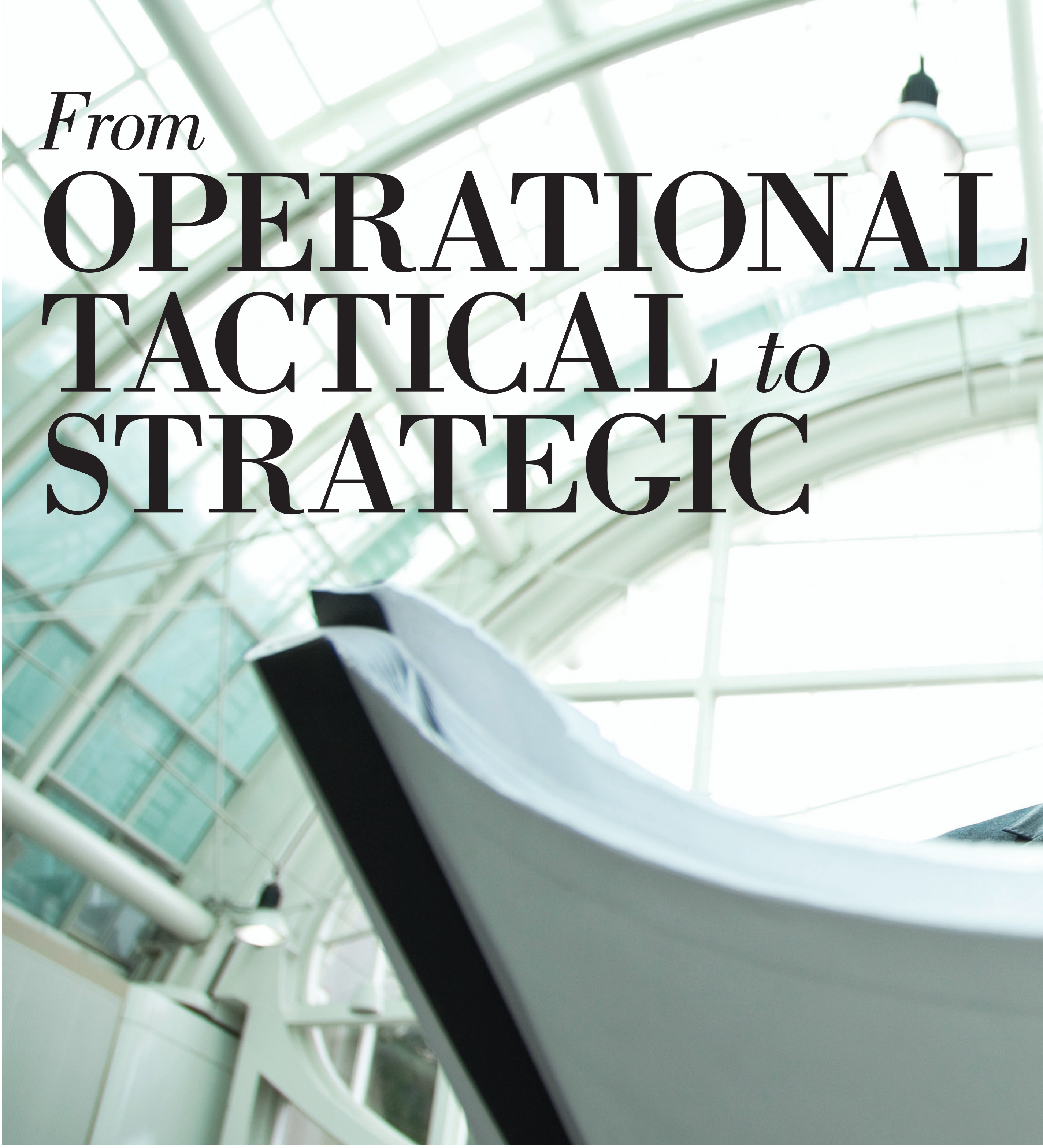
From OPERATIONAL TACTICAL *to* STRATEGIC



To keep up with risk and volatility in 2011, CEOs must think short-, medium-, and long-term. *By Matthew Budman*

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SO WHEN DOES THE GOOD ECONOMIC NEWS ARRIVE? Not just yet, according to Bart van Ark, chief economist of The Conference Board. His "pessimistic" 2011 forecast takes into account a global environment still reeling from broad shocks and lacking a clear path to stability.

Key to thriving in a climate of uncertainty and tensions, van Ark says, is strong corporate leadership and government readiness to encourage innovation.

THE GOOD NEWS FOR 2011 IS THAT YOU DON'T SEE ANOTHER RECESSION ANYTIME SOON.

Yes. During the second half of 2010, the U.S. economy gained some more strength, in particular in spending by consumers and businesses. But our forecast for 2011 is on the pessimistic side, compared to other forecasters', as we put a lot of emphasis on the structural elements of this crisis. High unemployment, continued weakness in housing, large budget cuts, and—as a result—a slow increase in personal income create a lot of volatility down the road. So while there are no recessionary signs in our leading economic indices, we're so close to the zero line that only one or two shocks to the global economy—for example, a ramp-up in inflation or a collapse of the euro system—could push us the wrong way. There is significant risk.

AND U.S. GROWTH WILL REMAIN SLUGGISH: YOU'RE NOW FORECASTING 1.7 PERCENT GROWTH IN U.S. GDP IN 2011, DOWN FROM ACTUAL 2.8 PERCENT GROWTH IN 2010.

The beginning of 2010 was still very much a recovery period, coming out of a deep recession. The rise in investment reflected companies finally getting back on track. However, in the third quarter of 2010, we suddenly saw a ramp-up in inventories. That's unusual in this expansion phase and reflects a certain amount of uncertainty. That will probably hold back growth in the last quarter of 2010—the economy can create growth in one quarter by building up inventory, but it compensates in the next quarters as businesses run them off again.

And once the holiday season is over, with people benefiting from discount sales, we can expect consumer expenditures to slow significantly going into 2011.

BUT YOU SEE REAL DISPOSABLE INCOME RISING FROM 1.4 PERCENT IN 2010 TO 2.0 PERCENT IN 2011. ISN'T THAT A GOOD SIGN? HAVEN'T WE ALL BEEN WAITING FOR CONSUMERS TO RESUME SPENDING?

Well, disposable income is income—after taxes—that is available either for spending or for saving. In an uncertain environment, consumers choose to save rather than spend, and that's not a bad thing for the medium and long term. But in the short term, it doesn't exactly help. In that sense, the consumer is playing a role in getting the economy back on its feet, but it's not because of consumption. We certainly can't consume ourselves out of this.

IS THE U.S. ECONOMY ALSO BEING HELD BACK, IN PART, BY BUSINESS DECISIONS MADE BY CEOs? WHY ARE YOU FORECASTING BUSINESS SPENDING REMAINING WEAK?

The investment story is a complex story. Large businesses have been investing more outside the United States than at home, which is in part due to sluggish demand. A lot of that will be overcome once demand gains strength, creating more potential for innovation—the supply side of the story.

The other issue is that we seem to be somewhat in between two innovation cycles; the previous cycle resulted from the IT boom at the end of the 1990s and the wide applications across the economy, and it had already slowed by 2005, well before the recession hit us. We're waiting for a new innovation cycle, whatever it may be—a new phase of IT applications, nanotechnology, energy-related investment, or climate-related investment. Once we see more opportunity for commercial applications there, investment will follow.

Investment in technology may come back once we leave the aftermath of this recession definitively behind us, but we also need to improve conditions for innovation. There are some positive signs, such as the Obama administration's decision to make tax credits for R&D permanent. But innovation is about a lot more than R&D—it's about companies investing in their workforce and restructuring themselves to grow again rather than just to cut costs. It's about moving from an operational to a strategic mode. And, importantly, there needs to be room for and trust in public/private partnerships, because that's quite often where the more radical innovations originate.

SPEAKING OF PUBLIC VERSUS PRIVATE: AFTER THE RECENT MIDTERM ELECTION, WE CAN EXPECT FURTHER CUTBACKS IN FEDERAL AND PARTICULARLY IN STATE AND LOCAL SPENDING. HOW DO YOU SEE THAT RETRENCHMENT AFFECTING THE ECONOMY IN GENERAL?

Government finances are a real problem and could hold back the transition to faster growth if we don't slow the rise in the deficit and debt sufficiently. The political debate seems very polarized between cutting taxes and cutting spending,

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on the one hand, and raising taxes and raising spending on the other.

We at the Board have done some work recently about investing in growth in a deficit environment. The only way to reduce the debt-to-GDP ratio is to reduce spending while at the same time growing output. Spending growth might be reduced so that it falls below the growth rate of GDP, while targeting the remaining spending to those areas that support productivity and innovation. For example, to support growth one might strengthen spending on education and certain parts of infrastructure and R&D, while reducing spending in areas that do not have a direct impact on growth. Productivity growth is the only sustainable growth in the long term.

IN YOUR RECENT WRITINGS, YOU'VE SAID THAT ECONOMIES SHOULD FOCUS ON INCREASING PRODUCTIVITY RATHER THAN ON INCREASING EMPLOYMENT. THAT SEEMS COUNTERINTUITIVE—SHOULDN'T JOBS BE THE MOST IMPORTANT THING?

Of course we need more jobs—the sooner the better. But we should not be blindly focused on creating jobs that don't add to the productivity of the economy. It's like quantitative easing—it helps a little in the short term, but in the long term it doesn't pay off. Many of those jobs are inefficient, are badly paid, and disappear as quickly as they arrive. Productivity is the only source for sustainable growth.

BUT WHY NOT CONCENTRATE ON THE SHORT TERM FIRST? ISN'T THAT WHAT, FOR EXAMPLE, PAUL KRUGMAN KEEPS TELLING HIS READERSHIP?

Well, as Keynes said, "in the long run, we are all dead." But he didn't say that to tell us not to care about the long term—he was pointing out that the long run is a misleading guide to current policy measures. The issue is that we are at a point in the global economy, and certainly in the U.S. economy, where the long term is already on our doorstep. We're in a structural crisis, and to see how we'll get out of this, and what the global economy will look like in ten years' time, we need to understand the dynamics of medium- and long-term growth. In the medium term, we need to close the gap relative to what we can potentially produce, by reducing unemployment and raising the utilization of capital. For the long term, we need to ask about the drivers that will put us on a sustainable growth path—innovation and productivity.

For businesses to be able to strategize around where they will be and what they will be like in a few years' time, they need to understand and strategize around these different time perspectives. It's important to think operationally, tactically, and strategically—short-term, medium-term, and long-term.

IS THERE A PERSISTENT LACK OF CONFIDENCE OUT THERE THAT JOBS WILL BE COMING BACK?

We may be out of the recession, but the consumer doesn't think so—the expectations component of our Consumer Confidence Index is still in recessionary territory. Consumers are not confident that their incomes will be increasing. You won't understand the economy if you're focused just on whether we get another 50,000 or 150,000 jobs next month. That doesn't really matter that much overall, since we lost eight million jobs in the recession. If we keep adding jobs at this rate, it will take many years to reduce the unemployment rate by more than a few tenths of a percent. We may not recover all these jobs anyway, but hopefully we can create new ones in new sectors and industries.

WHAT ABOUT CEO CONFIDENCE? DO YOU SENSE THAT CEOs FORESEE A LASTING RECOVERY?

CEO confidence is a lagging indicator. It increased significantly in the first half of 2010, but it weakened as companies, coming out of the recovery period, started to converge toward a slower-growth pattern. They're finding it hard to grow as fast as they'd like to.

ARE PEOPLE LOOKING AT OTHER ECONOMIES FOR COMPARISON? GERMANY SEEMS TO HAVE RECOVERED MORE SMOOTHLY.

Germany provides an interesting contrast to the United States. One reason why that country has been doing fairly well is because its confidence levels have stayed relatively high for most of the recession. That's because policy measures there have incentivized firms to keep people on the payroll: German firms cut hours during the recession but not many jobs. And then, coming out of the recession, they rapidly grew exports, so people saw the prospect of quickly adding more hours back in; confidence creates a positive spiral. The question, of course, is whether it can last: Germany is so dependent on exports that it's becoming very dependent on the emerging markets to keep up its growth rate.

SHOULD OTHER ADVANCED ECONOMIES BE LEARNING FROM GERMANY'S EXAMPLE AND ENCOURAGING COMPANIES TO CUT HOURS RATHER THAN JOBS?

In the United States, even without government programs like those in Germany, companies have been very creative in dealing with labor utilization during the recession and coming out of it. There was more cutting of payrolls here than in many European countries, but U.S. firms have also reduced hours partly to keep their most wanted employees, especially the highly skilled. That's the group that is most needed to keep the innovation process going—and, in fact, there's still a shortage of skilled people in many of these occupations.

So yes, there are lessons to be learned from Germany, but it obviously also depends on the political, social, and cultural environment. Moreover, keeping people on the payroll is a bit of a gamble that things will improve soon—you can do it for only a short period of time. If slow growth persists, it's simply not affordable, and German firms face the risk that they may not be able to hire and fire as easily.

OBVIOUSLY, EVERY OTHER COUNTRY IS UNDER PRESSURE AS WELL. IN A BROAD SENSE, DO YOU FORESEE MORE GLOBAL COOPERATION GOING FORWARD? LESS?

We're in a period of serious tension right now, and that's likely to continue for some time. There are always tensions when countries are growing at different speeds, and emerging economies are growing, on average, more than three times as fast as advanced economies; China is growing five times as fast. It is hard to find common ground for cooperation in such an environment.

Now, if the emerging economies fall short of the projections—if they slow dramatically more than we expect—then we will be forced into more global coordination, to come to agreement on how to fight another global crisis and how to get the growth rate back up. Countries will have to bridge their significant differences in policy orientation before it is too late.

WHAT ABOUT PRESSURE IN THE OTHER DIRECTION? IN TOUGH TIMES, CITIZENS AND LAWMAKERS EVERYWHERE TURN TO PROTECTIONIST RHETORIC. DO YOU ANTICIPATE ANY COUNTERPRODUCTIVE POLICIES ARISING FROM THESE LARGE DIFFERENCES?

We aren't seeing outright protectionism; I think everyone understands how high the price of that would be for global growth prospects. The World Trade Organization does seem to be reporting an increase in more subtle regulatory issues that have protectionist side effects, intended or unintended, and I do think we'll see more of that going forward. That will add to tensions. But real protectionism is unlikely—we project a 4.4 percent growth rate for the global economy between 2010 and 2020, and large and lasting trade conflicts could reduce that by half.

WILL WE SEE CURRENCY WARS?

I don't like the word *war*—it implies that the conflict is unmanageable and running out of control. But we definitely have serious currency tensions. We're seeing a gradual decline in the U.S. dollar and the currencies of other advanced economies and a gradual increase in those of emerging economies. That's to be expected, since the emerging economies are growing faster. Ultimately, the markets will take care of that, and that's better than government intervention. The latter nearly always leads to massive readjustments that are mostly not beneficial to the growth of the world economy.

DO YOU EXPECT TO SEE MORE VOLATILITY IN EXCHANGE RATES?

We're already seeing it. Since the recession, rates have been much more volatile, as a result of huge capital flows between indebted economies and surplus economies. But the long-term trend is evident: Economies that are performing well are seeing appreciating currencies. The question is whether a weaker dollar will necessarily be a disaster. I think not—the U.S. dollar is still the lead world currency, and I don't see that changing quickly. That will cushion the effects of devaluation.

HOW IS THE VOLATILITY AFFECTING CORPORATE DECISIONS?

In the short term, companies can deal with currency volatility through hedging. They have exchange-rate management practices well in place. However, the long-term trend will require companies to think strategically: Where do we want to be in ten years? What kind of products and services will we produce, and where will they be consumed? How will we organize our business in light of the changes in our labor force? How will we deal with the continued shortage of skills? It's these kinds of decisions on which companies will succeed or fail. These long-term risks are difficult to manage through simple procedures and mechanisms—they are managed by leadership. That's a major competitive force: Companies with strong leadership will make such strategic decisions and cut through the volatility in the short run; companies without strong leadership will be blinded by the problems of the day.

IN 2010, ADVANCED ECONOMIES HAD VERY DIFFERENT GROWTH RATES: GERMANY, THE UNITED KINGDOM, SPAIN, JAPAN, THE UNITED STATES. DO YOU EXPECT THE SAME KIND OF VARIATION IN THE NEXT FEW YEARS?

Yes. The crisis has hit countries in very different ways, depending on their recent experiences pre-crisis. Within the euro area, for example, member states differ a lot in the stability of their financial sector. In some countries, the political and economic environment is more conducive to deal with the aftermath of the crisis. That is true for most northwest European countries, but less so for the southern countries and Ireland, which have overshot in either their public or private financial system. In these countries, people are making significant adjustments. I think we also see that in the United States, where consumers are increasing the savings rate. Many of the hits from the crisis have been permanent, so I expect that behavior to last.

But we'll see volatility in emerging economies as well. Some countries, like Brazil and Russia, will remain dependent on natural resources and exports, which makes them vulnerable; others, like China, will make a transition to depend more on domestic consumption. Hence China will gradually slow its growth rate, as service industries will dominate an increasingly large part of the economy. India still has massive catch-up potential in manufacturing production and is therefore likely to accelerate over time.

There are always tensions when countries are growing at different speeds, and emerging economies are growing, on average, more than three times as fast as advanced economies.

There's also the issue of the long-term stability of economic policy—whether a country consistently pursues policy reforms despite changes in the political environment. Some countries, including India and Indonesia, have been successful in keeping their economic-reform agendas on track even with large political changes. Other countries, such as Russia and Mexico, have failed to do that: Every time there's a change in regime, they change the policy agenda, which is not conducive for creating an environment for long-term growth. In other instances, such as Brazil, the jury is still out.

LET'S TALK ABOUT CHINA, THE GIANT THAT'S ON EVERYONE'S MIND. A BIG PART OF ITS ADVANTAGE IS LOW LABOR COSTS, BUT THOSE ARE RISING QUICKLY. DO YOU SEE THAT HAVING A REAL IMPACT ON CHINA'S POSITION IN THE GLOBAL ECONOMY?

Well, China still has a very long way to go in terms of getting to cost levels that would make its economy uncompetitive; average wages are still far below advanced economies'. But the country's cost inflation is requiring rapid restructuring of the economy; it will be harder for China to produce low-cost goods, particularly in the eastern part of the country, and multinationals operating in that part of the country are feeling the heat. In the western part of the country, they still benefit from very low wages.

Foreign manufacturing operations in China will still benefit from lower overall cost levels and from larger markets. Most companies will stay simply because they can access the fastest-growing markets more easily. I don't see rising cost levels pricing China out of the market anytime soon.

SO WE SHOULD BE EXPECTING HIGHER PRICES ON CHINESE GOODS—BUT ONLY SLIGHTLY HIGHER?

Yes, and the effects will be gradual. Labor cost is a very small part of the final consumer price of products made in China. The odd thing is that the calls for appreciation of the renminbi would only mean that we'd be importing at higher prices.

CHINA ALSO MAKES THE NEWS QUITE A BIT IN REFERENCE TO ITS REPRESSIVE POLITICAL CLIMATE, INCLUDING CENSORSHIP, POLITICAL IMPRISONMENT, AND UNDECLARED EMBARGOES. IS THERE A POINT AT WHICH WESTERN COMPANIES WILL BECOME LEERY ABOUT DOING BUSINESS WITH CHINA?

Well, you have to live with the reality of doing business in a different way when operating in China. On the one hand, Western businesses have great opportunities for growth; on the other hand, they're operating in a very different business and regulatory environment than in their own countries. China is going through an economic transition that has many facets: going from government to more private and, more recently to some extent, back to government. The government has massive control over major parts of the economy, and it's very cautious about allowing foreign firms into various sectors of the economy. China's attitude toward foreign investment and overall participation of foreign business in the economy is very strategic.

Our projections show that China may very well become the largest economy in the world as soon as 2012. That is giving China new responsibilities in the global economy, at a time when it is still transitioning from a relatively low-income economy to a middle-class economy. I think this explains a lot of today's tension in international cooperation: China's international role is strongly self-serving, and that does not always produce the best outcome in international coordination.

HOW DO AMERICAN EXECUTIVES FEEL KNOWING THAT THEIR HOME MARKETS SOON WILL NOT BE THE WORLD'S LARGEST?

It's putting executives in a different mindset. While multinationals recognize that their growth is in the emerging economies, their base and their culture are still in the home markets. Such company cultures will not change overnight into something that is 100 percent global and a better fit for operating in the emerging economies. The executive leadership of many companies are still largely nationals from the home country. Companies will want to keep contributing to the economies of their home country; in many cases, they will feel political pressure to keep their head offices there—or, at least, a significant presence.

But companies are definitely making progress, some more than others. Whether you can make these changes without losing your identity and your brand has, again, to do with leadership.

DO YOU EXPECT, AT SOME POINT, AT LEAST SOME MULTINATIONALS TO ANNOUNCE THAT THEY'RE CORPORATE CITIZENS OF THE WORLD RATHER THAN OF ONE COUNTRY?

Many companies see themselves as global right now. But culture is something that changes very slowly. ■