The price of oil has been very erratic and has created numerous uncertainties in the world economy. From a reference point of $25 a barrel, it surged to $35 during a significant part of the year but never reached the nightmarish scenario of $50 a barrel due to the war in Iraq. After the war, it fell back to $24.

Economists reckon that a $10 increase in the price per barrel for one year would knock 0.5% off world economic growth. On the other hand, a similar drop in the price of oil is equivalent to a $250 billion tax break for enterprises and may generate an additional 2% in corporate profits. Oil therefore is a wild card in competitiveness. It can easily tip the balance one-way or the other. After the Iraqi war, however, the odds are for a stabilization of prices, and even a drop as Iraqi production recovers.

The two large world currencies have also fluctuated a lot in 2002, with a strong resurgence of the Euro compared to the dollar. The US dollar market rate stood at 1.14 Euro during the first quarter of 2002. At the end of the year it stood at 0.95 Euro, almost 20% down. Such disparities may distort international statistical comparisons when a common currency, Dollar or Euro, has to be selected as a yardstick.



During the first half of 2003, depreciation of the dollar has continued, probably because of the concern generated by the large budget and current account deficits foreseen under the current administration. However, for the past 20 years, the fluctuations between the US$ and a basket of the 11 currencies which constitute the Euro have narrowed. Intuitively, many economists believe that they will eventually fluctuate closer to parity.

The world economy is therefore in a period of convalescence. The IMF believes that the growth of the World GDP will be 3.2% in 2003. Any world GDP growth that would drop under 2.5% would normally be considered as a global recession. Morgan Stanley, is predicting a meager 2.4% progression of the world economy…

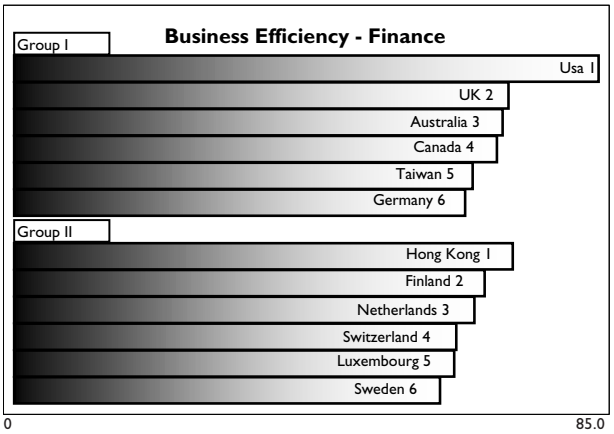
II. Competitiveness and Key business issues in 2003

The competitiveness of enterprises has suffered a lot in 2001 and 2002. The market has been characterized by the longest decline in stock markets in decades and restructuring of the financial sector, the explosion of corporate debt, the consolidation of the technology industry, which is no longer the locomotive of the world economy, and last but not least, public opinion's increasing distrust of corporate leaders.

1. Stock markets in tatters, but they still matter.

Since March 2001, the world stock exchanges have lost some $7'500 billion in market capitalization. This is roughly the equivalent of 75% of US GDP, which has gone up in smoke. The agony of the financial markets has huge consequences on competitiveness:

a. In 1989, 35.6% of US Households owned stocks. By 1998, the level was 51.8%. This means that, today, more people than ever are affected by stock market corrections. Although the proportion of stockholders is smaller in Europe (32%) and Asia (24%), turbulences in the financial markets not only affect, as in the past, wealthy individuals, but also the average consumer.



b. Stock Exchanges play a vital role in financing innovation and start-up enterprises. Experience has shown that banks are more cautious about financing new capitalist ventures than entrepreneurs who are ready to invest directly in the future of a company, through an IPO for example. The vitality of the equity sector, and not only technology, is fundamental to competitiveness. It was at the origin of economic expansion in the late 1990s. Today, such sources of financing have dried up.

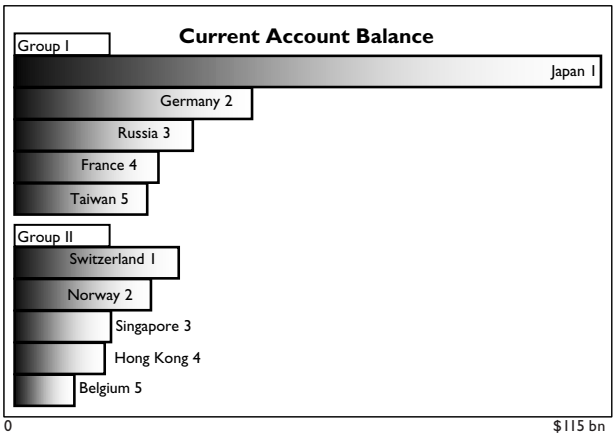
c. Pension funds have lost assets worth $2'800 billion in 11 stock exchanges since 1999. The refinancing of company pension schemes, which in many instances no longer meet legal requirements, is a real time bomb. Several companies had to restate their earnings in 2002 because of unforeseen expenses needed to keep their pension schemes afloat. State pension systems will be equally affected. Employees

are now concerned about the real value of their retirement plans. Many countries have started to address the very sensitive issue of reforming their pension system.

The collapse of financial markets has forced the financial industry (i.e. banking and insurance companies) into the most severe restructuring in years. It affects both the general level of revenues and employment. This is having a considerable impact on the competitiveness of nations. The financial industry has always been less "cyclical" than other sectors of the economy. It could always bridge the bad years with accumulated reserves. In short, it would act as a "buffer" for the economy. This role is gradually disappearing and the financial sector is consolidating and becoming increasingly volatile. This is not good news for many nations.

2. Corporate debt could become a nightmare

The days of cheap money are over. However, while they lasted, companies borrowed significantly to finance capital investment, especially to build their technological infrastructure. As a result, the long-term debt of US corporations has been multiplied five-fold during the past 20 years and the short-term debt three-fold. Whereas debt represented 5.2 times the cash flow in 1995, now, on average, it reaches 6.8 times.



Many large companies are struggling with a huge debt problem, which forces them to restructure or to sell assets if their collateral has recently lost value, for example on the stock exchange. Central banks have gradually lowered their interest rates to sustain economic activity. However, when the economy picks up, the monetary markets will tighten and the pressure to increase interest rates will reappear. If interest rates rise again, it could have significant consequences for corporations and nations alike, triggering a chain reaction of insolvencies and bankruptcies.

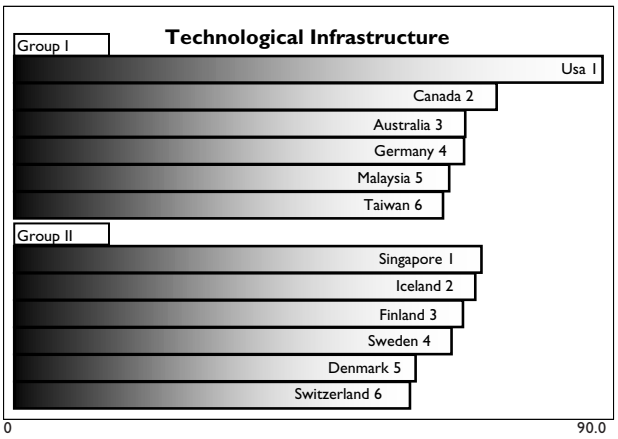
US policy will be crucial in this respect. The Bush Administration is trying to secure tax cuts from Congress in the amount of $350 billion despite an expected federal budget deficit of some $300 billion in 2003. In addition, the American economy is currently running a current account deficit in the order of 4.8% of GDP. If the tax proposals are accepted, the current account deficit is expected to rise to 7% of GDP. This means that the US economy will become a massive consumer of loans on international markets. It could put additional pressure on the US to maintain interest rates at an attractive level. As a consequence, it will be harder for developing nations to raise capital in international markets because the US economy would drain most of the world's financial resources. US foreign debt is estimated to reach $3,000 billion.

3. Information Technology continues to consolidate. What is next?

The Information Technology sector, which contributed so much to the growth of the world economy, is now maturing. In 1999, IT investments represented about 50% of capital investments for companies. In 2003, the forecast is that it will drop to 20 - 25%. The IT sector, which used to be the locomotive of the world economy, is now losing steam. A lot of enterprises have frozen IT investments. In addition, the link between IT investment and gains in productivity is probably easier to demonstrate at a national level than quantifying it at a company level. To clarify the issue, Microsoft has just announced, together with other leading IT companies, the creation of a center to study the relationship between IT and productivity.

The technological infrastructure of a nation or of a company is indeed a key factor of competitiveness. A strong new technology offering has always been perceived as a push effect to stimulate the economy. The question therefore is: what is "the next big thing" in technology?

- Wireless is one obvious candidate. This technology implies the connection of people, devices, and machines while getting rid of cables. It includes an array of technology, such as Bluetooth for short-range communication, Wireless Lan (802.11b) for middle range, and 3G telephony for the longer range. It will mean the development of a wireless commercial local-area network infrastructure, the so-called "hot spots" which connect the devices of users. Korea has recently set up some 8,500 such hot spots, thus accounting for more than half of the world total.



- Information is also exploding. During the past three years, the world has created 12 exabytes of additional information; this is the equivalent of a pile of 3'5 inch diskettes 38 million kilometers high … it is the amount of information created by society since the dawn of civilization. The 80 billion pictures generated per year constitute a significant proportion of this information content. Therefore, imaging will be a main driver of technology.

- Finally, the storage of information will gain in importance. Only 10% of the world information created is stored on computers. 90% is stored on perishable devices such as paper. For example, 18 trillion pages are printed annually, but only 4% are digital. This not only means that information can be lost, but that it can only be retrieved with difficulty. Corporate rules and national legislations will be changed to guarantee the security and the accessibility of information, while preserving data confidentiality, and the private sphere of people.

4. Confidence and trust in business must be restored. How?

For the first time in decades, the market economy is being challenged even in the most free enterprise countries. The excess of the Internet years and the shortcomings of control mechanisms have shaken the convictions of the most fervent free marketers. Irresponsible behavior by rogue executives has shocked even the business community.

- Accounting standards must be updated to face a new reality.

The old economy relies on physical assets, such as factories, warehouses, etc. But the new economy has very little physical assets. Instead, it thrives on intangible assets such as brand equity (recognition by the market) and customers' equity (loyalty of users). A better valuation of intangible assets has to be included in company accounts. Otherwise, stock markets will continue to step in and intuitively value these assets resulting in permanent volatility and irrationality on stock exchanges.

- The rights and obligations of auditing companies should be better defined.

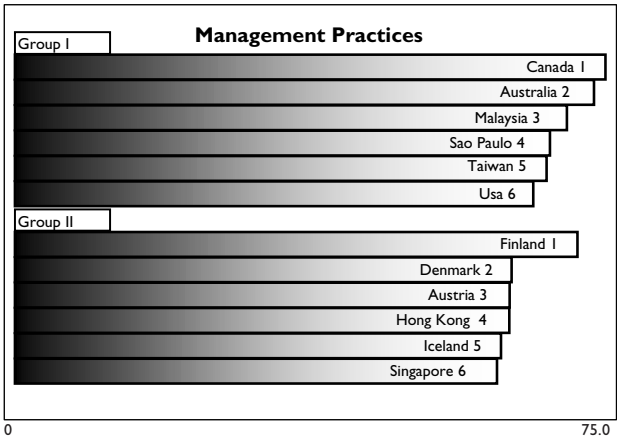
Companies need auditors not only to be audited but also to be advised. It is a relationship of trust based on shared information. This, however, may lead to abuse, shown by the Andersen case. New standards for the profession need to be rapidly implemented. Governments will most probably intervene, for example, in imposing the rotation of auditors every five years. The real issue here is the coordination of international legislation. Companies could hardly cope with a different set of rules in the US, Europe and Asia, with different standards and implementation horizons.

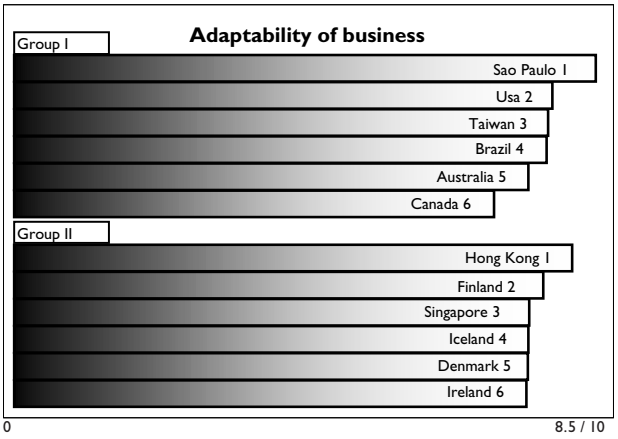
- The structure and role of Corporate boards should be reinforced.

The reform of corporate boards is an essential aspect for rebuilding confidence. Companies will be confronted with the following trends: more independent directors sitting on the board, especially in auditing, nominating and compensation committees, strict rules defining the presence of current or former company executives, avoidance of conflict of interest between board members and the company (such as being a supplier), activism of the board meeting without management, and maybe separation of the dual function of Chairman and CEO, disclosure of salaries, stock option exercises, etc.

- The financial sector should eliminate conflicts of interest.

Paul Volcker, the former chairman of the FED, believes that the formidable income generated by financial and banking executives has lead many professions to surrender their independence. The financial community will further lose its credibility if research departments, consulting divisions, etc. are not better insulated from investment practices. The temptation to " bend " the market is too high, and financial institutions will simply have to divest from certain activities to maintain the trust of their clients. Some experts also question how appropriate it is for a banker who is also a creditor of a company to sit on its board.





The multiplication of restricting rules, public or private, may however lead to a "whistle-blowing culture". The Sarbannes Oxley act, although responding to a legitimate concern in public opinion, will also have some unexpected consequences. Requesting CEO and CFOs to certify corporate data will lead to very conservative statements. "Sandbagging" will prevail, that is building reserves in enterprises rather than declaring profits. In a period of time when, on the contrary, buoyant perspectives would be welcomed by the market, fewer and fewer CEOs will risk being outspoken and bullish about their expected results.

Conclusion

In 2003, the competitiveness landscape is characterized by two fundamental principles:

- Nations should concentrate once again on sound infrastructure: for economic purposes such as Communication, Administration, and Sciences, and for social purposes, such as Education, Health, and Security. Governments cannot escape this ultimate responsibility, even if implementation is sometimes delegated to the private sector.

- Companies should rediscover the virtues of transparent and ethical behavior inside the nation in which they operate. No enterprise can be successful, and consequently no nation can be competitive, if public opinion is distrustful of the business community.

It has taken two of the most painful years in modern competitiveness to realize that policies need to be kept simple and adaptive. A sense of modesty prevails again. Nobody feels anymore that he owns the definite model of competitiveness, for a nation or a company. The message is that any policy, any business model needs to be constantly revised, because the environment is more volatile and unpredictable than ever. As the French writer Paul Valery put it: "The troubles with our times is that the Future is not what it used to be…" This was some 100 years ago…