

# UBS research focus

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Wealth Management Research

July 2011



## US competitiveness: America's *still* got talent

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*The US economy remains highly competitive, but America has also lost ground*

*Policy framework is key to a competitive future*

*US corporate leadership hinges on innovation, brands and talent*

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Mike Ryan



Kurt E. Reiman

Dear reader,

Americans — by their very nature it seems — are exceedingly competitive people. This competitive streak appears to have been acquired at a very early age, and doesn't seem to mellow with the passage of time. Many around the world have marveled at this American obsession with winning, while others have found it either curious or just plain annoying. But whether it is on the sports field, in the classroom, in the orchestra pit or on the trading desk, one thing is certain — if someone out there is keeping score, then Americans are playing to win.

It is not terribly surprising then to discover that this competitive spirit would extend into the world of commerce as well. And it is here that Americans have grown increasingly uneasy of late. Studies show that while the US still ranks among the most competitive in the world, it may be losing its edge, given both lackluster growth prospects at home and the emergence of China as an economic power on the world stage.

However, fretting about the looming threats from rival countries is another distinctly American feature. Americans worried that the Soviet Union would overtake the US militarily in the 1970s and that Japan would unseat the US economically in the 1980s. Neither happened. What's more, these perceived threats to US dominance were what put a man on the moon, shook up entire industries and triggered fresh new waves of innovation.

In this edition of the *UBS research focus*, we explore various aspects of US competitiveness from three vantage points: the real economy; the choices of policymakers; and the way corporate America does business. This focus on America's competitive strengths and vulnerabilities, as well as the policies that would likely boost the nation's competitiveness, yield important insights into both the outlook for the US economy and the prospects for various industry sectors and companies. What we found in our analysis may come as something of a surprise. Although America faces a whole host of challenges in the years ahead, the nation's competitive position appears secure.

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## Highlights

# US competitiveness: America's *still* got talent

### The US economy is highly competitive...

The United States consistently ranks among the top 10 most competitive nations in the world, according to the World Economic Forum's Global Competitiveness Index.

- Productivity, not competitiveness rankings, is the most important factor in determining a country's future economic prosperity. Despite its relatively large pool of domestic demand and low levels of international trade, the US economy consistently generates outsized gains in productivity.
- Because of these productivity gains, US labor compensation has risen by less than many of its emerging market and advanced economy peers. Although the US does not compete with other countries on the basis of cheap labor, lower unit labor costs since 1990 enhances the US' competitive position.
- The US derives its competitive edge from business sophistication, innovation, labor market efficiency, market size and higher education and training — areas where the US scores highest in global competitiveness surveys.

### ...but America has also lost ground

However, the US has lost the top spot in the international competitiveness rankings.

- Among more long-standing problems, the US performs poorly relative to its peers when it comes to the evaluation of public institutions, and the country also receives comparatively low marks in auditing and reporting standards, corporate ethics and business costs of terrorism.
- Regarding cyclical challenges, the macroeconomic environment and financial market developments have suffered, as the government deficit and debt-to-GDP ratio surged and the soundness of the banking system and access to loans deteriorated.
- The US also continues an ugly trend of buying more than it sells abroad and borrowing the difference. The resulting current account deficit creates a vulnerability for America.

### Efforts to rein in government overreach would boost US competitiveness

Policies to heighten US competitiveness would ideally focus on enhancing productivity and sustaining the ability of US businesses to generate new high value-added jobs amid a culture of innovation and entrepreneurship.

- Government efforts to scale back its overreach through regulatory reform and reduced long-term budget deficits are critical to improving US competitiveness.
- Lowering the statutory US corporate tax rate, closing corporate tax loopholes and streamlining business regulations would raise incentives for business to invest and create jobs, and could even boost much needed tax revenue.
- In addition, federal debt held by the public as a share of GDP is quickly approaching the danger zone where economists warn of long-term negative consequences for the economy. Sweeping reform of entitlements will be a critical component of controlling spending and reducing the size of government.

### Many factors support the return of high-end manufacturing to the US

A competitive nation is ultimately one that offers good jobs to those who seek them. The financial crisis highlighted and hastened trends in the US economy away from manufacturing and construction and toward services, but also left many out of work and unlikely to find it.

- While many worry that “the US no longer makes anything,” restoring manufacturing jobs is not an easy solution. Developed countries generally have seen a large drop in the share of workers in manufacturing as the economy migrates to higher value-added services. Additionally, in the US there is a skills gap for helping former manufacturing and construction workers transition to service sector jobs. People with the least educational attainment — the largest share of the unemployed — are often not qualified.
- A selectively weaker US dollar, corporate tax reform, retraining policies and greater openness to free trade and skilled immigration

offer the potential to collectively boost the prospects for a mini-renaissance in high-end manufacturing in the US. Such efforts may, in fact, prove essential at a time when the government is shedding jobs and service sector employment remains susceptible to offshoring and technological redundancies.

### US corporate leadership hinges on innovation, brands and talent

We found that in spite of the concerns about the US economy, large US companies dominate their respective markets and fields.

- US companies account for 33% of the market value of the global equity market, much higher than any other individual country or regional bloc. Also, US firms are more profitable than their global peers. In 2010, US companies generated a return on capital that was over three percentage points higher than non-US companies.
- The successes of both large and small US-based businesses yield positive benefits for the American economy. A full 80% of US-listed shares are owned by Americans, so corporate success generates domestic wealth. Furthermore, successful companies create job opportunities and momentum for additional business and capital formation.
- Not only are US companies doing well, their prospects are also bright. An emphasis on innovation, creativity, branding, and research and development, combined with an elite labor pool, are the factors that we believe give US corporations an edge. Overall, corporate America remains dominant in many markets, and we think it will maintain its lead.
- Our sector analysts have the highest conviction that Consumer Products and Services, select areas of Healthcare, Information Technology and Media have the strongest competitive positions.

# Introduction

Mike Ryan, CFA, Chief Investment Strategist

## A multifaceted concept

There is a deep and growing concern that the US may be losing its competitive edge. The lackluster pace of growth during the current recovery has caused many to question whether or not the US still possesses the economic vigor necessary to retain its standing as the world's largest economy. The mainstream media — as well as more thoughtful professional journals — have reflected upon this apparent deterioration in the US' competitive position in recent years. Stubbornly high unemployment rates, the continued loss of manufacturing jobs, staggering fiscal imbalances, sizable trade deficits, persistent dollar weakness and rapid emergence of China as an economic power have each been cited as evidence of America's decline (see Fig. 1 and Fig. 2).

But when we speak of "US competitiveness," exactly what is it that we really mean? Are we talking about the competitiveness of the US economy as a whole? Or are we instead referring to the competitive position of domestically based companies that operate globally? Is it perhaps the skill set and training of American workers and their ability to produce goods and services that are valued around the world? Or is it rather the policies and regulations that elected officials and policymakers have put in place to both prohibit and promote certain behaviors?

There are those who believe that the entire concept of international competitiveness is a fallacy.

They argue that nations cannot be compared in the same way as companies — and in this regard they are of course correct. The concept of competitiveness has different implications when used to describe businesses. That is, those companies that succeed in operating most profitably within the marketplace (often gaining market share at the expense of their peers) have typically been considered the most competitive.

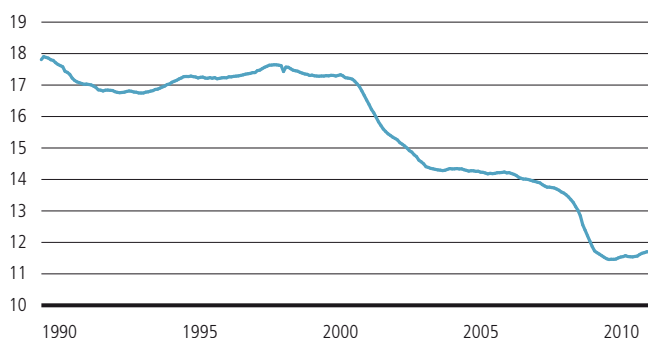
But nations do in fact compete on many levels for raw materials, skilled labor, entrée into export markets, advantageous trade agreements, intellectual property, military capabilities and access to sophisticated technology. The notion of national "competitiveness" reflects the way that governments across the globe choose to direct policies, commit resources and incentivize certain types of activities. We therefore choose to tackle the notion of US competitiveness on several fronts: 1) the economic environment; 2) the policy environment; and 3) the business environment.

## The economic environment

As we have already noted, the very notion of national competitiveness itself is a fairly nebulous and even controversial concept. Economics Nobel laureate Paul Krugman has gone so far as to categorize the obsession with competitiveness as dangerous and argues that when applied to nation states the entire concept becomes meaningless. Krugman reasons that most tend to

**Fig. 1: US manufacturing employment erosion**

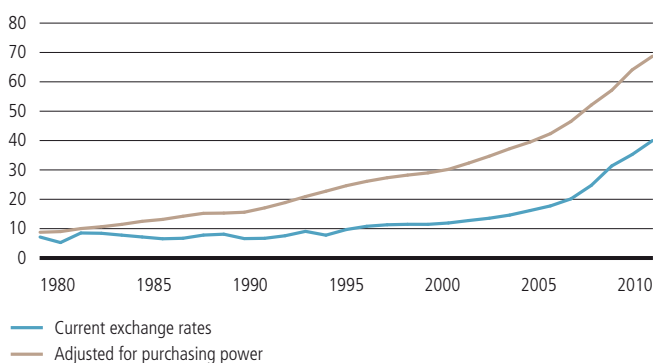
US manufacturing payrolls, in millions



Source: Bloomberg, Bureau of Labor Statistics

**Fig. 2: China's economy has grown much faster than the US**

China's GDP as a share of US GDP, in %



Source: International Monetary Fund, UBS WMR



A Tesla Roadster is plugged into one of West Palm Beach's new electric vehicle charging stations. Initially, there is no extra cost to use the spaces beyond normal parking fees.

confuse “competitiveness” with “productivity” and that while the latter is a key determinant of economic activity, the former is not.<sup>1</sup>

Despite such criticism, competitiveness research and analysis is now a fairly well-established field. Popular competitiveness rankings compiled by the World Economic Forum and others have become critical tools for decision makers in business and policymaking circles alike. Understanding what these rankings mean and what they tell us about the competitive position of nations is important in assessing how both elected officials and business leaders will act, as well as foreshadowing a country's growth trajectory.

The idea of competitiveness also has been used to describe the standing of nations within the global economy as part of mainstream economics — in particular, their ability to export goods and services. Countries with large current account surpluses are presumed to be more competitive, while those with large deficits are typically viewed as laggards. But this overly simplistic approach misrepresents trade as a zero-sum game with winners and losers determined by trade flows and account balances alone. In fact, competitiveness entails a great deal more than that. In Chapter 1, we summarize the findings of the World Economic Forum's “12-pillar” approach to gauging competitiveness, and focus on how the US stacks up against other nations in these rankings.

### The policy environment

The choices made by elected officials and regulators go a long way toward creating the type of “ecosystem” that can either enable commerce and business to thrive — or condemn them to wither. Perhaps the most obvious of the policy choices are the regulatory scheme

and the tax code. Well-crafted regulations can actually enhance economic growth and improve competitiveness by helping to increase transparency, promote uniform standards, enhance environmental sustainability and assure equal and open access to free markets. On the other hand, expansive regulation and “regulatory layering” can hamper economic output by raising costs, creating artificial barriers to entry and protecting entrenched and inefficient special interests.

The structure of the tax code also has a significant impact on the competitive position of the US. A fair, efficient and simple tax scheme can allow for efficient capital allocation and a greater leveraging of labor's skill set, as well as eliminate the unproductive channeling of resources toward tax avoidance strategies. This, in turn, would lead to higher sustained levels of economic growth, lower rates of inflation, a fuller utilization of the labor force and an improved competitive position. On the other hand, an overly complex tax code that is riddled with inefficiencies and incentive distortions will often result in structurally lower growth, greater inflation risks and/or periodic resurfacing of asset bubbles, as capital is diverted into selective assets favored by the tax code.

Other policy choices related to the fiscal outlook, immigration reform, worker training, educational reform, trade policy and energy security also have the ability to significantly impact the competitive standing of the US. While mounting budget deficits and the rising cost of unstable energy sources may represent more immediate threats, educational deficiencies, trade disputes and the lack of skilled workers represent equally serious challenges. In Chapter 2, we explore in greater detail how the choices of elected officials, policymakers and

*The notion of national ‘competitiveness’ reflects the way that governments across the globe choose to direct policies, commit resources and incentivize certain types of activities.*

regulators can serve to either enhance or hamper America's competitive position in the world.

**The business environment**

Keep in mind of course that the competitiveness of corporate America is not tied exclusively to either the economic fortunes or policy choices of the US. The accelerated pace of globalization over the past three decades means that companies headquartered in the US operate all over the world, and while they may benefit from the resources and characteristics of the US market, they thrive globally. Moreover, with growth prospects in places such as East Asia, Latin America and even frontier Africa likely to exceed our own for the foreseeable future, the competitive position of corporate America will be determined in part by how companies operate overseas. The ability to retain competitive positioning within existing markets and expand into new markets is essential to US corporate competitiveness.

To gauge the strength and durability of corporate America across this complex business environment we attempted to identify a set of "competitive value drivers" that enable certain industries to thrive in the global

marketplace. These drivers include product innovation, brand building, access to skilled labor, ability to minimize tax obligations and proficiency at negotiating a fragmented regulatory landscape. In Chapter 3, we review how different industries in the US rank competitively based on such critical criteria as innovation, branding, access to capital and regulatory and tax policies. We also offer our assessment of which sectors of the US economy are best positioned going forward to compete globally.

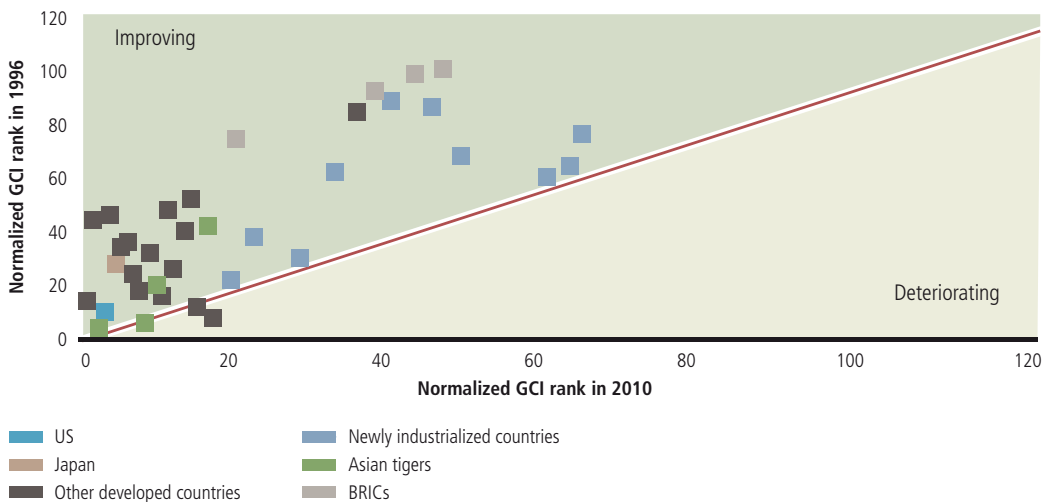
**Altered states**

What we found in our analysis is likely to alter the way that many see the US' competitive standing. Because while America faces a whole host of challenges — and rivals such as China will continue to make headway in closing the economic gap — the US remains one of the most competitive nations on earth by almost any way we choose to measure it (see Fig. 3). But understanding both the sources of those strengths, as well as potential vulnerabilities to the US' leadership position is essential in assessing our competitive outlook. We believe the next three chapters will provide the insights to thoughtfully form that view.

*The ability to retain competitive positioning within existing markets and expand into new markets is essential to US corporate competitiveness.*

**Fig. 3: US faces increased competition**

WEF Global Competitiveness Index for selected countries, normalized rank



Note: The WEF Global Competitiveness Indexes for 2010 and 1996 are normalized by dividing them by the number of countries in years 2010 and 1996, respectively, and then multiplying them by 100. A data point above/below the diagonal line indicates improvement/deterioration in competitiveness from 1996 to 2010.

Source: World Economic Forum, UBS WMR

## Chapter 1

# The drivers of *national competitiveness*

*The US has fallen from the top of some international competitiveness rankings and shows weakness in such areas as fiscal and monetary overhangs, trade imbalances and lack of trust in public institutions. However, relatively high increases in labor productivity bode well for future economic growth.*

Thomas Berner, CFA, Economist; Katherine Klingensmith, Strategist; Stephen R. Freedman, PhD, CFA, Strategist

The United States consistently ranks among the top 10 most competitive nations in the world, according to the Global Competitiveness Report from the World Economic Forum (WEF) (see Fig. 1.1).<sup>1</sup> However, competitiveness is notoriously hard to capture in a single measure.

We find that a country's competitiveness ranking does not have a strong impact on its future growth; rather, labor productivity has a much stronger effect. US labor productivity in the manufacturing sector has actually been improving in the US relative to advanced and emerging market peers, but given the small size of the sector, domestic demand matters more. To better understand the US competitive profile, we consider the stage of economic development as well as competitive strengths and weaknesses.

We conclude that while US external and fiscal imbalances are quite large, good marks on labor market flexibility, market size, business sophistication and innovation still make the US a

top global competitor, which is in turn reflected in the success of US-domiciled businesses.

### The elusive concept of national competitiveness

It is inherently challenging to capture all relevant factors that drive competitiveness — and presumably productivity and potential growth — in a single metric. It is often argued that countries compete like companies. But international trade is not a zero-sum game. Comparative advantages of competing countries lead to net benefits of trade for all trading partners on aggregate, even though one or more industries can lose out to the competition (see box on page 11 for a more detailed discussion of comparative advantage). This contrasts with competing companies in the marketplace, where one company's gain generally implies losses of the same magnitude — either in the volume of goods or market share — for its competitors.<sup>2</sup>

The WEF's report, in our view, provides a comprehensive framework that incorporates many

**Fig. 1.1: US no longer #1 but remains near the top**

World Economic Forum's top ten most competitive nations in 2000 and 2010

Rank	2000	2010
1	US	Switzerland
2	Singapore	Sweden
3	Luxembourg	Singapore
4	Netherlands	US
5	Ireland	Germany
6	Finland	Japan
7	Canada	Finland
8	Hong Kong	Netherlands
9	UK	Denmark
10	Switzerland	Canada

Source: World Economic Forum

**Fig. 1.2: The 12 pillars of competitiveness**

<i>Basic requirements</i>	
1	Institutions
2	Infrastructure
3	Macroeconomic environment
4	Health and primary education
5	Higher education and training
<i>Efficiency enhancers</i>	
6	Goods market efficiency
7	Labor market efficiency
8	Financial market development
9	Technological readiness
10	Market size
<i>Innovation and sophistication factors</i>	
11	Business sophistication
12	Innovation

Source: World Economic Forum

aspects of competitiveness. However, it does not necessarily provide a strong indication of future economic growth. This measure uses a wide variety of indicators organized into 12 pillars over time (see Fig. 1.2).<sup>3</sup> The WEF defines competitiveness as “the set of institutions, policies, and factors that determine the level of productivity of a country.” The level of productivity determines the level of economic prosperity and the rates of return on investments in physical and human capital as well as technology, and should therefore indicate the potential growth rate of a country.<sup>4</sup>

We found that the WEF’s rankings for 21 countries from 1983 to 2010<sup>5</sup> do indeed have some predictive power for real, or inflation-adjusted, gross domestic product (GDP) growth between two and five years out.<sup>6</sup> However, only by including the initial labor productivity and openness of an economy (a key growth driver for small economies) does the ranking become a significant factor for projecting future growth.<sup>7</sup> Somewhat disappointingly, the magnitude of the ranking’s impact on future growth is small compared to the impact of initial productivity and economic openness. A change in the relative ranking of 10 places raises per capita real GDP growth by only about 0.3% per year. In comparison, an increase of 10% in initial labor productivity raises per capita real GDP growth by about 1% per year. The data support a view that gives the starting level of domestic labor productivity much more importance than the initial competitiveness ranking.

### It’s all about productivity growth

A country’s economic growth may ultimately have little to do with its competitiveness relative to other countries, especially for large and relatively closed countries like the US. Real GDP growth can be purely a reflection of domestic productivity, regardless of how competitive the country is on international markets. To illustrate this point we compare two measures of US GDP: 1) real GDP, or the volume of goods and services produced by residents; and 2) command GDP, or the volume of goods and services the country’s residents can buy, or command, by selling their exports on international markets.<sup>8</sup> Fig. 1.3 shows US real and command GDP since 1969. The two measures

are virtually the same, suggesting that the increase in US prosperity (real GDP) has been almost entirely driven by domestic productivity gains rather than by improvements in international competitiveness. The main reasons for this outcome are a small trade sector — exports make up only about 12% of real GDP — and depreciation of the trade-weighted value of the US dollar of less than 1% annually since 1973, insufficient to boost US exports relative to imports to effect overall growth.

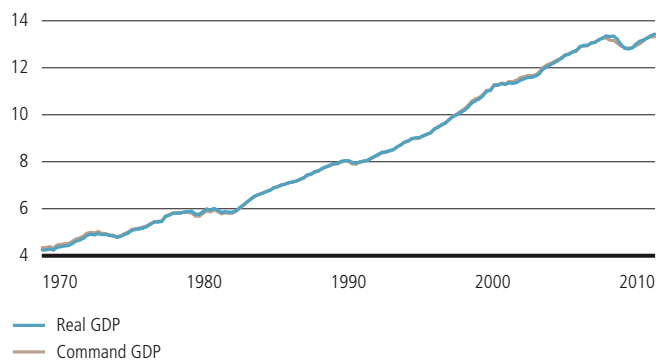
In the tradables sector, which is generally the manufacturing sector, a country’s growth potential is determined to a large extent by its productivity growth. Unit labor costs (ULCs), or the total labor compensation divided by real output, allow us to measure the “bang for the buck” that multinationals can compare across countries. A low ULC and falling ULC mean that a country is an attractive place to base manufacturing operations. ULCs rise when wages are rising faster than productivity. Therefore, productivity gains allow for a rise in wages without any deterioration in labor competitiveness.

While the US still has fairly high ULCs compared to its peers (see Fig. 1.4), the US has seen its real (inflation-adjusted) average labor compensation rise by less than other industrialized countries over the past two decades. Moreover, US labor productivity has risen somewhat faster than for international peers, with an acceleration of this trend during the last

*A country’s economic growth may ultimately have little to do with its competitiveness relative to other countries, especially for large and relatively closed countries like the US.*

**Fig. 1.3: US growth despite limited boost from trade**

US real and command GDP, in trillions of 2005 US dollars



Source: Bureau of Economic Analysis

decade. As a result, US ULCs have been falling since 1990, while they have risen in other developed countries in local currency terms. In US dollar terms, ULCs rose faster abroad than in the US, but only partly due to the US dollar, boosting relative US competitiveness.

The US is on a positive trajectory relative to other developed countries, and although the comparison is quite different, the gap has also been narrowing with emerging markets, namely China. While a significant gap in labor compensation has undeniably created incentives for manufacturing activity to migrate from the US to China, we expect this trend to slow over time. According to the Bureau of Labor Statistics, hourly compensation in China was 4.2% of the US equivalent in 2008, doubling from 2.1% in 2002. This gap will likely narrow even further, as Chinese wage growth has averaged 13% over the last decade, clearly outpacing US wage growth over that same period. When we consider how much more productive labor is in the US versus China, the gap in ULCs is even narrower than the wage gap.

### Stages of economic development

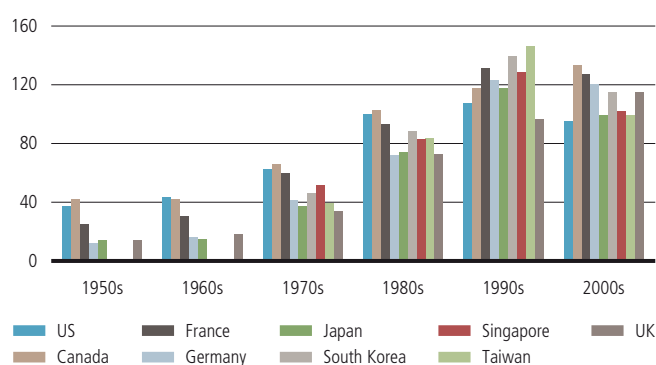
Another important consideration when assessing a country's competitiveness is its stage of overall economic development. An emerging economy is likely to compete with cheap labor, while a more advanced economy must increase its productivity to support higher wages through

## The benefits of comparative advantage

The English economist David Ricardo established comparative advantage analysis in 1817. In a simple two-country, two-good model he showed that one country could be less efficient in producing both goods but still have a comparative advantage in the production of one of these goods. Consequently, global production and consumption could be raised if the less efficient country specialized in producing the good for which it had a comparative advantage and exchanged it for the other good. In the case where both countries specialize in the production of the good in which each has a comparative advantage and then engage in trade, the total production of both goods rises above the total production for both goods in the case of a closed economy. It follows logically that both countries are better off since they now can consume more of both goods than in the case of self-sufficiency.

**Fig. 1.4: US labor cost competitiveness has improved**

Manufacturing labor costs per unit of output, US dollar index (2002 = 100)



Note: Each decade reflects the average of unit labor costs over the period.  
Source: Bureau of Labor Statistics

**Fig. 1.5: Ranking depends on stage of economic development**

WEF weights according to stage of development, in %

Industry sector	Factor-driven	Efficiency-driven	Innovation-driven
Basic requirements	60	40	20
Efficiency enhancers	35	50	50
Innovation and sophistication factors	5	10	30

Note: See footnote 7 for a detailed explanation of the WEF's methodology.  
Source: World Economic Forum, UBS WMR

innovation. See Fig. 1.5 for a summary table of how the WEF assigns different weights to countries according to their stage of development.<sup>9</sup>

Given this framework, the US is not directly competing with China, as the US is at a higher stage of development with the accompanying higher wages. Until China catches up with the US in terms of wages and productivity levels, it will have an absolute advantage in labor-intensive, low-end manufacturing. As the US is at an advanced stage of economic development, its competitive edge must lie in business sophistication and innovation. A simple example is a high-tech product such as the iPod from Apple. The idea emanated from the US, but the manufacturing of some of the iPods' components happens in low income countries. This notwithstanding, with Apple headquarters in California, the profits are taxed by the US government and shareholder value goes to whoever owns the shares, be it a US citizen or a foreigner.

**US competitive strengths and weaknesses**

As we have already discussed, a catch-all national competitiveness metric is hard to pin down. It follows that competitiveness is more than just the sum of a country's parts: any area of weakness can spell problems for the whole economy. We observe that some of the areas that are critical for advanced economies to be able to continue to improve their productivity and potential growth are indeed strengths for the US, such as business

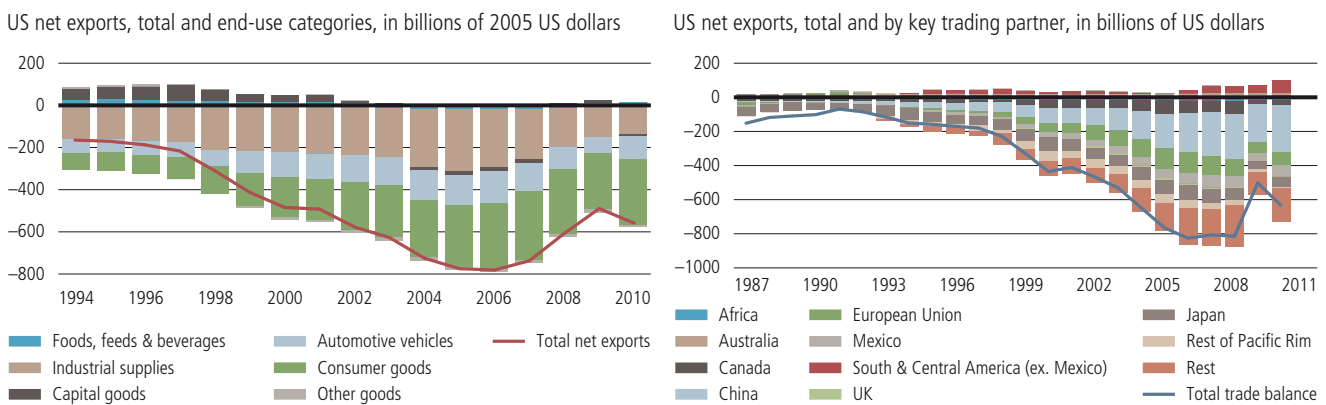
sophistication, innovation, labor market efficiency, market size, and higher education and training. The discussion in the final chapter of this report, outlining how the largest public companies in the US thrive in the global marketplace, illustrates how these characteristics have been critical to such success.<sup>10</sup>

Nevertheless, public worry has focused on the worsening external imbalances, as the US continues an ugly trend of buying more than it sells and borrowing the difference. While a trade imbalance must eventually be corrected, it is not the most relevant gauge of a country's success. A trade deficit can be a positive for a country if it reflects productive investments. For example, Norway had trade deficits of more than 10% in the mid-1970s when it was importing capital goods to build up its oil extraction industry, but since the late 1990s, it has been running trade surpluses of more than 10% as it reaps the fruits of its investments in the wake of higher oil exports.

*While a trade imbalance must eventually be corrected, it is not the most relevant gauge of a country's success. A trade deficit can be a positive for a country if it reflects productive investments.*

However, in the case of the US, the trade deficits have been piling up due to overconsumption and not due to productivity-enhancing investments. Furthermore, the countries with which the US does the most trade have also shifted (see Fig. 1.6). Consistent with our discussion, it is important to note that it is not the US current account deficit per se that threatens the US competitive position; rather, it is the fact that the deficits fueled consumption rather

**Fig. 1.6: US trade deficit driven by consumption and a trade imbalance with China**



Source: Bureau of Census

Note: Rest of Pacific Rim excludes Australia, China and Japan  
Source: Bureau of Census

than investment, and that the US is becoming increasingly dependent on foreign financing.

Keep in mind that external competitiveness and current account balances are affected by — and reflected in — exchange rates. If a country has an overvalued currency vis-à-vis its trading partners, then its exports will be relatively expensive, while imports will be relatively inexpensive, thus contributing to a trade deficit. Countries with strong economic fundamentals should see their currencies remain strong or increase in value, while those that run current account deficits will have more vulnerable currencies as they require foreigners to finance their overspending. Certain currencies are in demand regardless of their economic fundamentals because of the size of their financial markets or the role they play in international finance. The US dollar’s attractiveness in times of economic and financial market stress has likely contributed to the difficulties some US companies face competing on the global scale.<sup>11, 12</sup>

A weakening currency is not always bad. For example, a steady decline in the US dollar versus emerging market currencies in the years ahead could correct years of structural imbalances in international trade and capital flows. China’s persistent trade surplus with the US, for example, and its over USD 3 trillion in foreign exchange reserves enabled the flow of cheap exports to the US and hastened the offshoring of US manufacturing jobs (see

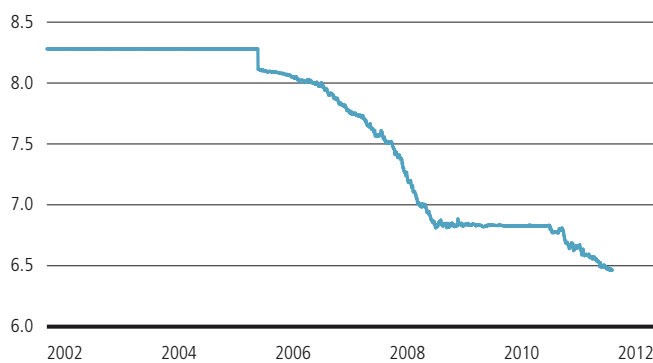
Fig 1.7). This imbalance is clearly unsustainable and a further appreciation of the Chinese yuan versus the US dollar would likely help to equilibrate this bilateral relationship.

In certain other respects, the US has longstanding weaknesses and has deteriorated sharply. As we address in the following chapter, some of these areas of weakness have deep roots, while others may be the result of the recent credit crisis and recession. However, even some of these more “cyclical” problems may be very hard to move past. Among more long-standing problems, the US performs poorly relative to its peers when it comes to the evaluation of public institutions — with public trust of politicians, favoritism in decisions of government officials and wastefulness in government spending sticking out as particularly weak. But there are problems within the private sector as well. According to the WEF Global Report’s rankings, the US is rated poorly in auditing and reporting standards, corporate ethics and business costs of terrorism relative to other countries. Among the cyclical challenges, the macroeconomic environment and financial market development criteria have suffered, as the government deficit and debt-to-GDP ratio surged, while the soundness of the banking system and the ease of access to loans deteriorated.

*Among more long-standing problems, the US performs poorly relative to its peers when it comes to the evaluation of public institutions...but there are problems within the private sector as well.*

**Fig. 1.7: China’s currency is managed**

USDCNY exchange rate, Chinese yuan per one US dollar



Source: Bloomberg

## Chapter 2

# The policy *environment*

*Policies to improve US competitiveness are not a panacea to the nation's economic woes but are an important catalyst of future growth at a time when the economy faces significant obstacles. We think an expanded high-end manufacturing base and less government intrusion will be part of the solution.*

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**Kurt E. Reiman**, Head, Thematic Research WMR-Americas



Abandoned and rusting remains of blast furnaces at Bethlehem Steel Plant that was closed in 1995.

### **No quick fixes**

Although still among the top countries in the world, the US has slipped in international competitiveness rankings in recent years, and the painfully slow recovery since the depths of the global financial crisis only serves to reinforce the perception that the country has lost its competitive edge. But the extended stagnation of the US economy since the crisis has less to do with any loss of competitiveness, and more to do with the collapse of the housing market and an unwinding of years of credit-fueled economic growth.

Looking ahead, it is important to acknowledge that policies to influence US competitiveness will not singlehandedly solve the long-term problems that emerged or intensified during the financial crisis. The need to repair household balance sheets, recapitalize the financial sector and absorb surplus housing requires separate solutions, which will take time. However, fixing these issues is critical to restoring US competitiveness, even though economic activity likely will remain sluggish for an extended period as a result.

The policy environment — from taxes and regulations to education and training — affects the ways the economy and US businesses operate. In our view, efforts to boost US competitiveness must therefore be seen not as a cure-all but as part of a larger comprehensive approach to solving today's economic problems and as an important catalyst of future growth at a time when the economy faces significant obstacles.

### **Boost productivity and jobs**

The principal aim of policies to enhance US competitiveness is to foster an environment that supports job formation in productive enterprises. Although nations do not compete with each other in the way that companies do, policymakers must ensure that the state does not interfere inappropriately with the private sector's ability to innovate and create opportunities for economic growth.

One only needs to look to Germany's economic success to see how the right combination of policies — such as greater employment security, wage moderation, a well-trained workforce, the removal of burdensome regulation,

reduced unemployment benefits and a focus on specialized, high-end manufactured goods — can boost both the domestic economy and export strength.<sup>1</sup> Consequently, Germany’s unemployment rate has actually fallen below the levels that prevailed before the global financial crisis (see Fig. 2.1).

In this chapter, we will explore those areas where we believe the policy environment can improve international competitiveness through job formation and enhanced productivity. Some policies have a distinctly domestic focus, such as limiting regulatory overreach, boosting tax efficiency, paring back government budget deficits and bridging the skills gap for unemployed workers through education and retraining initiatives. Other policies will have more of an international focus, such as negotiating free trade deals, reforming immigration policies and helping to ensure that the US dollar is neither too strong nor too weak.

**An intractable jobs problem**

Efforts to encourage job formation and productivity are critical because the US unemployment situation has become seemingly intractable. In addition to high levels of overall unemployment, the duration of unemployment rose to its highest level in a generation, labor force participation rates declined sharply and the unemployment rate for those without a high school diploma rose to three times the rate of college graduates (see Fig. 2.2).

The unemployment rate for those with a high school education or less is particularly worrisome given the grave reduction of jobs in low- and semi-skilled fields in the aftermath of the financial crisis, such as in retailing, wholesaling, manufacturing and construction.

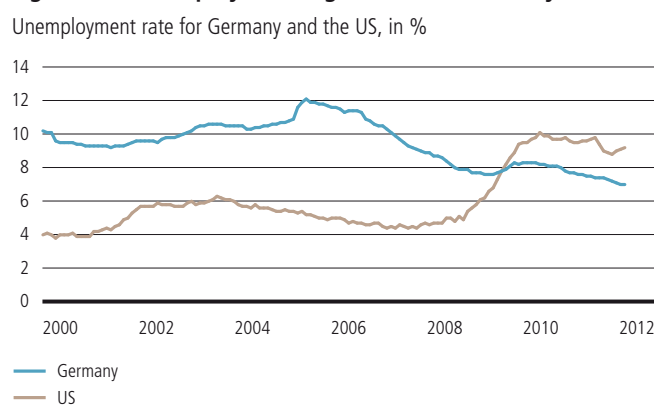
Although some of these trends may reverse course as the economy recovers, much of this deterioration in the job market is structural, which could eventually place considerable pressure on public finances precisely at a time when the government can least afford it and when demographic pressures are already bloating the demand for entitlements. So while high unemployment is one sign that the economy is finally adjusting to new economic realities, the aim of policy is to ensure that there is as little structural unemployment in the future as possible.

**Establish clear rules of engagement**

After a lengthy period of deregulation in the years leading up to the financial crisis, regulating industries is now back in vogue in the US. The Fraser Institute’s Economic Freedom of the World Index tracks regulation of labor, business and credit for a wide selection of countries.<sup>2</sup> The survey shows that in most measures of economic freedom, the US held up rather well. The one exception was in the area of regulation where the US slipped from 8th to 17th between 2007 and 2008. Given the sweeping legislative overhaul of health-care and financial services in recent years, it

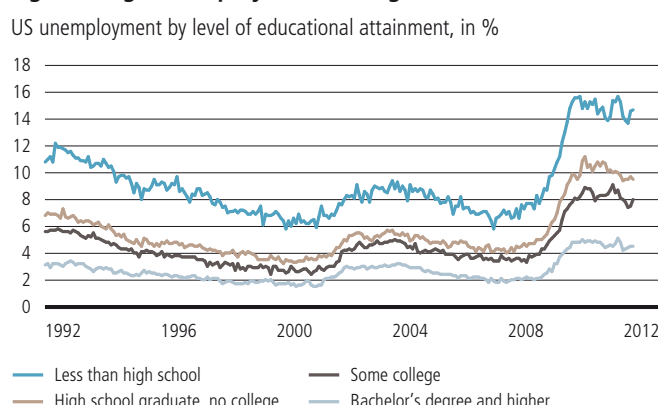
*Efforts to encourage job formation and productivity are critical because the US unemployment situation has become seemingly intractable.*

**Fig. 2.1: US unemployment higher than in Germany**



Source: Bloomberg, Bureau of Labor Statistics

**Fig. 2.2: High unemployment among least educated**



Source: Bureau of Census, Bureau of Labor Statistics, UBS WMR

would seem reasonable after the past few years to expect the index to slip further. As we wrote in the March 2009 edition of the *UBS research focus* entitled, “The financial crisis and its aftermath,” there is a statistically significant negative relationship between regulation and economic growth.<sup>3</sup> While the authors of new regulation always hope to achieve certain long-term societal benefits, the recent uptick in regulatory activity may have also put a governor on economic activity and job formation at a time when the recovery is already in a fragile state. For example, healthcare reform will likely make it more difficult for small businesses to hire given the mandate that firms with more than 50 employees must provide healthcare coverage.<sup>4</sup>

Perhaps sensing the potential negative backlash, the Obama administration adopted a policy in January 2011 to review and improve regulation with the goal of boosting efficiency and reducing cost. A periodic review of existing regulation across industry sectors could save businesses both time and money, and initiatives that exempt certain types of small businesses from new regulation for a specified period would help them grow and expand. Therefore, any progress to weed out unnecessary compliance costs and obstacles to either forming or growing a business would likely benefit the overall economy and help to generate new jobs.

### **Remove tax distortions**

The US corporate tax rate is one of the highest in the world. Despite its relatively high rankings in most aspects of the World Bank Group’s *Doing Business 2011* report, the US received its worst score in the area of paying taxes – with special attention on the high total tax rate as a percent of profits.<sup>5</sup> The system is also riddled with numerous loopholes, distortions and exemptions that make it needlessly convoluted and susceptible to special interest lobbying. The net effect is that the average US corporation paid an effective tax rate of somewhere around 25% in 2010 — also generally higher than in other developed countries — despite a combined federal and state statutory tax rate of over 39%.<sup>6</sup> Some companies notoriously paid no taxes at all despite reporting record profits.

A 2005 staff study by the US Joint Committee on Taxation evaluated three scenarios to provide USD 500 billion in tax relief between 2005-2014: decrease individual income tax rates, increase the personal exemption, and decrease the corporate income tax rate. The committee concluded that a reduction in the corporate tax rate has the greatest positive effect on long-term economic growth, “as the stock of productive capital accumulates and leads eventually to higher labor productivity.”<sup>7</sup>

Lowering the overall US corporate tax rate and also eliminating special exclusions and loopholes would raise the appeal of the US as a place to do business, enhance economic growth and could potentially even boost income tax receipts. If implemented with an eye toward improving overall tax efficiency and raising incentives for business to invest, reform of the corporate tax code could even boost government tax revenues (see Chapter 3 for a more detailed discussion of the effect of corporate taxes on Corporate America).

### **Restoring the middle class**

For a time, hollowing out the manufacturing sector and increasing polarization of incomes within the US created few transition costs and distributional questions (see box on page 18 for a more detailed discussion of the shift from a manufacturing to services economy). The credit-financed economic expansion fueled job growth in construction, retailing, finance and even government, which more than made up for the loss of manufacturing jobs. Meanwhile, low unemployment rates, as well as easy access to consumer credit and home equity extraction, concealed or otherwise mitigated rising rates of income inequality.

Given both the high unemployment rate among the least skilled and the threat that the job losses become increasingly structural, restoring manufacturing jobs would seem like a prudent strategy. However, this may be easier said than done. The problem is that policymakers can’t just flip a switch to employ these lower-skilled workers. In addition to the structural impediments to job formation in many areas of the economy in the aftermath of the financial crisis, there is a skills gap that

*A periodic review of existing regulation across industry sectors could save businesses both time and money, and initiatives that exempt certain types of small businesses from new regulation for a specified period would help them grow and expand.*

requires investments in human capital before businesses can hire workers (see Fig. 2.3).

For starters, people with the least educational attainment — the largest share of the unemployed — are not qualified for many service-sector jobs. Second, gains in educational attainment have stagnated (see Fig. 2.4). The share of the US adult population with a high school education remains stuck at about one-third, while the share with the fewest years of schooling has troughed in the low double-digits. Furthermore, many studies show that the quality of US primary and secondary education has failed to improve despite years of increased spending and may in fact be slipping relative to other countries.

As such, high-end service jobs would seem to be largely out of reach without long-term investments in education to lift the least educated up the skills ladder. And rebuilding a high-skilled manufacturing base (as opposed to low-skilled manufacturing, where US workers are unable and perhaps also unwilling to compete) would likely require some form of additional technical training and retooling to match people to the various job openings.

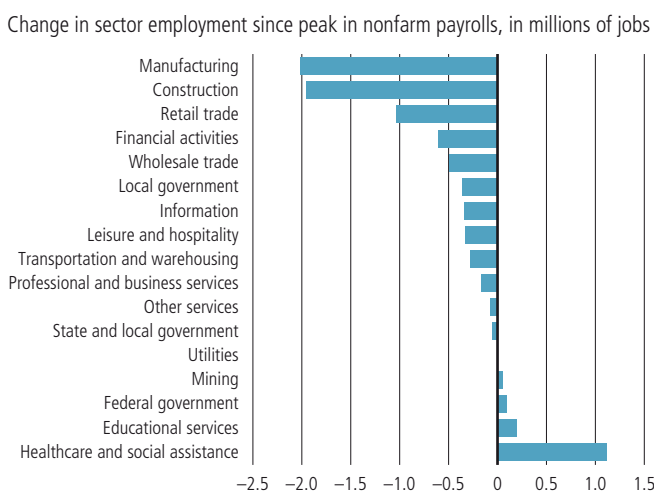
### Support efforts to retool and retrain

When the unemployed are also the ones who lack many of the necessary skills to compete in the information age, it becomes clear that a large share of the solution to new job formation rests with education and retraining. Keep in mind, the problem is not that US workers have become less productive. In fact, as we wrote in Chapter 1, the cost-competitiveness of US workers has actually improved relative to most developed countries and emerging markets during the past 20 years, thanks to higher productivity gains, restraints on wage growth and a weaker dollar. And as you will soon see, Chapter 3 emphasizes that the success of many US-based firms stems from highly skilled workers and elite research universities. The issue is about a skills mismatch in the overall population.

In the 2010 world education ranking report conducted by the OECD, the US ranked just 25th in math and 17th in science for secondary school students.<sup>8</sup> Given the importance of education in high-skilled manufacturing and service-sector jobs, improving America’s primary and secondary schools would appear paramount. As we wrote in *The Decade Ahead* in February 2011, “Failure to respond with meaningful educational reforms could leave the US at a competitive disadvantage longer term — and

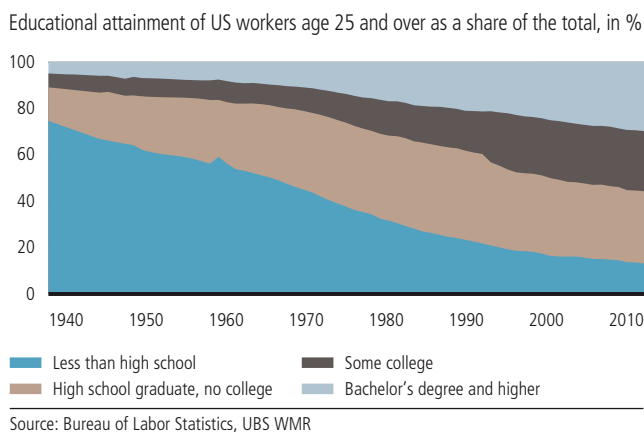
*Given the importance of education in high-skilled manufacturing and service-sector jobs, improving America’s primary and secondary schools would appear paramount.*

**Fig. 2.3: Largest job losses in manufacturing and construction**



Note: Nonfarm payrolls peaked in January 2008.  
Source: Bureau of Labor Statistics

**Fig. 2.4: Gains in educational attainment stagnate**



Source: Bureau of Labor Statistics, UBS WMR

## “Americans don’t make anything anymore”

One reason why many people believe the US has lost its competitive edge is simply the perception that Americans don’t make anything anymore. However, the US economy’s adaptability is perhaps one of its greatest strengths. Although globalization and technological progress continuously create redundancies and the potential to offshore jobs, this is also how economies become more productive. According to theory, countries will produce and trade those goods and services in which they have developed a comparative advantage, raising living standards for all who engage in trade. (See box on page 11 for a more detailed discussion of comparative advantage).

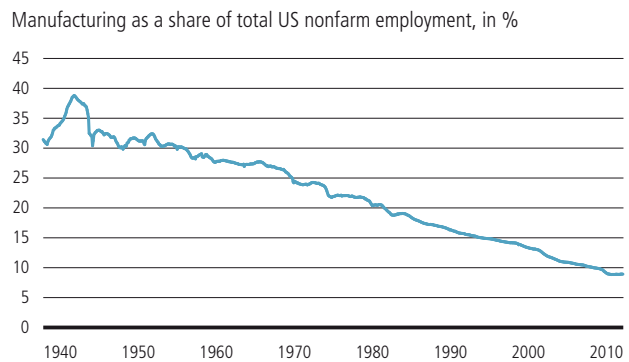
Perhaps the clearest example of this evolution is the decline in the manufacturing sector as a share of total US employment from roughly 16% in 1990 to below 9% today, a trend that has been pretty consistent throughout the developed world and predates China’s entrance into the World Trade Organization (see Fig. 2.5). Even Germany’s manufacturing base declined from nearly 35% since 1980 to just over 20% of employment (see Fig. 2.6). The reduction of manufacturing jobs and other mid-tier jobs in the US occurred with little friction, especially given the decline of union influence. By contrast, jobs at the extreme ends of the skills spectrum were retained, such as janitorial services and pharmaceutical research, since these are the toughest to automate and offshore.<sup>9</sup>

Meanwhile, services have taken on a larger share of economic output in the US and other developed countries. Advanced economies hold a comparative advantage in exchanging services (or at least those services that can be traded) for manufactured goods, whereas emerging markets hold an advantage in producing industrial and manufactured goods. This move up the economic value chain became possible as more Americans than ever before graduated from high school and college,

preparing a growing share of the US population for job opportunities in the service sector.

But while trade may yield certain benefits in the form of more leisure time or improved overall living standards, it redistributes employment and income opportunities in ways that create certain winners and losers within an economy. Understanding these distributional shifts and distortions helps to center the policy discussion on those dynamics that could potentially alleviate economic and social tensions and improve long-term US economic competitiveness.

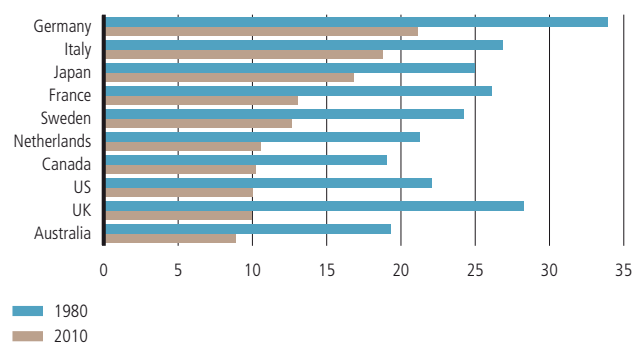
**Fig. 2.5: Hollowing out of manufacturing since World War II**



Source: Bureau of Labor Statistics, UBS WMR

**Fig. 2.6: Advanced economies rely less on manufacturing**

Manufacturing share of total employment in selected developed countries, in %



Source: Bureau of Labor Statistics

even more dependent on foreign-born engineers and scientists at a time when the competition for those skilled professionals is rising.”<sup>10</sup>

Another sensible approach to bridge this skills gap is to encourage partnerships between businesses and local colleges or technical schools to train workers in the specific high-tech skills that manufacturing employers demand. This represents a huge advantage for businesses looking to start up operations, relocate or expand in the US.

### Scale back fiscal overreach

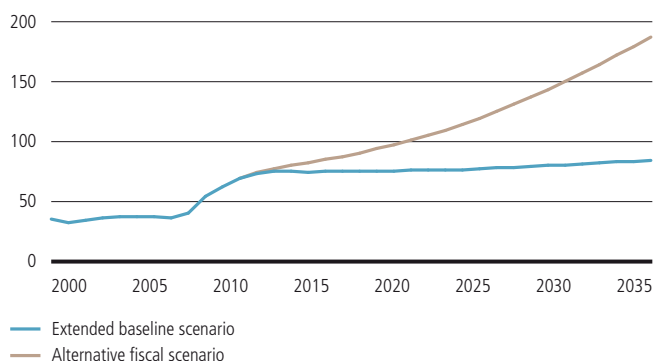
According to the Congressional Budget Office, federal debt held by the public as a share of GDP nearly doubled during the financial crisis and is quickly approaching the danger zone where economists warn of long-term negative consequences for economic growth (see Fig. 2.7).<sup>11</sup> Americans understand this relationship intuitively: in a June 2010 USA Today/Gallup poll, respondents cited the federal debt as one of the most serious threats to the future wellbeing of the US.<sup>12</sup>

In our view, the US will be able to avoid an all-out fiscal crisis, although the path to a more sustainable deficit trajectory will be a bumpy one. Sweeping reform of long-term entitlements will be a critical component of controlling spending, particularly healthcare outlays. The US already boasts the largest overall spending on healthcare as a share of GDP of any advanced economy (see Fig. 2.8). The US already boasts the largest overall spending on healthcare as a share of GDP of any advanced economy (see Fig. 2.8). Much of this spending arises from a healthcare system that creates significant costs and waste due to uncoordinated care and inefficient use of technology. Medicaid and Medicare spending represents 21% of federal outlays, and this is projected to rise to 30% of spending by 2030 if nothing changes. This is simply unsustainable under almost any reasonable economic growth forecast and suggests the entire approach needs to be rethought.

Some noteworthy recommendations to reform entitlements include: reducing Social Security benefits for current and future retirees; transitioning Medicare to a “premium support” program; initiating medical tort reform by capping damage awards; and reforming

**Fig. 2.7: Debt burden could spiral higher if unaddressed**

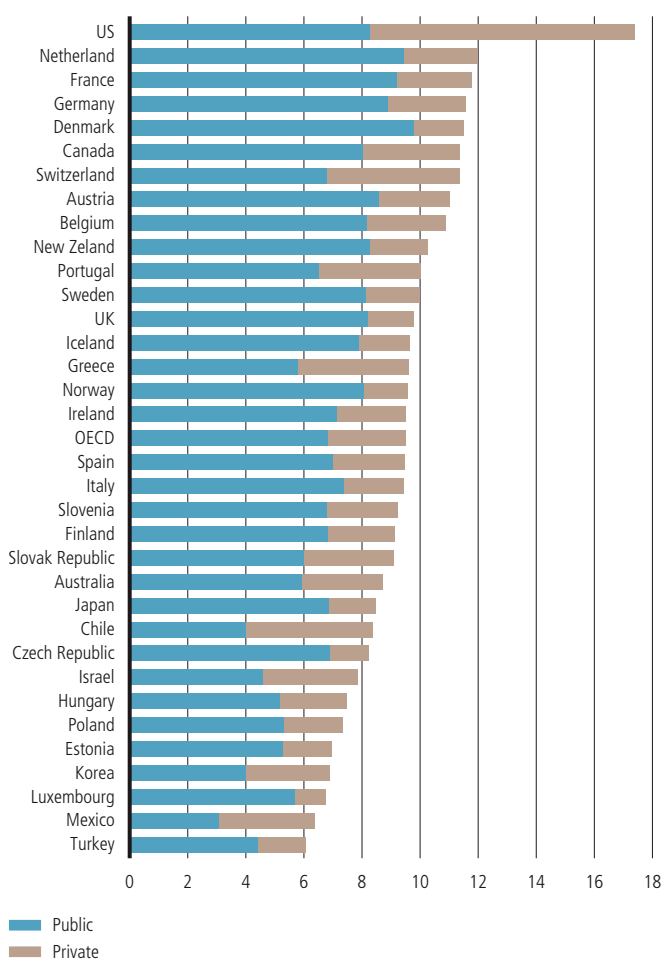
Federal debt held by the public as a share of GDP, in %



Note: Extended baseline scenario assumes that changes to policy that were made in the past – such as changes to the Alternative Minimum Tax and to the Medicare program’s payment to physicians – are not made again. The alternative fiscal scenario assumes the underlying fiscal policy in place today is extended.  
Source: Congressional Budget Office

**Fig. 2.8: Healthcare a growing burden on public finances**

Total public and private expenditures on healthcare as a share of GDP, in %



Source: Organization of Economic Cooperation and Development

the shared financing arrangement between federal and state governments for Medicaid. While any changes to entitlements will be contentious and must be phased in over time, perhaps the most encouraging sign is that all sides now recognize the scope of the problem — even if they don't yet agree on a solution.

Of all the potential policy changes that could boost economic prosperity and the nation's competitiveness, reducing the government debt-to-GDP ratio through reform of long-term entitlements is high on the list; however, the time for finding a solution is running out.

Many of the policies we have discussed so far deal primarily with domestic issues that can affect the US' competitive position, but there is also the international dimension, such as immigration, the dollar and trade policy to consider.

**Land of opportunity**

One of the hallmarks of US competitiveness is the ability to attract the "best and the brightest" to come to the US to build businesses out of innovative ideas. As we discuss in Chapter 3, many US companies dominate globally because of the talent they find in the US. Unfortunately, this strength is eroding in absolute and relative terms. Even as foreign students flock to US universities to receive a top-notch education, creating a "brain drain" on developing countries, this trend may reverse if graduates find it increasingly enticing to return

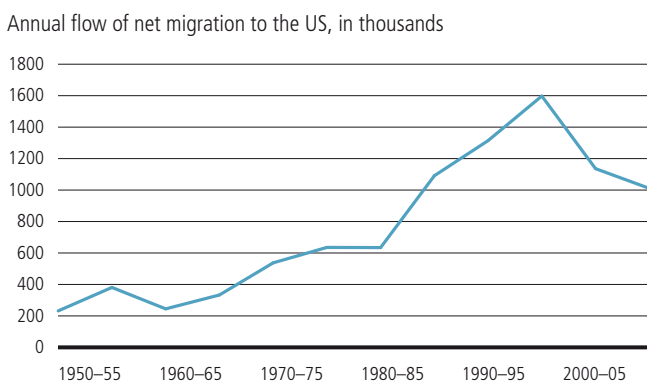
home to explore opportunities there. Aggressive efforts to tighten US borders in the wake of the 9/11 terrorist attacks has already restricted the flow of immigration, and the annual limit of temporary visas for specialized workers (H1-B visa) was cut by half over the same period (see Fig. 2.9 and Fig. 2.10).

Growth-oriented immigration policies have the potential to boost economic growth. Considerable research suggests that lifting visa caps on skilled foreign workers to meet the demands of US employers would likely improve business activity, create jobs and raise tax revenue. According to a 2008 study by the National Foundation for American Policy, every H-1B position (for temporary foreign workers) requested by a US technology company increased employment by five workers.<sup>13</sup> A US Government Accountability Office study found that H-1B visa holders earn about the same or more than their US colleagues after adjusting for age, contradicting the notion that foreign workers are just a cheap source of labor.<sup>14</sup>

But even more important, a 2007 study by technology entrepreneur and academic Vivek Wadhwa concludes that a quarter of all engineering and technology startups in the US between 1995 and 2005 had at least one immigrant as a key founder. These companies were responsible for USD 52 billion in revenues in 2005 and had generated 450,000 new jobs.<sup>15</sup>

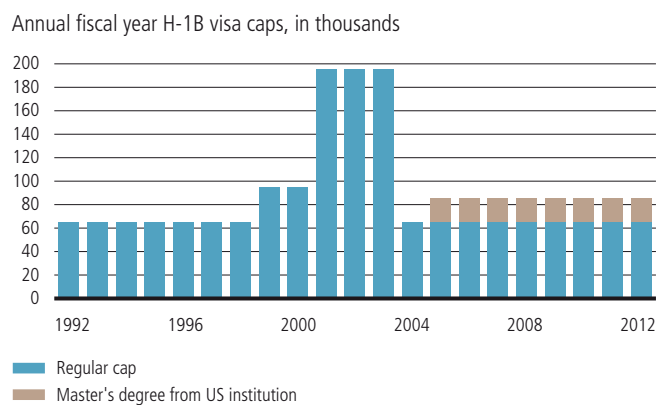
*Considerable research suggests that lifting visa caps on skilled foreign workers to meet the demands of US employers would likely improve business activity, create jobs and raise tax revenue.*

**Fig. 2.9: Immigration has declined over the past decade**



Source: United Nations Population Division

**Fig. 2.10: Visa caps restrict entry of skilled foreign workers**



Note: Unlimited visas issued to universities and research labs.

Source: US Citizenship and Immigration Services, Department of Homeland Security, UBS WMR

### Devalue the dollar?

A weaker currency is often seen as providing a boon to competitiveness, but the reality is far more nuanced than conventional wisdom would suggest.

For starters, a weak currency may be a reflection of economic instability or declining confidence. Structural weakness in the US dollar since the millennium — not only versus other major currencies but also versus gold — is likely the result of persistently wide trade deficits, rising government indebtedness, a weak economy, bloated central bank balance sheets, overly accommodative monetary policy and concerns about the potential for both inflation and deflation (see Fig. 2.11).

A weaker dollar also raises the cost of imports across the board, leading to a whole host of inflationary pressures. Specifically, this makes oil and other imported commodities more expensive for US consumers and businesses. Since the US is both the world's largest consumer and importer of oil,<sup>16</sup> a weak dollar erodes US competitiveness by raising the relative cost of energy (see Fig. 2.12). This creates not only an added cost for US businesses but also a tax on consumption. An industrial policy that encourages a shift to cheaper domestic oil supplies, greater adoption of alternative fuels (solar) and fuels that are in relative abundance (natural gas), as well as incentives and regulations that improve energy efficiency could mitigate this energy

cost pressure from a weaker dollar, reduce the US trade deficit and create domestic jobs.

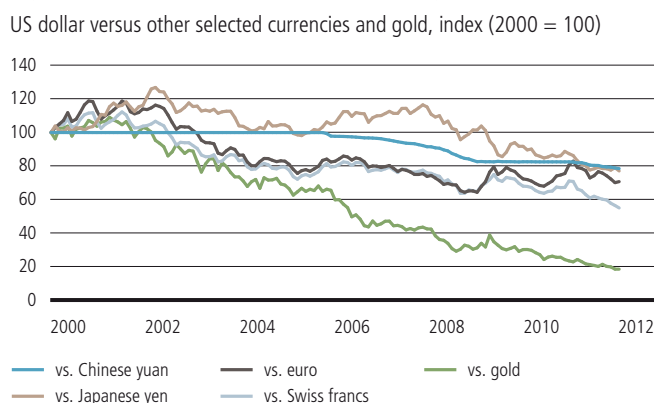
But as we wrote in Chapter 1, many emerging markets pegged their currencies at cheap levels versus the US dollar, leading to imbalances in international trade and capital flows. Weakening these pegs and allowing their currencies to appreciate has the potential to restore balance to the global economy by weaning emerging markets off their export dependency. If US productivity can continue to keep pace like it has more recently, a weaker dollar against a broad basket of developed and emerging market currencies might even help restore high-end manufacturing jobs to the US.

So what is the best currency approach to improve US competitiveness? It is neither a sharply declining dollar nor a prohibitively overvalued one — it is instead a wide range of macroeconomic policies that impart stability to the currency. A stable policy backdrop would eliminate the temptation for US officials to seek the short-term path to competitiveness that currency depreciation allows. And a steadier greenback could also limit upward pressure on funding costs as foreign investors become less concerned that a sharp deterioration in the US dollar will lead to erosion in their dollar-based investments.

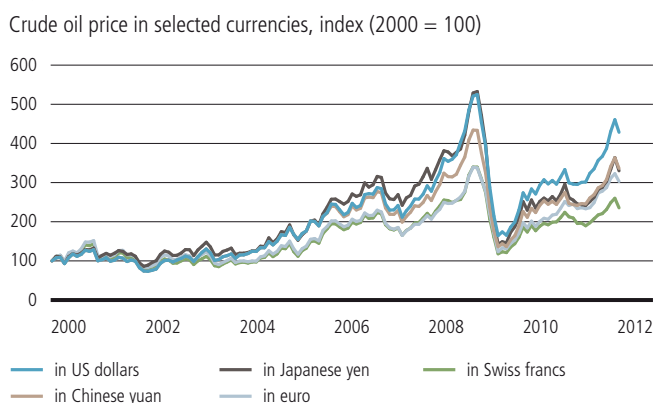
So although a steadily weaker dollar against certain artificially weak currencies may prove

*A stable policy backdrop would eliminate the temptation for US officials to seek the short-term path to competitiveness that currency depreciation allows.*

**Fig. 2.11: US dollar has weakened during the past decade**



**Fig. 2.12: Weak dollar makes oil more expensive in US**



beneficial to US economic activity and the profile of global growth, restoring prudent long-term fiscal and monetary policies are essential to ensuring the long-run stability of the US dollar and the competitiveness of the US economy.

### **Embrace free trade**

The risk of protectionism – perhaps one of the greatest threats to any country’s long-term competitiveness – is typically higher during periods of elevated unemployment, increased income inequality, unbalanced trade flows and high energy prices. With this in mind, the administration’s embrace of new free trade agreements with Latin America and South Korea is encouraging. Extending free trade zones to other countries, as well as progress in removing energy and agricultural subsidies (which may be unaffordable anyway given the gaping federal budget deficit), stand to benefit the US and its global competitive position. Such free trade agreements allow the US to benefit from natural resources and comparatively cheap labor in other countries, especially developing countries like those in Latin America. In turn, the US could export US goods and services, and US businesses could operate more easily in those countries.

### **Creating a competitive ecosystem**

The aftereffects of the financial crisis will likely restrain US economic growth for years to come. As such, we think policymakers will seek to avail themselves of the tools to foster job formation, boost productivity and generally improve US competitiveness. Some of the efforts will focus

on domestic priorities, such as efforts to weed out unnecessarily cumbersome regulations, scale back corporate tax rates and end special exclusions, retrain unemployed workers for high-end manufacturing jobs, improve primary and secondary education and reduce structural government budget deficits. On the international front, policies that embrace trade, bring the dollar back into balance and encourage high-skilled immigration also offer potential benefits.

The hollowing out of US manufacturing appears to have gone too far, especially in light of the increasing structural unemployment of those with the least training. A selectively weaker US dollar, corporate tax reform, retraining policies, and greater openness to free trade and skilled immigration offer the potential to collectively boost the prospects for a mini-renaissance in high-end manufacturing in the US. Such efforts may, in fact, prove critical at a time when the government is shedding jobs and service sector employment remains susceptible to offshoring and technological redundancies. In addition, as we point out in Chapter 3, the key to a successful policy framework is that it enables US companies to thrive and generate new high value-added jobs amid a culture of innovation and entrepreneurship. Therefore, government efforts to scale back its overreach through regulatory reform and reduced long-term budget deficits are critical.

## Chapter 3

# Made by America

*Corporate America remains dominant in many markets, and we think it will maintain its lead. This is welcome news for the US economy. Sectors with a strong competitive position include Consumer Staples and Services, select areas of Healthcare, Information Technology and Media.*

David Lefkowitz, CFA, Strategist; Jeremy Zirin, CFA, Strategist

### Still world leaders

It is tempting to assume the US “doesn’t make anything anymore” especially when it seems that so many of the goods we purchase these days are manufactured overseas. But this perspective is overly simplistic, as it fails to reflect the leading role that corporate America plays in producing goods and providing services around the world. While US companies may no longer be competitive in lower-end manufacturing, they continue to grow and in many cases even dominate higher value-added goods and services industries. Many of these industries may not produce frequently purchased products that we see everyday in our department stores and malls, but they are still very highly valued by the global marketplace.

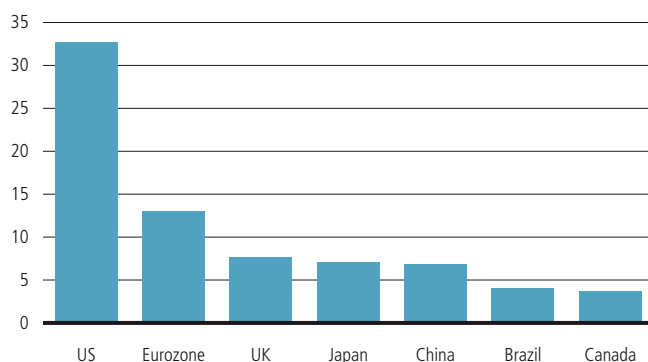
What’s more, US-based firms also have a supply chain footprint across the globe and therefore have broader exposure in both mid-level and even low-level manufacturing. These goods may not technically be “made in America” but they often are “made by America.” Finally, the

services that US companies provide are among the most highly valued in the world (consider for a moment global consumption of American movies, software and social media). In short, to focus narrowly on low-end manufacturing is to grossly underestimate corporate America’s leading competitive position across the world.

One simple way then to measure the scope and scale of corporate America’s impact on global commerce is to look at the market value of publicly traded US companies relative to their foreign competitors. This captures not just what US companies produce in the US, but also better assesses the value that investors place on the extensive operations and dominant leadership position that US companies have built across the globe. In the aggregate, domestic companies account for 33% of the market value of the global equity market, much higher than any other individual country or regional bloc (see Fig. 3.1). US companies clearly must be doing something right if global investors place such a high value on their ability to continue to

**Fig. 3.1: US companies dominate equity markets**

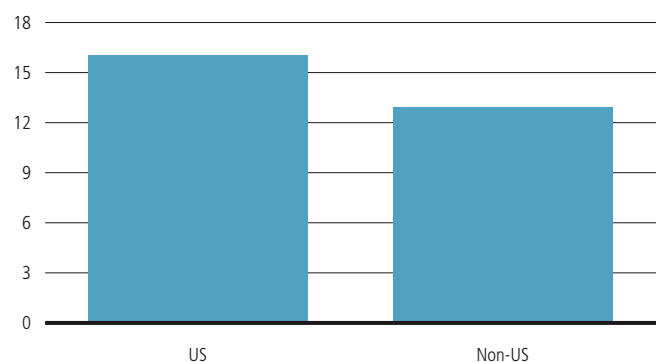
Share of global market capitalization by country or region, in %



Source: Thomson Reuters, UBS WMR

**Fig. 3.2: Leading where it counts**

Aggregate 2010 return on capital for US and non-US public companies, in %



Source: Bloomberg, UBS WMR



Coca-Cola signs decorate an outdoor ice cream stand in Bekescsaba, Hungary.

produce strong business and investment results.

US firms also continue to deliver stronger profitability than their global peers. In 2010, US companies generated a return on capital that was over three percentage points higher than non-US companies (see Fig. 3.2). Based on these two metrics alone — market value of US companies and US corporate profitability — it is clear that US companies are some of the most competitive in the world. And while the mix of goods and services that US companies produce has clearly changed over the past several decades, the current offering of American products and services is still in high demand relative to those of global competitors.

### Competitive firms drive the US economy

From a number of perspectives, all of this is good news for the long-term health of the American economy. First, according to Federal Reserve data, American residents own over 80% of US corporate equity (the rest is owned by non-US residents). So if US corporations do well, Americans will benefit from an increase in wealth. Greater wealth should drive consumption and investment, much of which will likely be deployed in the US. This will ultimately lead to job growth throughout the economy. Second, the most competitive US firms themselves will likely continue to add jobs over time. Some of this job growth will undoubtedly occur outside the US, but the alternative is worse. If US companies were not competitive, they would be less likely to expand, creating a headwind for domestic US job growth and wealth creation. Lastly, beyond wages and traditional benefits

like health insurance, American workers often gain highly valuable skills while working for the most competitive firms. These skills can enhance an employee's value in the increasingly global labor market, driving further wage gains over time and enhancing the US economy's competitive position as those skilled workers add to the productive capacity of the nation.

In this chapter we identify the key drivers of corporate competitiveness and discuss which US industries have the characteristics to remain competitive in the ever-changing global economy. One caveat is that our analysis is focused on large publicly traded companies around the world and does not include smaller or privately held companies. We don't believe this is a major limitation in our methodology because small companies are not generally competing internationally. However, we recognize that these results are not completely applicable to the smallest firms. For instance, as a result of the still recovering US banking sector, small US companies are likely having a harder time accessing capital than smaller non-US firms.

### Competitive "value drivers"

What are the characteristics that enable certain US industries — and companies within those industries — to thrive (or not) in the global marketplace? In order to try to understand the dynamics of US corporate competitiveness, we surveyed the Wealth Management Research sector analysts for their view on which "value drivers" determined US corporate success versus their global peers. Innovation topped the list, followed by brand building and marketing,

global scale, access to capital, access to labor, regulations, barriers to entry, geopolitics and tax policy. We examine our key findings below:

*How to interpret Fig. 3.3:* We asked our sector analysts to determine if US industries scored “High,” “Middle” or “Low” versus their global competitors on the value drivers below. For instance, our US auto analyst determined that the industry was about as innovative as its global competitors. We therefore assign a “Middle” ranking for the US Automobiles industry for Innovation.

**Innovate, innovate, innovate**

In earlier sections of this report we discuss some of the essential building blocks of competitiveness. To reiterate, several factors combine to create an environment that enables successful companies to thrive: the rule of law; property right enforcement; access to capital; an educated workforce; efficient public infrastructure; and, access to large markets for goods and services. With these key elements in place,

companies can focus on what is the major driver of corporate competitiveness: innovation. This should come as no surprise. Those companies that develop new products, new markets and new ways of doing business are usually the ones that generate the largest and most consistent profits. Innovation is often the result of research and development (R&D) spending as research teams, either in-house or at universities, develop and test new product ideas.

So which US industries are particularly innovative? It’s easy to think of all the innovations that have come out of Silicon Valley in recent decades. But US companies in many other industries are also global leaders. Think of all the innovation in Healthcare (advanced biotechnology and sophisticated medical devices), Energy (more efficient hydrocarbon extraction) and Media (new entertainment platforms). Surveying our industry analysts, many believe that US companies in their respective industries are far more innovative than their global competitors, (which is perhaps why profitability measures are

*Those companies that develop new products, new markets and new ways of doing business are usually the ones that generate the largest and most consistent profits.*

**Fig. 3.3: Corporate “value drivers”**

Analyst assessment of drivers of competitiveness, alphabetical order by industry group

	Innovation	Branding / marketing	Global scale	Access to capital	Access to labor	Regulatory	Barriers to entry	Tax policy	Overall assessment
Automobiles	Middle	Middle	Middle	Middle	Low	Middle	Middle	Middle	Low
Capital goods	High	NA	High	Middle	NA	Low	Middle	Low	Low
Consumer durables & apparel	Middle	Middle	Middle	Middle	NA	Low	Middle	Low	Low
Consumer services	High	High	High	High	NA	Middle	Middle	Low	High
Diversified financials	Middle	NA	Middle	Middle	Middle	Middle	Middle	Low	Low
Energy	High	Middle	Middle	Middle	Middle	Middle	Middle	Low	Low
Food, beverage & tobacco	High	High	High	High	NA	Middle	Middle	Low	High
Healthcare equipment	High	High	High	High	High	Low	Middle	Middle	High
Household & personal products	High	High	High	High	NA	Middle	Middle	Low	High
Insurance	High	Middle	High	Middle	NA	Middle	Middle	Low	Middle
Materials	Middle	NA	Low	Low	NA	NA	Middle	Low	Low
Media	High	High	High	Middle	NA	Middle	High	Middle	High
Pharmaceuticals, biotechnology	High	High	High	High	High	Low	Middle	Middle	High
Semiconductors	High	NA	High	High	High	Middle	High	Low	High
Software and services	High	NA	High	High	High	Low	High	Low	High
Tech hardware equipment	High	NA	High	High	High	Middle	High	Low	High
Transportation	High	High	High	Middle	NA	Low	High	Low	Middle

Note: The 24 Global Industry Classification Standard groups are the basis of this analysis. Banks, Commercial & Professional Services, Food & Staples Retailing, Real Estate, Retailing, Telecom and Utilities are excluded from the analysis either because overseas operations are not a material part of the business or companies do not face significant competition from foreign competitors. Source: UBS WMR

higher for US companies versus their peers). The data confirms this. The US continues to lead in new annual patent applications (see Fig. 3.4). Patent growth is also correlated with greater productivity growth (see Fig. 3.5). We analyzed the historical connection between R&D spending and future sales for the 10 S&P 500 sectors. From that standpoint, the Healthcare, Consumer Staples and Technology sectors stand out as having the strongest link between current R&D spending and year-ahead sales. (see Fig. 3.6)

**Brand building**

Consumer brands can also be a source of competitive advantage. A strong brand can be an essential component of attracting and retaining both employees and customers. There are a number of third parties that assess brand value. Although methodologies vary from survey to survey, American brands consistently dominate the rankings.<sup>1</sup> For example, the brand management firm Interbrand ranks the “Best Global Brands” each year. All of the top 7, 9 of the top 10 and 13 of the top 20 global brands were owned by US corporations (see Fig. 3.7) in the 2010 survey. Iconic American brands such as Coca-Cola, IBM, McDonalds, Google and Disney are invariably at or near the top on most lists of the world’s most valuable brands. Companies with strong global brands should be in an excellent position to grow as emerging market consumers gain purchasing power and “trade up” to established global brands that convey quality and trust. Many branded products also benefit from being aspirational or “cool” which, apart from quality, connects consumers of the brand with other brand loyalists. However, established US companies will have to continue to invest in their brands in order to resonate with an emerging market consumer that may not yet be familiar with the full gamut of developed market brands.

**Access to skilled labor and professional “clusters”**

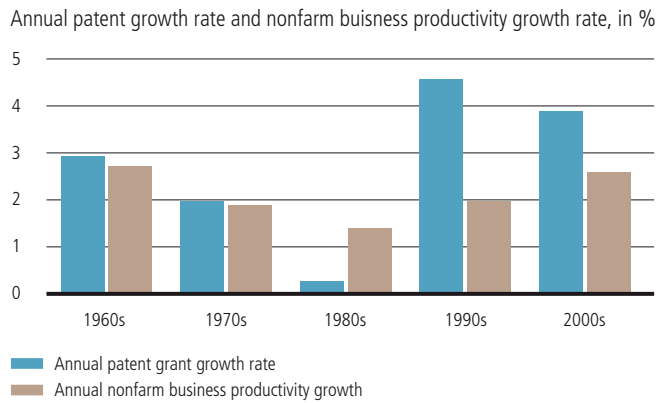
Another area of strength for US industries, according to our analysts, was access to labor. In the aggregate, American universities are still the most prestigious of all and therefore attract some of the best students in the world. This gives US-based companies access to some of the most attractive labor pools. This

**Fig. 3.4: The US leads in internationally recognized patents**



Source: World Intellectual Property Organization

**Fig. 3.5: Patent growth correlated with economic growth**



Source: Patent and Trademark Office, Bureau of Labor Statistics

**Fig. 3.6: R&D spending drives sales**

Ten percent R&D spending increase leads to sales growth of...

Healthcare	4.8%
Consumer staples	3.2%
Information technology	2.2%
Telecom	1.7%

Source: Worldscope, Compustat, UBS WMR

**Fig. 3.7: US companies dominate global brands**

The 20 most valuable brands in Interbrand’s 2010 assessment

1	<b>Coca-Cola</b>	11	Toyota
2	<b>IBM</b>	12	Mercedes-Benz
3	<b>Microsoft</b>	13	<b>Gillette</b>
4	<b>Google</b>	14	<b>Cisco</b>
5	<b>GE</b>	15	BMW
6	<b>McDonald’s</b>	16	Louis Vuitton
7	<b>Intel</b>	17	<b>Apple</b>
8	Nokia	18	<b>Marlboro</b>
9	<b>Disney</b>	19	Samsung
10	<b>HP</b>	20	Honda

Note: US brands are in bold.  
Source: Interbrand: “Best Global Brands 2010,” UBS WMR

is especially true in the information and medical technology fields. As we describe in Chapter 2, while more international students are choosing to return to their countries of origin in order to pursue careers, the US economy still benefits from the many overseas students that elect to begin their careers in the US.

But access to labor is not only about formal, high-quality education. Part of the allure for many talented individuals in various industries is the geographic “clustering” of professional talent.<sup>2</sup> New, talented technology entrants seek to work in Silicon Valley since it is in proximity to industry-leading firms and their top talent. The same can be said for financial professionals in New York City and the energy sector’s connection to Texas. But US-based companies also benefit from the rich worldwide talent pool. Those same marquee brands that attract consumers also represent a powerful draw for skilled workers around the globe. For example, the US software industry employs a large number of workers in India and US consumer products companies tap into local talent in all the markets in which they operate. So corporate America’s access to talent is not limited to the continental US, and the allure of working for a US company may be greater than the allure of working for a non-US multinational.

**Taxing taxation policies**

The only areas in which our analysts consistently

ranked US companies lower than peers were in taxation and regulation. US companies are at a disadvantage relative to global peers as a result of higher-than-average statutory corporate tax rates in the US relative to other countries (see Fig. 3.8). However, we would point out that there is a smaller gap between US and non-US tax regimes when looking at effective tax rates, which are the tax rates that companies actually pay (see Fig. 3.9). This is in part because: public US companies have expanded overseas into lower tax jurisdictions; many industries enjoy tax breaks; and the government enacted temporary tax reductions to encourage investment in response to the recession. Nonetheless, the higher tax rates that US companies face puts US companies at a modest disadvantage versus other global competitors. And as we addressed in Chapter 2, achieving the lower effective tax rate can require extensive resources.

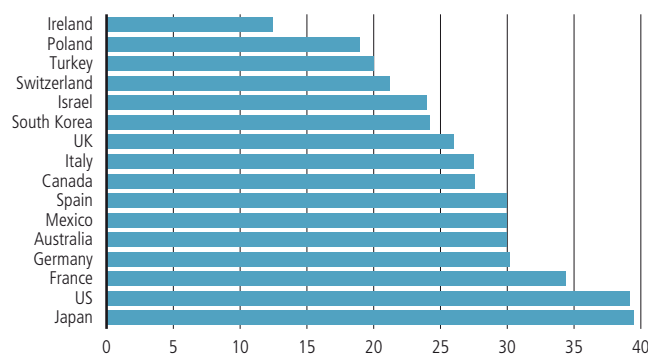
**Regulation: not enough protection abroad, uncertainty at home**

Our analysts also believe that the current global regulatory environment puts US companies at something of a competitive disadvantage. In some instances, this is not a direct assault on US policymakers or regulations. For instance, many analysts highlighted the lack of intellectual property rights enforcement in selected emerging markets as a source of competitive disadvantage for US firms. Protectionist policies in non-US markets also hinder US companies.

*Companies with strong global brands should be in an excellent position to grow as emerging market consumers gain purchasing power and ‘trade up’ to established global brands that convey quality and trust.*

**Fig. 3.8: Taxing times for US corporations**

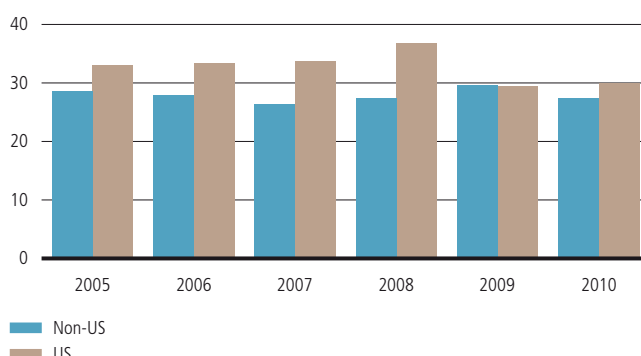
Combined central and local government statutory corporate tax rates, in %



Source: OECD Tax Database, UBS WMR

**Fig. 3.9: Effective tax rates higher for US companies**

Aggregate effective tax rate for non-US and US publicly traded companies, in %



Note: We used the S&P 500 as a proxy for US companies (excluding the distortory effects of AIG). For non-US companies, we used the S&P 700.

Source: FactSet, UBS WMR

Some analysts highlighted the myriad layers of US regulation (local, state and federal) as a hurdle for US businesses. In addition, ongoing and possible further regulatory changes in the US financial, healthcare and energy sectors have created one of the more uncertain regulatory environments in recent memory.

**Determining the winners**

In order to identify the industries that we believe are best positioned to compete globally over the next three to five years we scored each industry on: 1) historical quantitative factors such as market value relative to non-US competitors, profitability and other financial metrics that drive innovation, market share and growth; 2) current analyst assessment of “value drivers” that we discussed above such as innovation, brand, access to labor and capital

(see Fig. 3.3); and 3) projected analyst forecasts for changes in market share and profitability.

The results are presented in Fig. 3.10. This methodology combines quantitative data, which by its very nature is generally backward-looking, coupled with more forward-looking views that leverage WMR industry analysts’ expertise. Note that we excluded from our analysis industries that do not truly compete on a global basis.

To conclude, WMR analysts detail five US industries identified as best positioned to continue competing successfully in the global marketplace in the years to come.

**Fig. 3.10: Global competitiveness assessment**

Combined quantitative and qualitative competitiveness assessment, organized by rank

Industry sector	Quantitative factors	Value drivers	Outlook
<i>High</i>	Consumer services	High	Middle
	Food, beverage & tobacco	Middle	High
	Healthcare equipment	High	High
	Household & personal products	Middle	High
	Media	High	High
	Software & services	High	High
	Technology hardware & equipment	High	High
<i>Middle</i>	Energy	High	Low
	Insurance	Low	Middle
	Semiconductors & semiconductor equipment	Middle	High
	Transportation	Middle	Middle
<i>Low</i>	Automobiles & components	Low	Low
	Capital goods	Middle	Low
	Consumer durables & apparel	Middle	Low
	Diversified financials	Low	Low
	Materials	Low	Low
	Pharmaceuticals, biotechnology	Low	High

Note: Quantitative factors = assessment of US industries’ market share, profitability and increase in fixed investment versus non-US peers. Value drivers = summary of Fig 3.3. Outlook = analyst assessment of the outlook for US industries’ market share and profitability relative to non-US peers. Just like Fig. 3.3, US industries that scored better/worse than non-US peers were assigned a High/Low rating. Industries that were judged to be on par with non-US peers were assigned a Middle rating.  
Source: UBS WMR

## Information technology — it's in America's DNA

Robert Faulkner, Analyst

The US has dominated the IT sector for decades and, in our view, will continue to do so. For much of the 20th century, the US offered the best science and engineering schools in the world, attracting the best and brightest from all corners of the globe. Many of these brilliant minds wound up in the burgeoning technology industry or prestigious research organizations. In addition, tax policy attracted risk capital to fund “ideas” in the form of a venture capital industry. Last, and maybe most important, the US has a culture of independence where challenging the status quo is encouraged.

There are a number of threats to US dominance of the IT sector but we do not see them materializing over the next three to five years. While the US still has the best engineering schools, there are now very competitive alternatives abroad, as well as job opportunities at global technology companies. The venture capital community has also pushed beyond US borders and is being mimicked by some governments. All of this will force US-based technology companies to run faster and jump higher. But the one advantage that remains difficult to match is the culture of creativity and individuality in the US, which has been a major driver of innovation in the IT industry.

## Consumer staples — dominant brands

Sally Dessloch, Analyst

US consumer packaged goods companies enjoy competitive advantages, including strong brands, leading market shares, innovation, scale and high barriers to entry. The large-cap US-based companies undoubtedly lead the world with well-recognized brands that compete globally. Because of their financial strength, these companies can continue to invest in their brands while still earning attractive returns.

Outside the US, these same companies have been “on the ground” across the globe for years; their brands are well-established and they are often viewed as local players (e.g., Colgate-Palmolive in Latin America). Operating locally helps level the playing field, as materials and services can be sourced in local markets, keeping costs low and managing foreign currency risk. Innovation also plays a role in lowering the cost of production in emerging markets, positioning these companies to capture more than their fair share of the expected growth in emerging markets.

## Healthcare — leading edge

Jeremy Brimeyer, Analyst

US healthcare equipment and biotech companies have long been dominant in world markets. In medical equipment, particularly in medical devices (such as orthopedic implants, cardiovascular devices, etc.) and diagnostics, US companies are particularly strong. There are many reasons for the industry's historical dominance, many of which should enable these US companies to remain leaders for years to come.

Not surprisingly, innovation is at the heart of US dominance in these healthcare industries. Innovative products create high barriers to entry for non-US companies. US healthcare equipment and biotech companies also attract some of the best talent in the world, partly because of their world dominance but also because the US remains the leader in science and technology education. This innovative environment has given rise to successful medical equipment and biotech industries. Similar to other industries, high start-up costs (manufacturing, labor, etc.) and R&D expenses present a

formidable barrier for non-US competitors. Another important barrier is the global marketing and service prowess of US healthcare companies, especially given the sales force required to market often highly technologically complex products.

### Consumer services — satisfying the customer

**Alexandra Mahoney**, Analyst

US companies in the restaurant, hotel and leisure industries have become dominant global players in large part because of the “lessons learned” from decades of competing in the mature, cutthroat US consumer market. This intense competitive environment forced corporations to create keen marketing, thoughtful merchandizing and efficient supply chains. It also led them to expand overseas, where the competition was somewhat less advanced. The industry also enjoys strong cash flows and easy access to capital, which has funded expansion beyond US borders.

In the next three to five years, we estimate the US consumer services industry will expand its global market share, as US companies focus on growth abroad. As a result, we believe industry profitability will improve.

### Media — the show goes on

**George Lambertson**, Analyst

US media companies are world leaders in terms of both creative and highly technical content production. The companies also benefit from strong brand recognition. As a result, the industry enjoys good pricing power and has gained share both in the US and abroad over the last few decades. Cable and broadcast television networks have become the most profitable segments, with film lagging behind due to weakness in DVD sales.

US entertainment companies face a number of challenges that could threaten their current strong position, including sluggish film revenues, the proliferation of fragmented digital media platforms and the risk that Internet video could supplant traditional cable video. We think these companies are likely to surmount these risks. Although US box office film revenues have been uneven, we see the potential for healthy growth in non-US markets as entertainment companies with strong and trusted brands continue to attract large audiences, especially in an increasingly fragmented media environment. Over time, new technologies typically enable media companies to reach more consumers, ultimately expanding the pie for all industry players.

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## Conclusion

# Reinvented in America

After a fairly thorough analysis it has become apparent that the entire concept of US competitiveness is exceedingly difficult to define, let alone try to measure. There are many factors that contribute to assessing productivity and rankings. Moreover, there is a tendency to dwell too much on small shifts in relative standings and lose sight of what is truly important in discerning our nation's competitive edge. We have therefore tried to gauge the outlook for US competitiveness through three different but interrelated lenses: the economy, the policy environment and commerce.

For those prone toward lamenting the decline and fall of the US in the world, the results may come as something of a shock. To paraphrase Mark Twain, reports of the country's "death" have been greatly exaggerated. In almost every measurable way, the US remains among the most powerful, productive, adaptive and innovative nations in the world. This is due in part to America's deep-seated sense of insecurity. For example, the US believed it was losing the space race, outnumbered and outclassed during the Cold War, and destined to fall hopelessly behind Japan economically in the 1980s. None of these fears were ever realized. Instead, these challenges served as the critical catalysts behind an American renaissance, as this nation once again chose to reinvent itself.

But there are lessons as well for those who simply assume that US leadership is both fixed and unassailable. Keep in mind that there are a whole host of structural challenges that, if left unattended, will severely undermine America's place in the world order. Had the US not risen to the occasion during the early days of the Cold War, it is doubtful that America would be the same country that it is today. The competitive challenge — and all that it entails — may therefore represent this generation's "Sputnik moment." Americans are once again faced with having to make difficult but necessary choices, and it is clear that some "reinventing" is now in order. However, the US confronts these issues from a position of strength thanks to its innovative and entrepreneurial culture, its flexible system of government and its successful world-class companies. In our view, the hurdles to US competitiveness are surmountable but will require both hard work and the emergence of focused leadership.

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- 7 Labor productivity is measured as output per hour worked of employees, while openness is measured as the sum of total export and imports as share of GDP.
- 8 Command GDP uses the aggregate import price index instead of the aggregate export price index to adjust exports for price fluctuations. That way it measures the volume of imports that can be purchased by selling US exports on the international market. (See: Krugman, Paul. *Competitiveness: A Dangerous Obsession*. Publication. 2nd ed. Vol. 73. Foreign Affairs, 1994. Print., Krugman, Paul. *Making Sense of the Competitiveness Debate*. Rep. 3rd ed. Vol. 12. Oxford Review of Economic Policy, 1996. Print.)
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developed to the point of achieving high-wage and high-efficiency status. In order to be able to classify the countries, the WEF classifies the 12 pillars into three categories. The first four pillars are categorized as "basic requirements," the fifth through tenth pillars are categorized as "efficiency enhancers" and the remaining two pillars are classified as "innovation and sophistication factors." Consistent with this classification, countries at a lower stage of development will have to improve their "basic requirements" pillars first in order to be competitive on international markets before they can strive to move up the value chain of production and become "efficiency-driven" and, later on, "innovation-driven" economies.

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