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SKILLS AND THE BRITISH ECONOMY

Extracts from a talk given by Sir Digby Jones, U.K. 'Skills Envoy' and Director General of the CBI 2000–2006, to members of the Economic Research Council on Tuesday 19th June 2007*

For Globalisation

If, during my time at the CBI I learnt one thing more than anything else, it was that the 21st century belongs to Asia – in the sense that the 19th century belonged to us and the 20th century belonged to America. And in this 21st century world we in Britain, more than any other developed nation, have a chance of putting the ball in the net – because we start ahead of the game. Globalisation involves goods, services, capital flows and people. And if there is one country that does all of that, out of the Americas and the Germanys and the Frances and the Japans and the Australias and the Canadas and the Italys and the Spains, it is us.

We have the Goods

I bet every one of you, if you fly anywhere this summer, will get on an airbus at some point. 65% of every airbus that has ever been built, was built in Britain. The wings are built in Braughton in North Wales, the avionics by Smiths at Watford, GKN and BAE systems in Tilton, the undercarriages by Massey and Dougherty in Gloucester, and the engines by Rolls Royce in Derbyshire. The Germans make the fuselage but there is not a lot of technology in a fuselage. And the French, they draw it together. But the really clever stuff, the bit that gets it off the deck, the bit that keeps it there, the bit that brings it down again are all made here.

Look at autos. I know you will find this very difficult to believe, but the second most productive car plant in the entire world, and the most productive car plant in Europe, is Nissan in Sunderland. The British motor industry used to be a joke but last year, 2006, we exported more cars made in this country to elsewhere in the world than we have ever done. Today we are the most productive place to make motor cars in the world.

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* Now The Lord Jones of Birmingham and Minister of State for Business, Enterprise and Regulatory Reform.

and the Services

Think of this city and financial services. We are now the capital of the world. If you want to raise it, borrow it, insure it, get advice on it, you come to London. It's not Dubai, it's not Shanghai, it's not Frankfurt, it's not Paris, it's not Manhattan, it's here. We are number one in the world. And why? Because it is deregulated and open. We don't really care where they come from. We just say bring your money. Come in here. Create employment. Pay tax. Help build hospitals and schools. Make Great Britain greater. And do it here.

We are 17% of the entire world of creative industries. That's textile design, web design, architecture, consulting engineers, advertising and tourism. It's music, video, DVD, theatre and cinema.

And then look at pharmaceuticals. Glaxo Smith Kline is the second biggest pharmaceutical company in the world and Astra Zeneca the fourth. The biggest, Phizer, has its European headquarters in Britain as does the third biggest, E R Lilley.

In all of tomorrow's businesses, the ones that can charge a lot more for value added and innovation we, a bit by serendipity, and a lot by hard, tough decisions taken over many years, are absolutely number one or number two in the world.

and the Capital Flows

And just when the developing world is saying to the developed world that they are not going to buy goods, services and commodities at top prices because they can get them more cheaply elsewhere, we are the one nation that has said, Yes, I'll take you on. I'll open up. America – the greatest and most powerful economy the world has ever seen is so frightened of little Dubai that it says 'You can't come and buy three of my ports. Clear off!' Diddums! And the French have just declared yoghurt a matter of national security! And here we are. We say 'come in'. To those who object to the Spanish owning Heathrow we say, we want them here risking their capital, creating wealth, creating employment and paying tax.

If globalisation means that India wants to serve you your lunch and China wants to serve you your dinner, we need to move up the value chain – value added, innovation, quality, brand. And up we go, every year, in every way whilst we open our markets, open ourselves to competition, open ourselves to trade in two directions. The disgusting hypocrisy of the

Americans, the French, the Germans and the Japanese, on trade, is actually pitiful. On trade and investments (despite our faults in many areas) we can hold our head up. We are on the moral high ground. We do say that we practise what we preach and you can come in and do it, and we'd like to do it in your countries too. Which we do; we invest more in China, for example, than anyone else and we have floated more Chinese companies in this city than the Americans, the French and the Germans put together. It's a two-way street.

and the People

If you turn to the fourth pillar of globalisation – people – the greatest migration of people the world has ever seen is going on right now. We may (rightly) look at this as a very British issue but it's an American issue, it's a German issue, a Swiss issue, a French issue, a Spanish issue, an Italian issue, all over. Those who – forget asylum seeking and violence and persecution – just want a better life, are no longer prepared to sit there and say, I'm going to take it. They want to come and do it and share in it. Who can blame them? And if there is one nation that gets a good share of this, it's us. We have a history of saying, we don't care about the colour of your skin, the dodgy worship, not being able to pronounce your name, come here. Bring your family, live in peace, work hard, but meet me half way – speak English.

I do wish I'd got politicians in this country who had the courage to stand up and be counted and say, actually you're very welcome but you will speak English or you can leave. You will bring your National Insurance number, you will work in a transparent economy and on that basis you will pay some tax, but in return you will get the protection of health and safety and employment legislation and if we find any gang master trying to exploit that he is going to prison for a long, long time. If we had politicians who said, bring a skill, come here and make this country greater, wouldn't that be fabulous? Instead of which, my Mum, 83 years old, opens her curtains every morning and believes there are 15 Latvians camping on the lawn. Why? Because the newspapers tell her so, that's why!

So if you look at the four pillars of globalisation: goods, services, capital flows and people, we are made for globalisation in a way that no other nation in the developed world is.

But we have a Dirty, Nasty Little Secret

But there is one big thing that could stop us doing it. Right now, we don't have enough skilled people and if we don't change this, it's going to kill us. We have 7 million adults in this country who can't read. There are 33.5 million adults in Britain and 7 million of them are functionally illiterate. They can do: exit, toilet, stop, go, but if you threw them a Yellow Pages and said find me an electrician in that, they couldn't do 'elec…'. There are 11 million adults who can't add up two 3-figure numbers. That's a third of the adult population Before someone tells me, oh that's what you get from immigration, the average adult illiterate in Britain is white, male and 26 years old, the product of an education system where half the kids who take GCSE cannot get grade C or above in English and Maths, and they are the ones who actually take their GCSEs. Half of them can't read, write and count to a level at which they are employable: this is our dirty, nasty, little secret. But it's something you don't hear about. Politicians don't want to talk about it. Readers of newspapers find it boring. They'd rather it ran away.

But how on earth are we going to put the ball in the net in the way that globalisation is demanding if we are going to carry on with this? These people have always been with us. Nothing's new. But we used to put them down the pits, put them in the fields. In Huddersfield you put them in a textile woollen mill, in Manchester you put them in a cotton mill, in Newcastle you put them in a shipyard, in Port Talbot you put them in a steel works – they all had something to do. Now, in a value added, innovative, quality branded economy, where all the commodity jobs have gone, they've got nothing to do. This is a reservoir of potential talent that we are not tapping in to. These people are not stupid, they are not thick, they are quite bright actually, but they hide it every day from you and me. They can't read, they can't write, they can't count and they hide it from you because they are cunning and they are clever – but terrified of being found out. As we move, more every day, to value added, they are found out. 'Hello, Bill, we've got a new machine coming Monday. There's the instruction manual, you read it and come back Monday.' 'A bit of a problem, Boss, can't read.' 'What do you mean, you can't read? You've operated this for the last twenty years.' 'Oh yes, sir, I get by. But I can't read the instruction manual.' What are you going to do? Sack him? He'll never work again.

Or at the same time, we rightly in our economy are saying to the public sector, we want more for less. We don't want you to work longer hours; we

merely want you to work more efficiently, effectively and cleverly.

Well, you won't pull that off if you're stuck with people who can't read, write and count. The NHS has got 1.2 million people. Your taxes pay for 1.2 million people in the NHS and some of those people are the most highly skilled people on earth: brain surgeons, cancer specialists, heart specialists. Fabulous people. The NHS has got 400,000 people who can't read!! 400,000 employees, paid for by your taxes, who are functionally illiterate and innumerate! So when people like me say come on, let's get more efficient, more productive, give me more for less, you can't do it with people who can't read. They've got no skill in the game. They've got nowhere to go. So we can't dip into a reservoir of talent because we haven't got enough of it. But at the same time, what are we going to do? Because both our public sector and our private sector are leaving town.

And then what happens? These people, well they don't respect themselves very much because they are frightened. They are hope-less. Then what they do is they go home at night and they do all the nasty stuff, and then their bodies respond, and the NHS has a bigger call on its resources. If you don't respect yourself very much, you sure as hell don't respect your neighbour and you don't respect your community and your environment, and we start to live in a rather dirty, nasty world. And you go home at night and the house has got no books. Why would they have books? No-one reads. So the kids come home from school and you carry on, the same problem. And then the bloke selling white powder at the end of the street seems to have the answer, and then they come and mug you and nick my car to pay for that. Obviously, this has got a social consequence the likes of which we have never known. And you see the trouble is people like me, people like you, we've done nothing, well, we've succeeded really. Nice house. Good job. A few bob in the bank. Success is it? You've got razor wire on your boundary fences. I hope your burglar alarm's working while you're here. Your kids get mugged on the way to school and your car, if you dare park anywhere on a Saturday, gets vandalised. Oh, that's real success in a society isn't it? Oh yeah! And we are doing that, and if we are not careful, we just won't put that ball in the net. Economically we won't. But socially we won't. And then, who picks up the pieces? How do we deal with it? Isn't it better to deal with it at source?

The Skills Pledge

We have now launched the 'Skills Pledge' inviting private and public sector undertakings to sign up and make a difference. It's not a contract, you can't be sued on it. It is basically just a statement that says, I will facilitate an employee in my business or in my public sector organisation, and I will give up a bit of time, they must give up a bit of time, and the Government will pay for it, and we will get them to their first level 2 where it is relevant to what they do in their lives and it relevant to what we need. If we haven't pulled this off in three years with a step change in training these people at the bottom end of the employment ladder, the Government may be prepared to bring in regulation – which would be awful – the great clunking beast of regulation.

You see, if this is going to make a difference in our society for the 21st century, this has to be in a compartment called 'Leadership and Cultural Change'. It has to go into the DNA of our being. It has to be there on the forefront of the minds of every aspect of our society because it is the right thing to do. If you regulate, people do it because they have got to. It therefore goes into the box called Cost and Compliance. I've got an inspection coming up a week Friday, get me through it. Tick these boxes. Do the least you have to. Get me there. And then no-one buys it. They just focus on inspection and compliance and not on the societal need. And Gordon is under huge pressure from the trades unions to regulate today. They'd love you to regulate. They lost the opportunity of nationalising British business when they abolished Clause 4 so now they want to nationalise British business through regulation. They want decision-making processed out of business through regulation. But they are going to lose this one as well because the employers of the nation are going to do this. It's not a lot to ask actually. Facilitate it. Get it to a point at which all you have to do is say, you can do it on the premises if you want so I can check and know that you're not going off to the 4.50 at Wincanton. Or you can go down your college and do it. You can do it where you like. You can do it Saturday mornings or Sunday afternoons, I don't care, but the Government will pay for it and we will begin to get rid of our dirty, nasty little secret of these people who can't read, write and count.

and Beyond …

And we need at the same time to take this message into one or two other aspects of our society. Did you know the prison population of this country

is 85,000? 75,000 of them can't read. Do you know what we do with them when they're inside? We actually pay them a few bob every week to go and work in the prison factory. I'd like to tell you they sew mail bags but they don't do that these days, but they do other manual tasks and they get a sum of money every week, £10, I don't know what it is but it's that sort of thing. Instead of that they get a choice. They can actually go into a classroom every day and learn to read, write and count, and operate a computer and do you know how much they are paid for that? Half of what they get if they worked in the factory. And so when I go and talk to prisoners and I talk to Home Office civil servants and I say 'This is bonkers' because every time someone comes out of prison and re-offends it's £250,000 because that's what it costs you and me when they go back inside. Now a lot of them re-offend, go through the arresting procedure, through the cost of what it costs, through the Magistrates' Court, or the Higher Crown Court, back into prison for a short term of custodial sentence, and it's a quarter of a million quid, every time, every person. There's been about four or five today and what are we going to do about this? What do we do? We put them inside, put them back on £10 a week and wait until they come out and they can do it again!

I am a UK schools envoy. I get around and I learn every day about ways in which we can add value to the training and skilling regime. For instance, why is 16 the 'Clapham Junction' of education? Just because a Secretary of State in 1964 said 'I think everyone should leave school at 16'. Why? The world has changed fundamentally. There are loads of 14 year olds who shouldn't be anywhere near school. There are loads of 14 year olds who want to be in school, want to be in a structured learning environment, teachers who want to teach them, and they are going to go right the way through and thank God they do. But there are loads of 14 year olds for whom school is just not any more a suitable place to be. They need to get into the world of work and get training which is relevant to that.

The other thing of course is that people are going to have to change their jobs seven or eight times in their lives. My Dad did two jobs in his life and my Granddad just one. Even people in their 30s and 40s are probably going to have some full-time retraining, and they are going to have to work until they are 70. The 21st century is about a society where you have no property in the job any more, you have no right to 'a job'. It is more about 'protect me in the ability to always have a job'. So that if somebody comes along and says 'you're fabulous, but I'm sorry what you do the world doesn't want any more, or what you do sorry, someone else is

doing' then you are equipped, you feel competent, you feel confident, and you feel you can actually move it and go to another place where someone wants your skills. That is the greatest protection against unemployment anybody could ever have. It is to be so skilled that you will always be in work. That is not only the obligation of government, it is the obligation of the person themselves to take responsibility for themselves that way. If we can get this right there isn't a thing this country couldn't do because all the rest is in place.

IT'S THE SILLY SEASON …
But Look Ahead for Gains in the Commodity Production, Engineering and Infrastructure Sectors

by Damon de Laszlo

It's the silly season, when we expect an increase of volatility in the markets, i.e. small amounts of news producing disproportionate effects. Volatility also seems to be being exacerbated by the enormous increase in computer programme trading and the huge amounts of money flowing across the main exchanges but also probably more importantly into the burgeoning derivative exchanges, that are driven by enormously complex algorithms that take advantage of minute movements. Many of the trades made by these complex beasts last for fractions of a second and try and trap movements that are measured by the number of noughts after the decimal point. It should be a fun, if that is the right word, few months.

Underneath the froth, the inexorable upward trend in interest rates around the world, with the possible exception of America, will continue to stress the economic system. While world liquidity generated by the shift of resources to the Middle East and Asia is funding some market excesses, the re-rating of debt instruments by Moody's and others, is likely to destroy enormous amounts of value held by institutions that have bought sub-prime debts and other instruments constructed on its back. Moves by the rating agencies that I anticipated in January have now become a subject of journalistic debate. The danger here is that large financial institutions will start to unload some of the paper they are holding as their finance departments start to consider their year-end reporting requirements. This will create problems in market liquidity as we approach the year-end.

Markets will also be unsettled as the retail and house-building sectors feel the effects of a reduction in consumer expenditure as higher costs of fuel, food and interest take a larger share of the consumer's budget. The increase in prices of Chinese sourced retail products will also affect consumer consumption, or retail profits if the prices aren't passed on.

Asian growth is inexorably driving up prices of all commodities where the shortage of supply in virtually all areas will take five to ten years to correct. The volatility in individual prices created by financial institutions trading the commodities and their derivatives, will continue to produce very confusing signals.

In the oil and gas market volatility is being exacerbated by the activities of Mr Putin in Russia who has effectively taken control of European gas supplies, and governments from Nigeria to Venezuela, who are disrupting supply for various reasons. While these are relatively recent phenomena, the response by the governments of the US and Europe to the long predicted decline in the easily accessible oil and gas prices has been effectively zero.

Political smoke screens and by vested interests that are confusing the 'green' movements mean that government policy is not addressing the potentially very serious economic consequences of major disruptions to our fuel supplies in the relatively near future – within the next five years. One can only conclude after careful examination of the various options that strategic security (the business of government?) can only be met by nuclear energy fission in the short term, and possibly fusion in the longer term. Both options are being delayed by lack of government policy. It is interesting to note that, with the exception of the senior members of the Chinese Government, there is almost a total lack in Europe and America of qualified scientists or engineers in the upper echelons of government.

These observations are likely to produce markets, which are polarised between increase in profitability in sectors relating to commodity production, engineering and infrastructure building, or in many areas re-building, while markets are likely to sag in the financial sectors and the retail areas. Economic imbalances are self-correcting and the optimistic view that one can hold in this globally connected, technology driven world, is that the correction will not be violent as knowledge and information is so widely available. While changes in trend will tend to be smoother, because of globalisation, short-term volatility could easily be exacerbated by the same technology.

CUSTOMER EQUITY: A CORPORATE ASSET?
Building, Sustaining and Capitalizing the Equity in Your Customer Relationships

by Robert McGarvey

What is Customer Equity?

Every CEO knows that customers pay the bills, and most senior executives appreciate that loyal customers are a valuable resource. But, what exactly is customer equity? While *equity* is traditionally associated with a company's residual value or the value of its stock, *customer equity* is increasingly being regarded as a formal asset representing the current and future value to the company of its customer base. Managing the assets of an organization is the CEO's responsibility; a deeper knowledge of customer equity can help a senior executive augment competitive advantage, while increasing the asset base of the organization.

Consider the asset value of customers in the case of Tesco. In 1999 Tesco PLC, a leading UK retailer, was faced with a major competitive challenge as Wal-Mart announced plans to enter the UK market. Tesco CEO Terry Leahy did not sit idly by while Wal-Mart planned and launched its invasion of Britain[1]; instead he undertook a series of sophisticated customer equity initiatives to strengthen Tesco's position. Tesco management realized that their greatest asset was the relationship they had with their customers. To strengthen that relationship and to essentially 'salt the earth' for Wal-Mart, Tesco initiated their Clubcard Program signing up 12 million members to a program that gave members discounts in exchange for their contact and other relevant personal data. This was no ordinary club card; Tesco probed deeply in its questionnaire for shoppers' tastes, personal habits, preferences, ethnic background and other relevant information. Working the Clubcard Program aggressively has paid off for Tesco and left Wal-Mart smarting. Tesco's detailed database allows it to tailor promotions right down to individual shoppers and to target specials to key ethnic and other demographics resident in their database. This strategy has been effective in retaining strong personal loyalty for Tesco, helping them maintain market leadership in the face of increased global competition. Indeed the Program has helped Tesco increase its share of the UK grocery market to 31%

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1 WSJ June 6, 2006, See No 1 Retailer in Britain Uses 'Clubcard' to Thwart Wal-Mart by Cecilie Rohwedder.

– nearly twice the market share of Wal-Mart.

Customer equity analysis has come of age. Indeed, analysis of customers and their contribution to the bottom line is being taken to new levels nowadays according to the Journal of Services Research:[2] ‘*In its modern incarnation, individual customer analysis looks beyond the computation of a single year's profitability to the forecasting of the stream of profits attributable to the customer and the computing of a discounted present value.*’ In other words, it is possible today to determine the net present value (the value today discounted for time and the cost of money etc.) of projected future business – providing the CEO and other senior managers with useful tools to visualize and monitor the health of the customer asset.

It is clear that loyal customers and the associated stream of earnings they represent equate to hard value for companies, large and small. As a consequence, customer equity is increasingly being treated by CEOs, Wall Street analysts and M&A specialists as a legitimate asset: a realistic measure of the ongoing viability of the company.

All of this activity has attracted the attention of governing bodies in major accounting institutions. The London-based International Accounting Standards Board (IASB) in company with the U.S. Financial Accounting Standards Board (FASB) are at present formalizing reporting standards for customer equity (and other intangible) assets, building on SFAS 141 (purchased asset treatment in business combinations) & 142 (testing for goodwill impairment). The IASB statement on intangible assets (IAS 38) recognizes a number of customer-equity assets including customer lists and a variety of contractual or quasi-contractual customer and supplier relationships. As a consequence of these changes in accounting standards, there is a growing consensus in board rooms that customer equity is of strategic importance, a factor which is elevating key aspects of the customer interface to the CEO, and not just marketing departments.

What the CEO Needs to Know About Building Customer Equity

It is no coincidence that customer equity management has grown alongside technological advances that have been made in Customer Relationship Management (CRM) software. The large scale, systematic gathering (and processing) of customer transaction data integrated with help desk inquiries

2 Seven Barriers to Customer Equity Management, David Bell, John Deighton, Werner J. Reinartz, Roland Rust, Gordon Swartz, in the Journal of Services Research, March 12, 2002.

and related service values have generated vast amounts of rich customer data, particularly in very large scale retail situations; it has, not surprisingly, enhanced many organizations' ability to identify key buying criteria and to increase sales opportunities.

Because customer equity has it roots in both IT (information technology) and marketing sources, it should come as no surprise to a CEO that there are differing approaches to building customer equity, with considerable variability in the fundamentals. Typically approaches to customer equity start by defining and focusing management attention on profitable[3] customers or customer segments, and then developing means of fully leveraging that 'asset'. Anyone who's a banking customer these days will recognize that their 'relationship' with the bank has changed over the past decade. Today that relationship and associated behaviour is subject to exhaustive analysis, intended to identify prosperous (or otherwise desirable) banking customers and to leverage that customer 'asset' through the promotion of a host of profitable up-sell and cross selling opportunities. Banking customers today are subjected (often through telemarketers) to a host of unsolicited insurance, equity and other special offerings. Some of these offerings have been popular with customers[4], but many of these offerings have done as much damage as good.

Unsolicited, indiscriminate offerings, which ignore customer sensibilities, can often be counter productive; they are at odds with the concept of developing meaningful relationships with customers; which we believe should be a primary goal of management. Approaches to building customer equity must acknowledge an undeniable reality: customer equity is rooted in a commercial 'relationship'. As we all know from personal experience, relationship building requires empathy and a degree of sensitivity to others. Let's face it, relationships can be hard work, time-consuming and are often

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3 Seven Barriers to Customer Equity Management, 'the idea that marketing should be concerned with the profitability of individual customers is not new. Nearly thirty years ago Sevin (1965) laid out a method to compute a single customer's profitability allocating functional cost groups to specific customers and subtracting them from each customer's annual revenue.'

4 Consider the recent Royal Bank of Canada customer equity initiative for first-time home buyers. RBC developed a First Home Buyers Guide which contained important buyer information and tips for first time buyers. RBC then bundled a mortgage package with a variety of free or discounted banking services for this select customer segment. As a consequence RBC increased its overall share of the Canadian mortgage market and strengthened its share of the key first-time home buyer segment.

a complicated two-way street: not well-travelled roads for most hard-minded senior executives.

What Do *We* Mean by Customer Equity?

It's important for a CEO to remember that customers are *not assets*; the asset value to the firm resides in the strength of the *relationship* between your firm and its customers, the most important aspect of which is the relevance your customers place in the relationship. So, although you may not own the customer, you can *own* the relationship with the customer. The relationship is potentially a very valuable asset and must be treated and protected with the same vigour and care that you apply to other (traditional tangible) assets. In order to understand this concept more completely, let's just step back a bit and look at what is meant by the term 'equity':

n. pl. **eq·ui·ties[5],** derived from the Latin aequus, *even, fair*.

1. The state, quality, or ideal of being just, impartial, and fair.
2. Something that is just, impartial, and fair.
3. *Law.* Justice applied in circumstances covered by law yet influenced by principles of ethics and fairness.
4. The residual value of a business or property beyond any mortgage thereon and liability therein.
5. *Securities* The market value of securities less any debt incurred.
   a. Common stock and preferred stock.
6. Funds provided to a business by the sale of stock.

Clearly there are several aspects to equity, one involves the concept of fairness and equitable rights, and the other (a derivative of the first?) is a residual value to the firm or corporation. We believe that customer equity is rooted in 'fair dealing' in a commercial relationship that serves the interests of all parties, customers and suppliers.

But clearly there is a cause – effect relationship here. First and foremost customer equity is founded in consistently delivered value to the customer.

The four principal areas of customer value that are critical to building the asset quality of a commercial relationship are:

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5 http://dictionary.reference.com/search?q=equity

1. Objective value, those competitive advantages that differentiate your organization from the competition in terms of delivered quality, service or price.
2. Brand reputation, the opinions that customers (or prospective customers) hold on your perceived value, positioning your organization in their hierarchy of suppliers (or potential suppliers).
3. Loyalty or retention programmes: the elements of a commercial relationship that encourage customers to continue doing business, even when (not if) problems arise.
4. New business activities, the systems your organization employs to reach out to new customers, opening channels for customers to enter into a business relationship.

Delivered value is the 'causal' agent here, initiating the commercial relationship, what sustains it is trust; belief on the customer side that the value proposition will be sustained over time. However, fair dealing also implies reciprocal supplier value as well. Taking this concept a step further, we believe that customer equity is most solidly built at the interface where a 'Customer of Choice' meets a 'Supplier of Choice'. The CEO's job is then to know enough about their own organization and the competitive landscape to identify the 'fit', the positioning that is most appropriate for the market. Knowing this well will help management to identify its 'natural' customers and the particular value proposition that allows the company to become a favoured supplier to customers.

Marketing Concepts Every CEO Should Know

> *'Bottom line: at the end of the day a successful, focused enterprise is one that has developed a deep understanding of its customers' needs, its competitive environment, and its economic realities.'*
>
> Louis V. Gerstner, Jr. Former CEO of IBM

How to Identify your 'Customers of Choice'

While customers are the people who buy our products and/or services and customer equity is an asset representing the lifetime value of those customers to the firm, it is a giant mistake to believe that '*customers are*

always right'. While this can be true in some cases, many customer demands can be so unreasonable, and some customers may be so costly to maintain, that they are not worth having at all.

Customer Segmentation is the prioritization process by which organizations rank their customers in order to weed out the undesirable ones and determine whether or not there are 'natural' customers that have a long term value to the company.

A CEO must insure that the organization has in place the required customer segmentation capabilities, with a proven methodology for identifying the winners, the 20% of customers who generate 80% of profits, and for identifying those customers who the company is unable to serve profitably or who, for a variety of reasons, the company may be subsidizing. A principal element in customer segmentation lies in understanding the 'customer life cycle' in your particular industry. Knowing this well helps determine how and when managers communicate with customers, at what level they interact and how they distribute precious company resources. It's no secret that some customers are more valuable than others. The goal of customer segmentation is to identify[6] the:

Suns – Gold Standard Customers – without these customers (the proverbial 800 lb. gorillas) we'd be in trouble.

Planets – Cash cows – the customers that don't require a lot of additional energy, the company is meeting their needs and they provide a sustainable profit.

Black Holes in space sucking energy – these are the customers that are costing more to serve (cash, materials and energy) than we make from them.

Shooting Stars – customers whose value to the organization has yet to be determined.

What it takes to become a Supplier of Choice

What is a *supplier of choice*? Well at the very least, a *supplier of choice* is much more than the price-driven commodity brokers that many supply relationships are becoming these days. *Suppliers of Choice*, companies that are serious

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6 Stuart Sanders, President of Sanders Consulting and author of the training manual, Cohesion, developed the customer classification of Suns, Planets, Black Holes and Shooting Stars.

about building customer equity, engage with their customers proactively, it's a top management priority. Achieving and maintaining *supplier of choice* status requires a long-term involvement with customers, in other words building customer equity requires a deliberate 'process'.

The process begins with market intelligence. Becoming a *supplier of choice* requires an intimate understanding of each particular market situation; there is not a 'one size fit's all' strategy. In many cases the requirements vary widely by industry and can be quite regionally specific. Customer equity intelligence gathering begins with an intimate understanding of purchasing histories and life-cycles, the qualities influencing customer satisfaction and the customer segments that are most relevant in their particular market situation. This general information is then augmented by more specific market intelligence which helps evaluate both the nature and strength of customer relationships.

Evaluating the Customer Relationship

The first step a CEO needs to take in coming to grips with customer equity is to get a clear understanding of why customers are attracted to the company (or its brands), delving into the so-called 'why of the buy'. This involves gathering specific data from customers on key purchasing values. Specifically data needs to gathered on

1. The material advantages in quality, service or price that exist in the market, and which customers identify as important buying criteria – competitive advantages,
2. The perceptions about the company (and its competitors) that reside in the minds of customers and which play key roles in establishing preference,
3. Those factors that contribute to sustainable customer loyalty and the predictable stream of earning that define customer equity, and
4. The ability of the organization to generate new customers, its new business capabilities.

Evaluative intelligence involves the systematic gathering of the following categories of market intelligence:

1. Value drivers: those key functional values that establish a material

advantage in the market. Value drivers evaluation requires data that:

- Identifies what customers want, the key buying criteria. In other words data that illustrates what customers value, and in what proportion they value it.
- Differentiates competitors on the basis of advantages in each of the principal vectors of customer value: quality, service and/or pricing (each category of which can have many component parts)

2. Brand drivers: those differences that exist in customer perceptions of competitors that influence purchasing decisions in the market. Brand drivers evaluation requires data that:
    - Identifies brand awareness, the degree of customer awareness of your company, its logos' and or trademarks associated with the company's products and/or services in the market.
    - Differentiates brand image from brand identity, in other words helps establish the distance between the brand's actual or objective qualities vs. the reputation of the brand with customers.
3. Customer retention drivers: the strength of customer loyalty and those factors that shape customers' willingness to maintain the commercial relationship. Retention evaluation requires data that:
    - Identifies the nature and levels of customer loyalty, distinguishing between customer advocates, neutrals and critics.
    - The key factors that determine the differing levels of customer loyalty, and that build (or erode) consistency in the customer relationship.
4. Customer acquisition drivers: the presence of a new business capability and the ability of the organization to attract and sustain new customers. Acquisition evaluation requires data that:
    - Identifies the drivers that link brand awareness, customer preference and the conversion rates leading to new sales.
    - The key factors that determine the rates of new customer acquisition.

Metrics for Monitoring Customer Equity

If the CEO and other senior management are to manage the customer asset effectively they must have their own direct lines of feedback from customers. Therefore the second stage of this evaluation process involves monitoring a variety of customer indicators designed to provide a predictive

measure of the ongoing health of the customer equity asset. Monitoring customer equity involves annual assessments of value, brand, retention and acquisition metrics to help track changes in the levels of customer loyalty and churn. Care must be to taken to understand the relationship between the various metrics and the strength and durability of customer relationships. If this is well understood this monitoring provides a series of leading indicators that will provide the CEO (or boards of directors) with a predictive indicator of any changes in the value of the customer equity asset.

Programmes to Strengthen Customer Interdependence

The process of building customer equity does not end with market intelligence, becoming a *supplier of choice* involves management commitment to strengthening the customer-company relationship through the implementation of a variety of customer related activities such as:

1. Programmes to encourage loyalty
2. Permission marketing exercises leading to possible cross-selling and up selling opportunities
3. Initiatives that anticipate customer dissatisfaction and forestall potential defections.
4. A communications strategy that effectively reinforces the company's brand, its overall value proposition, keeping the company top of mind with customers.

This is not simply a marketing exercise, the process must operate at all levels in the organization, from CEO all the way over to shipping & receiving; it must be active from the acquisition stage, through the service stage and the retention stage – in order to maximize the value of the customer relationship.

Suppliers of choice understand these issues clearly and differentiate themselves from run-of-the-mill competition by becoming integral to the success and profitability (or the lifestyle) of their customers, and then communicating that fact effectively. In the B2B world, *Suppliers of Choice* recognize that their most effective positioning in the minds of customers is to be acknowledged as an integral part of the 'team', a vital cog in their customers' 'virtual' (integrated) supply chain. Successfully implemented,

this positioning leads to more consistent and reliable sales, reduction in downward pressure on prices, as well as more effective selling propositions and growth strategies.

Don't abuse Customer Knowledge

The market intelligence gained in such processes provides companies with intimate knowledge of customers' buying habits and values. Do not abuse this knowledge or you risk damaging the very relationships you hope to build. Consider this cautionary warning from Harvard's Luc Wathieu: *Sooner or later customers will rebel against companies using information about them as they please and in a manner that is often perceived as insistent and intrusive. Customer information belongs to the customer as much (or more) than to the company that uses it*. The rule of thumb in cases like this is '*ask before you act*'. If you're in possession of intimate knowledge use Permission Marketing, a basic courtesy, that's easy enough to meet before engaging in cross selling or up selling activities. Remember, this is a 'relationship' and the activities that will enhance customer equity must be win-win, not simply selling opportunities for the company that emerges from the process.

Now – Translate Knowledge into Action

We believe in the old adage, '*it is not businesses that do business with business, it is people who do business with people*'. Unfortunately for those specialists who love IT or sophisticated technology, building customer equity is most effectively done the old fashioned way, value to value, problem to problem, face to face. Keep in mind that market intelligence alone is not going to build you customer equity; before 'equity' can be built, the knowledge, insight and system efficiencies gained from market intelligence need to be put into action. Implemented successfully, however, market intelligence can have a material effect on customers, and customer equity.

Consider the Speedpass originally developed in the 1990s by Mobil Oil (now part of ExxonMobil). The Speedpass initiative came out of research suggesting that customers valued their time measured in the speed (and efficiency) required getting into and out of the gas station, more than a few cents on the price of gas and more than other service features. The result, Mobil developed a little RFID (radio frequency identification device) which fits on a key chain, allowing its customers to pull up to the gas pump, wave their Speedpass and be instantly recognized. ExxonMobil customers can

now fill their tanks while the payment is automatically being deducted from their accounts: allowing them to save time and hassle. In other words, the Speedpass is building customer loyalty by fulfilling a critical customer value; enhancing customer equity for ExxonMobil as a consequence. It wouldn't have happened without the market knowledge, and more importantly, the Speedpass wouldn't be building customer equity if it were not implemented effectively and communicated widely[7].

Customer Equity Valuation Concepts Every CEO Should Know

> *Everything that can be counted does not necessarily count; everything that counts cannot necessarily be counted.*
>
> Albert Einstein 1897–1955

The data that needs to be gathered and processed in quantifying customer equity is, fortunately, data that most companies have access to or whose marketing and/or accounting departments could relatively easily assemble.

In its simplest form:

- Customer equity = (volume of purchases over the lifetime of the customer(s)) × (the margin[8] the company receives)

Given that customer defections are a business reality, customer equity calculations generally including a defection (or retention) factor to account for these losses. Therefore:

- Customer equity = (volume of purchases over the lifetime of the customer(s)) × (the margin the company receives) × (a customer defection/retention factor)

Additional factors influencing customer equity are being identified by researchers in the field, adding to the accuracy of valuations and the complexity of the calculations. These factors include:

- Costs to acquire, develop and retain customers

7 ExxonMobil (Esso in Canada and the UK) has now taken this even further. Some of the gas stations offer an additional price discount if you use the Speedpass.

8 This margin is calculated from gross product/service margins minus any associated costs incurred in managing the customer account.

- Cost of capital, (discount rate)
- Growth in the customer base, the effects of brand switching and competition

Customer lifetime value (CLV, also known less frequently as lifetime customer value LCV) is the value of a customer over the future of their anticipated relationship with the company. Customer equity is very often calculated as the net present value of the aggregated individual Customer Lifetime Values and can, depending upon the degree of sophistication, be very complicated.

Because customer equity is so vital to corporate profitability and stock market valuation, it is as important to gather this information accurately and consistently, as it is to calculate traditional asset values.

Fortunately researchers in the field of customer equity are making progress in modelling CLV (customer lifetime value) that most, if not all, companies can utilize from data that can fairly easily be acquired. For specific methodologies for calculating customer equity refer to Blattberg and Deighton (1996). The authors suggest a method of calculating what they refer to as 'static' customer equity, which represents the present value of already-acquired customers. For a more aggressive and thorough treatment of the subject I recommend *Driving Customer Equity: How Customer Lifetime Value is Reshaping Corporate Strategy*, Roland T. Rust, Katherine N. Lemon (Joint Author), Valarie A. Zeithaml (Joint Author).

However, this is an evolving field and CEOs will no doubt feel the need to develop appropriate metrics for their own specific situations: yes, much work remains to be done on the valuation side of customer equity. Also it's important to remember that customer equity, however calculated, is a measurement defining the capital value of the customer asset; in order to 'book' the asset on the balance sheet (and thereby legitimize it in the minds of senior management) procedures must be followed and handling of the asset must meet accounting standards that are only now being formalized and agreed.

Accounting Concepts Every CEO Should Know

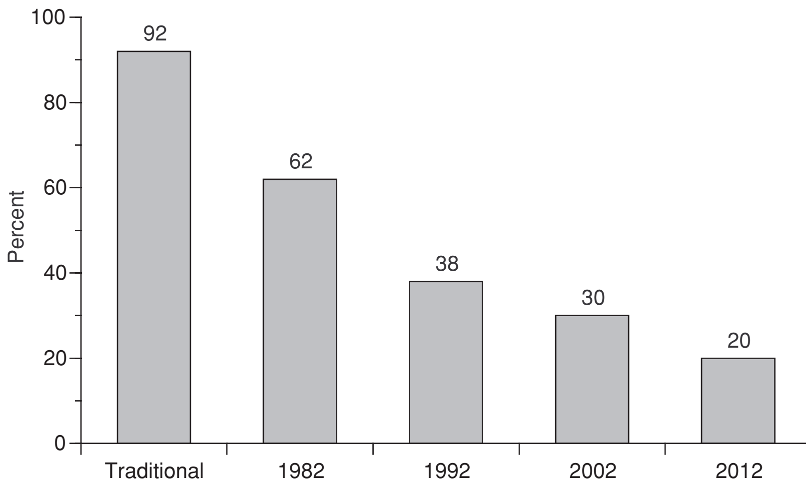
Do *not* make the assumption that your CFO is going to welcome your customer equity initiative[9]; he or she will probably rebel against the idea

9 This advice comes from accounting futurist Joseph Batty, C.A., an accounting

and, most likely, find considerable support for their scepticism among their professional colleagues. Customer equity is an intangible and as every CFO knows, intangible assets do NOT have a history of being recognized under established accounting customs. In addition, despite the fact that they are clearly playing key roles up and down the economy, intangible assets require new skills to identify them, are encumbered with a decided lack of traditional 'solidity' and are accompanied by a host of unfamiliar risk factors. So … given all this you can appreciate the CFO's problem[10].

The Rise of Intangible Assets (and subsequent decline in importance of tangible assets)

Despite the scepticism there are facts that we all, the CFO included, cannot escape. Since the 1970s, there have been revolutionary changes taking place as Western economies transition from economies largely underpinned by famil-



Source: Brookings Institution

Figure 1: Tangible Assets as a Percentage of Total Market Capitalization

specialist and frequent lecturer on the subject of intellectual property and the Knowledge Revolution.

10 This accounting conservatism is not without foundation, there is real personal and corporate risks involved: *'inaccurate measurements or surprise write downs of non traditional assets could (probably will) get them (the senior management including the CFO and the CEO) sued,'* according to Halsey Bullen, Senior Project Manager at FASB (the U.S. Financial Accounting Standards Board).

iar industrial assets to economies dominated by 'intangible' knowledge-based assets. For those who doubt that major changes are impacting the economy, consider that between 1995 and 2002 the world's 20 largest economies lost 22 million industrial jobs[11]. Nevertheless, despite the shrinking of their industrial work forces, the output in these countries as a measure of GDP increased by an astonishing 50%. Today, in the US and other Western economies in particular, market services have displaced industrial production as the primary engine of growth[12]; studies suggest that 'intangible' assets are now contributing over three-quarters of US GDP[13].

Fortunately for your CFO, professional guidance on these issues is forthcoming. The International Accounting Standards Board (in tandem with FASB) is in change mode; in modernizing accounting standards they are incorporating the new classes of assets and moving off the traditional 'historical cost' model for reporting asset values. These two related areas of accounting reform are designed to make financial reporting more accurate and relevant by (1) establishing a 'fair value' standard in the recording of corporate assets and (2) including the full range of tangible and intangible assets on the financial statements.

As a consequence of these massive changes the IASB and FASB have identified 30+ intangible asset classifications. These asset classifications include the more formal forms of knowledge assets, licence based (contractual) intangibles, artistic and technology (copyright and patented) based intangibles as well as many other informal brand and customer-equity (contractual and quasi-contractual) related intangibles. It is the Boards' intention to standardize reporting standards in these new asset classes and to gradually incorporate them into the mainstream of asset management.

In widening the asset matrix in this way, the Board has revisited the definition of an asset and broadened it considerably*: an asset is a resource that is controlled by the enterprise as a result of past events (for example, purchase or self-creation) and from which future economic benefits (inflows of cash or other assets) are expected*.

The Board defines an intangible asset as: *An identifiable non-monetary asset without physical substance*. The IASB goes on to set the parameters of acceptance: *Thus, the three critical attributes of an intangible asset are: [IAS 38.8]*

11 'The Misery of Manufacturing', *The Economist,* September 27, 2003.

12 Consider that in 1965 the ratio of 'service' to manufacturing jobs in the US was 1.5:1; today it's about 5:1, Source: Bureau of Labor Statistics, Payroll Survey.

13 KNOWLEDGE AND SHAREHOLDER VALUE, Baruch Lev, January 2000, Page 2.

- *Identifiability*
- *Control (power to obtain benefits from the asset)*
- *Future economic benefits (such as revenues or reduced future costs)*

Identifiability

According the new IASB Standards [IFRS 38.12] an intangible asset is classified as 'identifiable' if it:

- *Is separable (capable of being separated and sold, transferred, licensed, rented, or exchanged, either individually or as part of a package) OR*
- *Arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.*

This is a more liberal interpretation than traditional GAAP. In the past, the separability of an asset, the ability to remove it from one company (and potentially transfer it to another) was an irreducible qualification of an asset. Separability is now being interpreted more liberally. Consider the following example taken from CFO Magazine: *The 'separability' (of an asset) is not a necessary condition for an asset to meet the legal contract criterion…We recently valued a manufacturer with a single contract to supply hearing aids to the Australian Government. This contract was 98% of their business and was not separable, in the sense that it could not be transferred to any other company. Under the old standard, this contract would never have been valued, while under the new regulations (the Australia version of IFRS 3 is AASB3) it must have a value assigned to it.[14]'*

Bryan Browning, Senior Vice-President with the U.S. Valuation Research Corporation, explains the US position in more detail: *'Early on after the implementation of SFAS 141, a view was taken that customer relationships from acquisitions were not 'contractual', based on initial interpretations. As customer relationships cannot be separated from other assets, nor can they be sold, it seemed that they should not be valued under the existing standard[15].'* Since experts were not including [balance sheet] values for customer relationships, the FASB [Financial Accounting Standards Board] came out with a clarification that *purchase orders* constituted contractual obligations. (And therefore renewals of contracts should be looked at carefully.)

14 New accounting standards create risks and opportunities in the management of intangible assets, By Bernard Kellerman CFO. 01 May 2005

15 Browning made this statement in a presentation to the Group of 100 in March 2005.

Cost Model vs. Revaluation

An important consideration in capitalizing an intangible asset, particularly a 'customer' related asset is the issue of cost vs. value. Having made a determination that the customer base has met the relevant asset qualifications, a choice needs to be made as to what value to assign to that asset. Guidance on this issue comes from [IAS 38.72]. The new Standard identifies two valuation options:

- *Cost model.* After initial recognition, the benchmark treatment is that intangible assets should be carried at cost less any amortization and impairment losses. [IAS 38.74]
- *Revaluation model.* After initial recognition (at cost), intangible assets may be carried at a revalued amount (based on fair value) less any subsequent amortization and impairment losses only if fair value can be determined by reference to an active market. [IAS 38.75]

Clearly in most commercial situations, and almost by definition[16], customer relationships and their associated value are established and maintained in market situations in a competitive environment, a factor which supports the revaluation model with asset valuations based upon 'fair' market value with appropriate amortization and impairment considerations, as opposed to the more conservative cost-based valuations.

Useful Life of Customer Assets

What is the 'life' of an intangible customer-related asset, when as we all know customers are generally free to choose alternative suppliers freely? According to the new standards, intangible assets are classified as having: [IAS 38.88]

- *Indefinite life:* No foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity.
- *Finite life:* A limited period of benefit to the entity.

Clearly, this is an issue where the (1) customer life cycles calculations and (2) customer loyalty/churn estimations need to be determined with high levels of accuracy and reliability. If a case is made (and customer histories

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16 The exception of course is monopoly situations, or government related contracts in which there are no clear competitive, or independent arms-length alternatives.

can confirm) that although individual customers may come and go, the 'customer-base' itself is (statistically) stable, it has been determined that the asset may be treated as having 'infinite life'. And being an (intangible) asset with an indefinite useful life *(the customer asset) should not be amortized.* [IAS 38.107]. The Standard goes on to say: *Its useful life should be reviewed each reporting period to determine whether events and circumstances continue to support an indefinite useful life assessment for that asset. If they do not, the change in the useful life assessment from indefinite to finite should be accounted for as a change in an accounting estimate [IAS 38.109].* A more likely situation (and more conservative position) is that the customer asset has a finite life, and based upon contract terms, industry norms and well documented customer life cycle histories, the asset value should be amortized over an established period, whatever that may be.

Annual Impairment Analysis

Given the complexity of the undertaking and the special risks involved, the Standards make the sensible requirement that impairment tests should be conducted annually, to confirm (or otherwise) the original assumptions: *The asset should also be assessed for impairment in accordance with IAS 36. [IAS 38.111]*

What Should a CEO do Next?

Start by taking a broader view of your organization's assets. With intangible assets representing as much as 70% of the market capitalization of public companies[17] it is critical to gain the expertise necessary for identifying, managing, valuing and capitalizing this newly explored class of assets.

Customer Equity as a Valuable Management Tool and Metric

Let's face it; at the moment customers are essentially invisible on financial statements (apart from a single 'revenue' line item). As such when a CEO huddles with his CFO and the hard decisions are made, customers and their asset value to the organization are largely ignored. For example, management's decision to improve profitability through the adoption of lean manufacturing processes and just-in-time supply chain management (carrying only the minimal product inventory) will almost certainly improve

17 The figures are only marginally lower for private companies these days.

the bottom line. All to the good according to traditional financial management principles, until you discover that those new lean processes have the unintended consequence of lengthening the order and delivery timelines for customers, leaving the company at a competitive disadvantage, undermining customer loyalty and increasing customer defection rates. Clearly the situation looks a little different from this perspective. If potential customer equity losses are factored into this decision making process, it would be clear that more work needs to be done to manage the implementation of these new lean manufacturing systems in order to achieve both customer equity growth and bottom line growth. Without a visual asset, through the quantification of customer equity, the management debate simply never takes place.

There are additional advantages to a more formal approach to customer equity. One of CEO's principal responsibilities is to husband the assets of the organization to best advantage; working the intangible (particularly customer related) assets more diligently, could expand the capital base of your organization as well as open new financing, tax and/or transactional opportunities. For example, '*Intangible assets such as trademarks are suitable for structured finance purposes, as they are separable and transferable intellectual property rights, often with robust revenue streams.*[18]

Begin today preparing for new accounting standards in 2009

The IASB and FASB will not require the application of new International Financial Reporting Standards (IFRSs) currently under development or major amendments to existing standards, before 1 January 2009. The establishment of 2009 as the first date of required implementation of new standards will also provide countries yet to adopt IFRSs with a clear target date for adoption.[19]

CEO's should be taking advantage of the transitional period, between now and 2009, to develop the internal systems, processes and expertise necessary to meet these new standards, and to revisit their fundamental priorities. Customer equity is an intangible, relationship-based form of corporate *capital*; that – at least – is becoming evident to many senior

18 New accounting standards create risks and opportunities in the management of intangible assets, by Bernard Kellerman CFO, 01 May 2005.

19 http://www.iasb.org/news/index.asp?showPageContent=no&xml=10_907_25_24072006_20072007.htm: IASB and IASC Foundation News, IASB takes steps to assist adoption of IFRSs and reinforce consultation – No new IFRSs effective until 2009.

executives these days, and it should be treated accordingly. Whether or not it can in future become a formal *balance sheet asset* depends upon:

- How accurately and consistently it is measured
- The professionalism by which it is managed
- And the extent to which the treatment of it meets GAAP (Generally Accepted Accounting Practices).

A Three Stage Customer Equity Plan

Clearly such major changes in accounting standards and the formalization of customer equity and other related intangible assets represent a formidable challenge to most companies. A staged approach to implementing a customer equity program is recommended.

Stage 1: Evaluation Stage
The process of capitalizing your customer equity begins with a qualitative analysis of the customer asset and the establishment of key metrics to monitor changes in customer behaviour. The objective is to establish the analysis and feedback systems that will allow the company to determine the material and psychological factors that underpin their relationship with customers. The evaluative stage requires the development of competencies in determining key customer metrics: (1) value drivers, (2) brand drivers (3) defection/retention drivers and (4) customer acquisition drivers. Thus testing and experimenting at this qualitative stage will help the company understand what actions support or erode customer confidence and loyalty and will provide the metrics necessary to monitor changes in the customer base over time.

Short term benefits: There are immediate benefits of the market intelligence activities at this stage. One, reaching out to customers, gathering their feedback often identifies: (1) immediate sales opportunities, (2) various points of (actionable) friction at the customer interface, (3) competitive strengths and weaknesses and/or (4) other opportunities to gain competitive advantages in the market. Secondly, understanding the essential value your company delivers, from the customers' perspective, helps the CEO clarify organizational priorities, improving decision making.

Stage 2: Valuation Stage
Following the establishment of competent evaluation and monitoring systems, the process moves to the quantitative or valuation stage. The

objective at this stage is to put numbers to the customer asset, so that the CEO and his or her management team can gain a familiarity with handling the customer equity asset (and its volatility) and then begin to incorporate customer equity values into the financial statements on a trial basis. Testing and monitoring are vital at this point to provide management with the experience and market indicators necessary to monitor any changes in customer expectations, overall loyalty or other factors that that might influence the reliability and consistency of the valuation.

Short term benefits: The immediate benefits of quantifying customer equity lie in the discipline it brings to an organization and the additional opportunities it provides for establishing accountability, particularly at the marketing level. Many CEOs are using customer equity as a means of establishing a ROI (return on investment) for marketing and related expenditures, measuring the growth in the customer asset value against the costs associated with acquiring that growth.

Stage 3: Capitalization Stage

At an appropriate stage, when the CFO is confident that customer equity valuations are reliable enough and the organization has built sufficient internal systems and competencies in this area, capitalization of the customer asset becomes a real option. By 2009, GAAP reporting standards for customer equity will be in effect for all international business combinations (M&A) and – most likely – for any formal financial reporting in the United States. Building competencies at all levels of the organization to evaluate, monitor, value and capitalize these new classes of assets will require time and effort, it can not be achieved without strong organizational commitment, but clearly the direction in accounting standards and sound asset management is plain.

Short term benefits: The immediate benefits of capitalizing customer equity lie in the additional (formally quantified) assets that the CEO and his or her management team has at its disposal, as well as clarifying the most significant 'hidden' sources of earnings in the organization. This additional asset strength can be translated into financial strength. Reducing debt-to-asset ratios could reasonably be expected to increase leverage opportunities with banks, bond markets and other debt financiers. Perhaps more importantly for management, gaining a clarity in identifying, valuing and managing intangible assets ahead of the competition may open up arbitrage opportunities, particularly in M&A situations with acquisition targets lacking such expertise.

Customer equity is a real, if non-traditional asset, it is not a management panacea; it most assuredly is not a new management 'paradigm'. The quantification of customer equity and the recognition of the asset value of the customer base are only valuable if they operate in tandem with traditional management processes. Becoming more expert in customer equity and other intangible assets allows CEOs, CFOs and other financial specialists to gain a much greater insight into the seemingly hidden sources of earnings in their organizations and to begin to balance their priorities more effectively. In addition customer equity, by providing a quantification of the customer asset utilizing a suit of new and relevant metrics provides the CEO, directors, investors and other shareholders with improved reporting standards and systems of accountability.

Getting through this maze requires insight and change. At the very least it is important to recognize that new approaches and a more balanced asset assessment are a good starting point. In an increasingly competitive global economy, the challenge for a CEO is to gain mastery over these emerging sources of value and profitability; to build, sustain, capitalize and fully leverage their most valuable asset: the equity in customer relationships.

THE ORIGIN OF WEALTH

Eric Beinhocker, *The Origin of Wealth: Evolution, Complexity, and the Radical Remaking of Economics* (Random House: 2006)

The Origin of Wealth is another must-read from McKinsey & Co, in the tradition of Richard Foster's *Innovation* and Foster and Sarah Kaplan's *Creative Destruction.* The author, Eric Beinhocker, is senior fellow at McKinsey Global Institute, graduate of the Sloan School of Management at M.I.T., writing his thesis under the guidance of two of the Sloan School's 'star' faculty, Rebecca Henderson and John Sterman. His title *The Origin of Wealth* must be a conscious amalgamation of Darwin's *The Origin of Species* and Adam Smith's *The Wealth of Nations*, marrying economics to evolutionary theory.

What is the origin of wealth? Wealth creation is a central topic of economics. How can we become wealthier? What is the recipe? This ques-

tion grips not only individuals and families but cities, regions, and nations. Beinhocker's book addresses this issue, and many more.

Another theme of *The Origin of Wealth* is found in the book's subtitle, which announces 'the Radical Remaking of Economics'. Has this new brand of economics, dubbed 'complexity economics' or 'complex adaptive systems', replaced neoclassical traditional economics? For decades, a stream of critics have stressed that some of the theoretical underpinnings of economics were unrealistic: an equilibrium system, at rest, perfectly competitive. Everyone now agrees that the economy is not characterised by perfect foresight and a mathematically perfect and stable competitive equilibrium. *The Origin of Wealth* shows how recent advances make economic theory more realistic and relevant.

The economy is also more complex than neoclassical theory suggests. Billions of uncoordinated transactions made every second across the world form today's global capitalism. Billions of participants, trading billions of billions of different products and services. Out of this seeming chaos comes economic evolution and indeed progress – new wealth. 'The economy is a marvel of complexity,' Beinhocker says. 'Yet no one designed it and no one runs it.'

Another insight of Beinhocker is that technology and knowledge are not exogenous forces but integral to economic theory. Building on Schumpeter, Drucker, Keynes and such current economists as Richard Nelson and Paul Romer, the author shows that powerful forces (technology, entrepreneurship, financial innovations, and other forms of knowledge) are endogenous to any credible theory of capitalism, creating greater complexity and positive feedback effects, usually positive (akin to Schumpeter's 'creative destruction' or Keynes' 'animal spirits'). In short, the economy is a 'complex adaptive system' which must take account of the strong forces which keep propelling it forward.

The Origin of Wealth makes another contribution. The author's history of economic thought is an update to such classics as Heilbroner's *The Worldly Philosophers*. He explores, in sparkling detail, the evolution of economic ideas from Adam Smith and others who built neoclassical economics, spelling out refinements and new developments of the past five decades.

Returning to the title, where does wealth come from? Beinhocker's answer is these three evolutionary processes: Physical Technology, a process which W. W. Rostow described as Four Industrial Revolutions, spread over two centuries or more; Social Technology – including law, money, markets, and democracy – factors which institutional economists such as Nobelist

Douglas North have stressed; and Business, vehicle of Schumpeter's process of creative destruction.

Aside from its appeal to observers of economic theory, *The Origin of Wealth* can be read at a practical level, as one might expect from a McKinsey-sponsored study. The perspectives championed in *The Origin of Wealth* illuminate issues of strategy, organization and finance for business professionals – entrepreneurs, corporate strategists, professional managers, and investors. And politicians, bureaucrats, and the foot soldiers of democracy, informed citizens, will find it enlightening for its insights into politics and public policy. Seeing economics from the perspective of an open, complex, organic and learning system adds an angle lacking in the neoclassical model of economics built on the static, stable equilibrium of Newtonian physics.

Again, is traditional economics threatened by 'complexity economics'? One can perhaps best leave aside quibbles of whether the term evolution, as applied to economic systems, is real or metaphorical (Beinhocker insists it is real), and whether complex adaptive systems will replace neoclassical economics. But 'replacement' is not the issue. Traditional economics is enriched, not supplanted, by these intellectual developments.

Clearly our economy – driven by Physical Technology, Social Technology, and Business – changes and is becoming ever more complex. All around us we see how virtually all sectors have become more dynamic and more knowledge-intensive and technology-driven. Complexity economics provides a fresh set of tools for the economist's toolkit from which to examine such issues as business strategy, politics and public policy, economic history and economic systems – and much more.

Review by Kenneth D. Walters, Professor of Business Administration, University of Washington

WHERE YOU KNOW NOTHING, PLACE TERRORS

Some thoughts on *Yo Blair!* by Geoffrey Wheatcroft (Politico's, 2007, £9.99) and *Fantasy Island* by Larry Elliott and Dan Atkinson (Constable, 2007, £7.99)

At the very moment that Emperor Blair interrupts his triumphal farewell world tour staking out his legacy in order to attend the G8 Summit and, having already agreed to double the UK's annual contribution to the EU, to prepare for his final appearance on the stage of an EU summit, where it is said he prepares to sign away more of Britain's independence,[1] the Royal Academy displays the Emperor – and his Empress – naked. The Royal Academician, Michael Sandle, shows a 15 x 5 feet triptych, the centre panel of which shows the Blairs, in puris naturalibus, shut out of their Garden of Eden – 10 Downing Street – a hooded Iraqi at their feet. On the left, a soldier beats another hooded Iraqi prisoner, and on the right a pile of corpses almost obscures the windows of 10 Downing Street. To rub in the Blairs' indignity, the Royal Academy awarded this charcoal sketch the Hugh Casson Prize. We are accustomed to satirical attacks on politicians by, for example, Bremner, Bird and Fortune, and to dramatisations ridiculing the extra-marital 'love' antics of Blunkett and Prescott, but Mr Sandle's image has a permanency that a television programme lacks. Its bitter shaft, rapidly sketched though it was – it took only ten days to complete – is even more telling. In the wings of the long hand-over of the Premiership we have Gordon Brown, described by another satirist, Craig Brown, pursuing his 'tortuous struggle to appear normal'. But why bother? The British people 'are now crying out to be led by a humourless, buttoned-up sociopath'.

In appealing so vociferously for his legacy to be recognised and striving desperately that it shall be munificently gold-plated, Mr Blair has provoked instant historic evaluation. Much as Mr Brown might wish to distance himself from aspects of 'the Blair legacy', only the most sycophantic office-seeking Labour politician can divorce the two leaders from responsibility for the events of the past ten years. No one (except O-S L Ps) will meekly

1 That our politicians are not the only ones to practice deceit is apparent from a leaked letter from the German Chancellor, Angela Merkel, which apparently says that the new EU treaty would have much the same legal substance as the Constitution voted down by French and Dutch voters but would make 'presentational changes' and use 'different terminology' so avoiding the need for the referendum on a Constitution promised to the British people (Sunday Telegraph, 10 June 2007).

regard Brown as having no share in Blair's actions. Yes, Mr Blair can claim credit for painstakingly building on Mr Major's initiative towards a peaceful settlement in Northern Ireland; yes, Mr Brown can claim credit for giving independence to the Monetary Policy Committee of the Bank of England, but the nub of Mr Sandle's charcoal triptych (and how aptly symbolic that it should be sketched in charcoal!) is Iraq. Both men stand accused of complicity in this adventure. As Mr Sandle pointedly puts it, 'there have now been more Iraqis killed than we lost at the Battle of the Somme'. Blair may have led the charge (from a safe distance – no Henry V he, nor even a George III)), but Brown ensured that in Iraq (and Afghanistan and elsewhere) the men in the front line were not backed with adequate financial resources. Both stand condemned, as do many MPs, Tory as well as Labour, of falling for the spurious claim that Saddam could launch Weapons of Mass Destruction in 45 minutes. To me the real flaw in this preposterous excuse was not the weapons of mass destruction but the forty-five minutes. If neither UN inspectors nor aerial surveillance could find launchers and rockets they must have been dug in. If the relatively tiny rocket launchers firing twin one-cwt rockets from 'Z' Batteries on which I served over sixty years ago had been concealed (not sited on concrete emplacements in full view) they could not possibly have been unearthed, assembled, loaded and fired in 45 minutes. An inter-ballistic missile obviously presents infinitely greater problems in being put into service. Quite apart from deception, Blair and Brown were also guilty of stupidity. One is reminded of the Minister who assured us (and our servicemen and servicewomen) that in the government's adventure in Afghanistan not a shot would be fired.

Now, whilst Blair acts the pop-star, Brown and his close allies 'prowl and prowl around' like 'the troops of Midian' two short books have been published which 'up and smite them'. One, Geoffrey Wheatcroft's *Yo Blair!*, 'demolishes the outgoing Prime Minister's character' (I quote Jeff Randall) and the other, *Fantasy Island* by Larry Elliott and Dan Atkinson, exposes, as its subtitle puts it, 'the incredible economic, political and social illusions of the Blair legacy', and puts under the spotlight Brown's shared culpability.

Yo Blair! has plenty of detail and analysis (and a fair number of misprints); it is enlivened with wit and humour matching that of Bremner, Bird and Fortune. This to some degree offers comic relief to Wheatcroft's account of the lies, incompetences, and deceptions so persistently practised on the British people over the past ten years. *Fantasy Island*, which concentrates on the economic implications of Blair and Brown, will probably be of greater interest to readers of *Britain and Overseas*. What is so telling about *Fantasy*

Island is that the authors come, not from the carping *Daily Telegraph* stable but are associated with *The Guardian*[2]. Thus, while they can hope that 'Under Mr Brown, policy making may well be thought through, rather than, as all too often under Mr Blair, made up on the hoof in a television studio'. Brown 'is both architect and cheerleader of the project, a true believer that fairness and enterprise, war and peace, higher taxes and lower taxes, the Swedish model and the American model can be joined together; and that the resulting jumbo chalk and cheese sandwich will be both delicious and nutritious. Furthermore, his presumed rivalry with Mr Blair has provided a valuable cover for the Chancellor. … It is also troubling that Mr Brown is a master of the oft-repeated policy announcement, of the selective use of statistics, and of public spending increases counted twice and sometimes thrice. … Mr Brown is as big a fantasist as Mr Blair' (pp. 224–5). They then concentrate on three fantasies: defence, debt and environment.

Elliott and Atkinson do give credit for what they see as Blair's achievements but they are chiefly concerned with seven fantasies: 'an economy built on debt; the shrinking of the industrial base; the unfinished battle against inflation; the disastrous commercialisation of the public sector; the looming crisis in the labour market; Britain's dangerously over-stretched armed forces; and the game of Russian roulette being played with the environment'. The first and last of these they regard as the most threatening. On the world stage they quote from *Le Monde Diplomatique* in October 2006: 'Reality is out of control. The entire financial global structure is becoming uncontrollable in crucial ways that its nominal leaders never expected, and instability is hallmark'. To the authors, 'an almighty financial crash is likely' (p. 230).

As one who is no more of an economist than an amateur observer, the analyses of *Fantasy Island* strike me as well founded. A pretty depressing picture they paint. I can do no more than urge readers to study their arguments. It will be £7.99 well spent. What, in addition, does surprise me are the contrasts with what the government proposes and their outcomes, coupled with the contrast between the public statements by those such as Mrs Hewitt and lived experience in the community. Are she and her like living in a fantasy world? There is much to choose from here: lack of planning computer programmes; the equipment squeezed out of the

2 If there is a single criticism I would offer anent the authors' links with *The Guardian* it is that when they refer to Labour's new core vote 'the swollen army of white-collar, public-sector bureaucrats' (p. 125) they do not mention that The Guardian has been to some degree subsidised by advertising for these very bureaucrats.

Treasury for our forces from rifles that jam to inter-com radios that don't work and boots and body army 'unfit for purpose'; and claims for the health service. Today, as I drafted this, I heard Mrs Hewitt vaunting the turn-round in NHS finances. Then I think of our local, long-established hospital at Savernake, partly funded by local people and recently updated (again partly paid for by the people it serves). It has not yet been officially re-opened following its refurbishment, but already its highly-regarded mental health unit has been closed and its staff dispersed; its Minor Injuries Unit is to close in October and we are to take our bleeding limbs (often on the bus) to Chippenham or Swindon (a hospital with the longest waiting lists in the country). To top that, the Chairman of the Primary Care Trust attended the Friends of the Hospital AGM on Wednesday 30 May, and gave assurances of continuing support for the hospital but failed to mention that 48 hours later his authority would give notice of the closure of its Day Hospital unit in four weeks' time. Now, if these cuts are justified, even before the hospital is officially re-opened, why ever was it decided to spend a small fortune on updating the hospital – and with so much financial support from the community? Is that effective planning? Is it honest? One can go on but everyone will, I imagine, have similar experiences. It is petty stuff to what Elliott and Atkinson expose but it is sadly and depressingly indicative of chaos, bad planning, waste, and deception.

Governments of all shades seem to learn nothing. After a generation of tower-block building, followed by blowing up some of the worst monstrosities, we now have whole streets bulldozed and their communities dispersed. Yet, eighty years ago, writing in 1928 of events immediately after the collapse of the General Strike, John Galsworthy in chapter 4 of his novel Swan Song, outlines a practical scheme for the elimination of slums without building 'barracky flats' and without dispersing settled communities, yet maintaining the old rents.[3]

Now we shift from Sofa Government to what might well be called Divan

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3 Television has possibly painted John Galsworthy (1867–1933) in a more comfortable light than is justified. He was the subject of George Orwell's first literary essay, published in French in Paris in 1929. Orwell percipiently noted that Galsworthy 'was concerned less with art than with the cruelty, injustice and folly of his time and his country. … Only rarely was he content with mere storytelling' (Orwell, Works, vol X, p. 139). We can still learn from, say, his play Justice in which a young man is imprisoned in solitary confinement and eventually commits suicide. Winston Churchill, then a Liberal Party Home Minister, saw the play and, in 1911, brought about a change in the law relating to solitary confinement. Yet we still seem unable to stop young people killing themselves as a result of our prison system.

Government. Before the world was adequately mapped, there was much ‘Onknowne Land’ and map-makers would fill in where they knew nothing with strange animals and fishes and such legends as ‘Here be Terrors’. So, in our present situation, to quote John Galsworthy again, ‘in the spirit of the old cartographers: “Where you know nothing, place terrors”’.[4] Stand by to be terrified!

Review by Peter Davison

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4 John Galsworthy: The White Monkey, 1924, ch 10. The word Divan means, among other things, an Oriental seat of government but, in the original Persian, ‘an account book’ which seems appropriate for Mr Brown. The chapter is aptly titled ‘But Take No Chances’.

LETTER

A Response from Mr John Gibson to 'Some Challenging Thoughts on Governance' by Mr Brian Lewis (Britain and Overseas, Autumn 2006)

Sir,

In several contributions to *Britain and Overseas* Mr Brian Lewis has rightly expressed frustration over the implications of current practices regarding nationality – especially as experienced by the large and growing number of ex-pats. Is the whole idea of allegiance and identity being linked to geographical location now bankrupt? What should be the alternative?

Since fiction is the realm in which to explore new ideas I would like to pass on to members a passage from a very recommendable science fiction story – 'Singularity Sky' by Charles Stross published by Orbit in 2003. The central character – Martin Springfield – is from (future) Earth and has been sent to work on the rather backward planet of New Republic. In the following passage Martin is seeking work clearance papers from a Home Office type bureaucrat.

After another minute, the Citizen lowered his pen and looked at Martin. Please state your name,' he said softly.

'Martin crossed his arms. 'If you don't know it already, why am I here?' he asked.

'Please state your name for the record.' The Citizen's voice was low, clipped, and as controlled as a machine. He spoke the local trade-lingua – a derivative of the nearly universal old English tongue.

'Martin Springfield.'

The Citizen made a note. 'Now please state your nationality.'

'My what?'

Martin must have looked nonplussed, for the Citizen raised a gray-flecked eyebrow. 'Please state your nationality. To what government do you owe allegiance?'

'Government?' Martin rolled his eyes. 'I come from *Earth*. For legislation and insurance, I use Pinkertons, with a backup strategic infringement policy from the New Model Air Force. As far as employment goes, I am incorporated under charter as a personal corporation with bilateral contractual obligations to various organizations, including your own Admiralty. For

reasons of nostalgia, I am a registered citizen of the People's Republic of West Yorkshire, although I haven't been back there for twenty years. But I wouldn't say I was answerable to any of those, except my contractual partners – and they're equally answerable to me.'

'But you are from Earth?' asked the Citizen, his pen poised.

'Yes.'

'Ah. Then you are a subject of the United Nations.' He made a brief note. 'Why didn't you admit this?'

'Because it isn't true,' said Martin, letting a note of frustration creep into his voice. (But only a note: he had an idea of the citizen's powers and had no intention of provoking him to exercise them.)

'Earth. The supreme political entity on that planet is the United Nations Organization. So it follows that you are a subject of it, no?'

'Not at all.' Martin leaned forward. 'At last count, there were more than fifteen thousand governmental organizations on Earth. Of course, only about the top nine hundred have representatives in Geneva, and only seventy have permanent seats on the Security Council. The UN has no authority over any non-governmental organization or over individual citizens, it's purely an arbitration body. I am a sovereign individual; I'm not owned by any government.'

7 Tufnell Mansions
73 Anson Road
London.

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