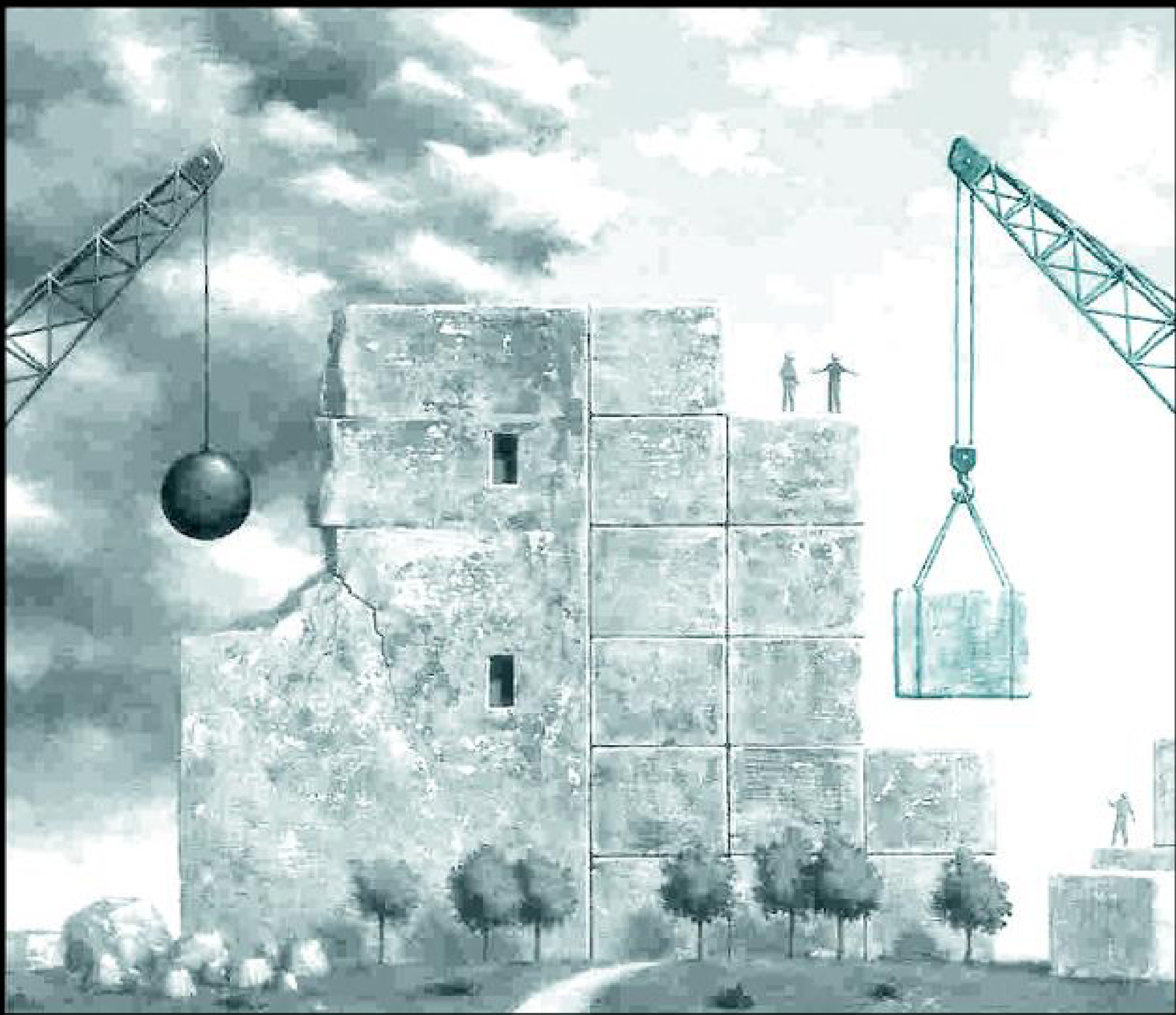


The Macroeconomics of Global Outsourcing

CRYZTAL CAPITAL

guest column

Max P. Michaels

Disruptive Creation

Every job outsourced creates another job with higher intellectual content and better pay for an American

The current hysteria in the US around the job losses—100,000 per year—arising from global outsourcing of services is misguided. According to McKinsey & Co, every $100 of labour cost outsourced offshore creates over $112 of value for the US economy through savings, related revenues, new revenues and repatriated profits; only 22 per cent of the total value accrues to outsourcing destinations. As shareholders, consumers and workers, we all benefit from global outsourcing.

US companies and their shareholders benefit from the lower costs (50-70 per cent savings) and productivity improvements that result from outsourcing; they also profit from the new exports of telecom services, it equipment and software. It is reported that GE adds about $340 million a year to its bottom line from its service centres in India.

Knowing what to outsource is the ultimate core competency of a company. At American Express, a significant proportion of the recent improvement in earnings has been attributed to its cost-effective back-office operations in India.

The most defining part of American capitalism is the idea that protecting the welfare of the consumers (not workers) is the basis of national prosperity. The welfare of American consumers translates into offering them the widest choice of goods and services at globally competitive prices. This philosophy suggests that global trade is an integral part of American prosperity. Global trade also expands the economic pie, and results in net gains to the American economy. The economic surplus initially accumulates as savings and profits to the corporations. With increased trade and investments in cost-saving strategies, the industry supply curve flattens. American consumers initially derive the benefits from increased quality of services; they will directly benefit from the cost savings when outsourcing reaches a critical mass.

The increased returns to the shareholders from global outsourcing are reinvested to create better jobs in America. The underlying strength of the American economy is evident from the rate of job creation over the past decade: 3.5 million jobs per year. Many of these jobs have a higher intellectual content and also pay better.

The only way the American economy can continue to grow without inflation is by improving the productivity of its workforce, by undergoing cycles of disruptive creation. Today the wages are growing much faster than the inflation, aided by productivity improvements. At two per cent per year overall, real wage growth is well above the average for previous economic recoveries. The productivity gains get split up between wage increases and corporate profits.

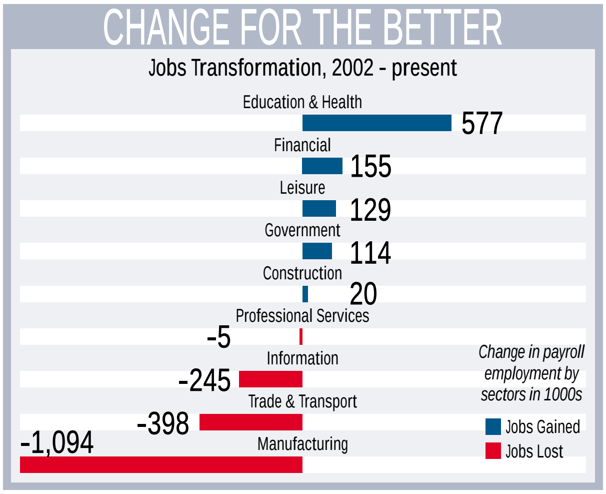
Global outsourcing helps to grow productivity and wages. This kind of global trade is an imperative as the nation approaches the imminent labour shortfall. According to a white paper released by the National Association of Manufacturing, America will experience a shortfall of skilled employees and factory workers from 2004 due to its demographic and educational structure. The American workforce will peak at 160 million, and the labour shortage will grow to 5.3 million by 2010. This would lead to production

Barriers to global outsourcing will undermine the competitiveness of American multinationals.

bottlenecks, and trillions of dollars in opportunity costs. Every job outsourced generates cost savings to be invested in a better job for another American.

America will need to open its borders far wider for outsourcing and immigration to address this structural problem. Outsourcing low-skill jobs to other countries helps America solve the problem with minimal disruption. This is far less demanding on national resources than massive inflow of immigrant workers.

YOGESH CHAUDHARY



Source: Bureau of Labor Statistics

The reality is that global outsourcing alone cannot replace enough jobs to avoid the imminent skill shortages and associated inflation. For example, India's 250,000 outsourcing workers represent less than 0.2 per cent of the American workforce.

America is a powerhouse of productivity, making it the growth engine for the global economy, accounting for over 90 per cent of the cumulative increase in global GDP over the past decade. US companies continue to capture the lion's share of the corporate profits; they account for about half of the global market capitalisation. Productivity growth has been the key factor setting the US apart from most countries. Increasing the underlying growth of its services productivity is a major challenge that America faces today. Outsourcing onshore offers a way to improve services productivity. Outsourcing offshore accelerates the growth in productivity through deeper cost savings.

As the pace of job losses accelerates to 1.2 million per year, global outsourcing of services has become the central issue in American politics. The dilemma is whether to protect its jobs or let the global forces eliminate American jobs paving the way for a productivity-led expansion.

Underlying issues such as services productivity, demographics, skill shortages and unfilled positions are invisible; so are the savings from outsourcing and increasing exports. For instance, outsourcing services overseas is saving US companies over $20 billion per year. America exported $292 billion in services ($3 billion to India) and generated a trade surplus of $65 billion in 2002. These savings and surpluses offer the best protection against potential displacement arising from global trade. However, the pain from outsourcing overseas due to dislocation and job losses is often concentrated. The disruption is immediately visible, causing the outcry for barriers.

The business leaders and public policy makers are in the process of developing a solution to job disruptions. Some politicians have advocated outlawing outsourcing to preserve jobs. Some of their arguments are based on macroeconomics, some rooted in legitimate concerns of the aging American workforce. Unfortunately, the most vocal arguments are based on political expediency, which is not too different from the clamor for protection against disruptive technologies, global competition or immigration during the economic recessions in the past three decades. This too shall pass.

Productivity is enhanced when goods and services are produced in countries with comparative advantage and then traded. Barriers to global outsourcing in any form will undermine the competitiveness of American multinationals and derail the economic recovery that is under way in America. Any such legislation will weaken productivity, innovation and wealth creation in America, and will tax the same workers they are trying to protect. Let the invisible hand of the market make its way. Let the American companies and their shareholders enlighten their consumers and workers on the merits of productivity-led growth and global outsourcing.

> Barriers to global outsourcing will undermine the competitiveness of American multinationals.

The policy makers need to focus on the two key players affected by the dynamics of global outsourcing—corporations and workers. Investment booms are naturally followed by some slowdown as firms reach their desired level of capital. A full recovery, including a slowdown in layoffs and the opening of new jobs, is far more dependent on recovery in business investment than on stronger consumption growth. The business investment turned from growing at 15.1 per cent in the first quarter of 2000 to retracting at 3.2 per cent in the last quarter (adjusted for inflation). This decline in the level of investment outlays is the core issue to be addressed. The expectations and attitudes of the managers entrusted with making investment decisions is the key to an accelerated recovery.

We need creative solutions to help workers directly affected by global outsourcing. Wage insurance and tax credits are positive measures that align the incentives of employees and employers. Wage insurance offers the dislocated workers half of the difference between the old wage and the new wage. Tax credits are offered to employers who hire dislocated workers. Let us learn from the past and reinvent the future.

Global trade helps shareholders, consumers and workers, as the economic benefits ripple through the economy. The larger the waves of global trade, the larger will be the ripple effects.

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guest column

Max P. Michaels

Global Citizen

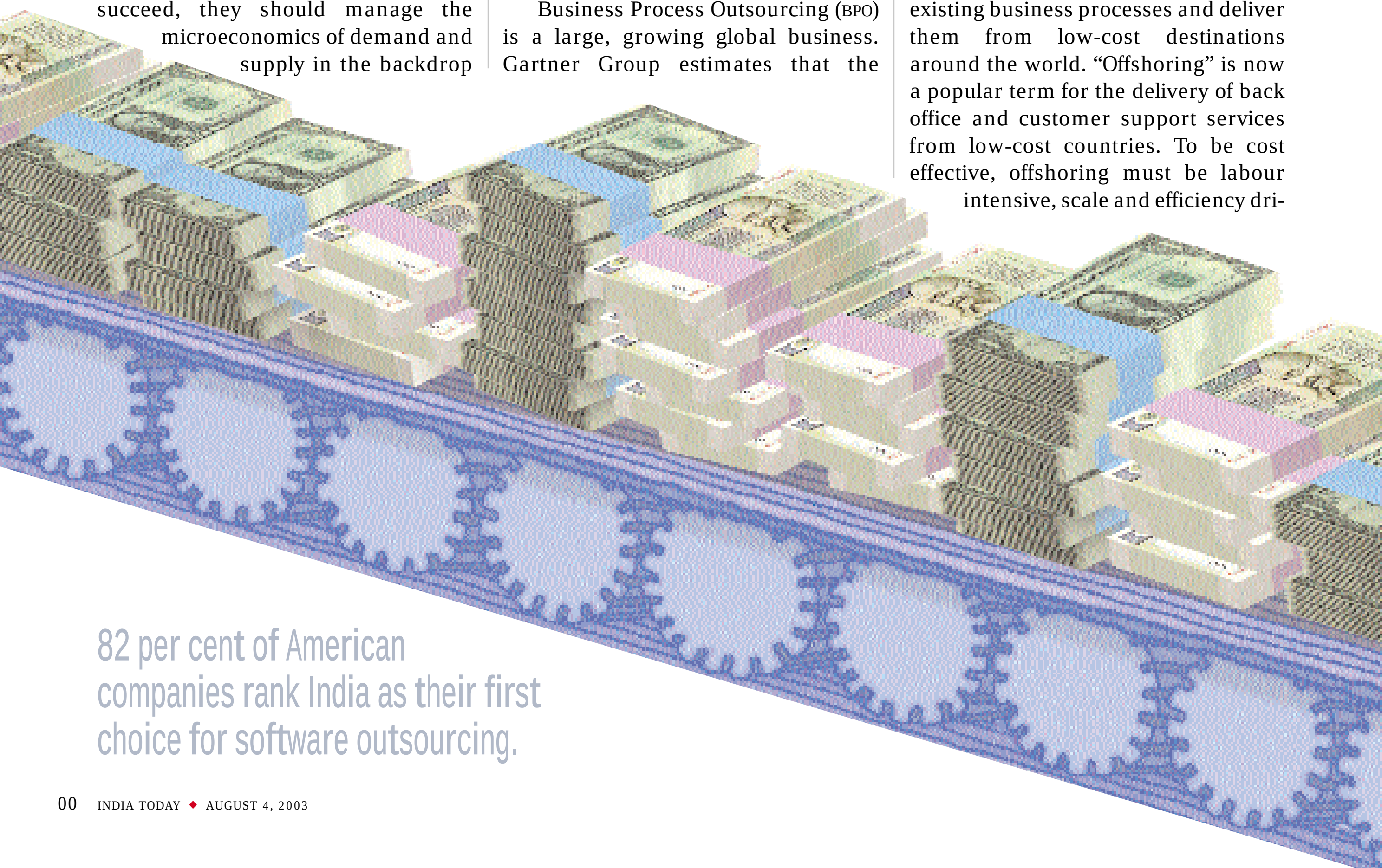
India can sustain its comparative advantage in outsourcing services only by increasing productivity

The information and telecommunication technologies have made it possible to trade what has long been locked up within national borders: skills, talent, ideas and enterprise. India is well positioned to become the back office of the world, just as China has emerged as the factory of the world. However, the barriers to moving services overseas are much higher than the hurdles in relocating manufacturing plants. Besides the economic and technical issues, social and political barriers need to be overcome. The success of Indian companies would depend primarily on the ability of its industry captains to navigate through these uncharted waters. In order to succeed, they should manage the microeconomics of demand and supply in the backdrop of the dynamics of global trade in services.

The impact on the American economy of outsourcing services is bound to be more than that of manufacturing, for two reasons. First, the savings from outsourcing back offices overseas can be as high as 70 per cent due to the high labour intensity of services jobs. Secondly, over 75 per cent of America's $10 trillion economy is in service industries. The 108 million information workers—physicians, engineers, accountants, financial analysts, teachers, managers, records processors, contact centre operators, data analysts—in America earn about $4 trillion in income. There is a lot at stake.

Business Process Outsourcing (BPO) is a large, growing global business. Gartner Group estimates that the global market demand for outsourced business services will be over $300 billion by 2004, primarily from the US, Europe, Canada and Japan. It is estimated that American corporations will generate over $250 billion in cost savings to be shared by users and service providers over the next five years.

Offshore outsourcing can radically improve the economics of outsourcing. The adoption of the Internet, the standardisation of underlying telecommunication protocols and the development of web-enabled applications have significantly lowered transaction costs in delivering services from remote areas. This has enabled global corporations to reconfigure their supply chains: map existing business processes and deliver them from low-cost destinations around the world. "Offshoring" is now a popular term for the delivery of back office and customer support services from low-cost countries. To be cost effective, offshoring must be labour intensive, scale and efficiency dri-



82 per cent of American companies rank India as their first choice for software outsourcing.

ven and have low interaction and integration requirements.

McKinsey projected a year ago that India would generate $17 billion in outsourcing revenues, employing 1.1 million by 2008. This translates into $60 billion in benefits to the American economy arising from cost savings, new revenues, repatriated earnings and labour redeployment. Given the exponential growth experienced by the India-based service centres over the past year, the revenues could reach $25 billion, corresponding to an economic benefit of $110 billion to the global economy. This is indeed a phenomenal contribution to global GDP.

The US market for BPO is estimated to be over $200 billion. According to Gartner, almost 82 per cent of the American companies rank India as their first choice for software outsourcing.

IBM, ACS, EDS, CSC and Exult have all established their service centres in India as the low-cost employee pool enables them to offer customised, specialised services to their Fortune 500 clients. They face competition for $100 million-plus contracts from Indian companies such as TCS.

For India, the key factor is indeed labour. It has built an absolute advantage in providing cross-border services as it is the lowest cost producer. This can be converted into a competitive advantage if it can be matched with high labour productivity. India should keep its workforce productive, even if it means hiring more expensive knowledge workers.

India has already established an excellent track record in the offshore software services sector, where it has a market share of over 70 per cent. Given its pool of 300 million English-speaking, college-educated workforce and low wages, it is the ideal offshoring destination. In India, wages for highly skilled professionals are 70 to 80 per cent lower than they are in America.

There are two major challenges that Indian companies face as they compete for business with other nations. First is development of management talent. India suffers from a lack of high-quality middle management talent, relative to the large, growing services workforce. Attracting successful managers across industries and developing their cross-border execution skills is the key to success.

The other challenge is motivation and growth opportunities for employees. Matching an employee's skills to the available work is a key management issue. As demand goes up and the level of opportunities for an information worker diminishes in a company, the attrition level goes up. Indian companies need to find a way to retain their employees.

The key elements that affect the effective cost structure of a remote processing facility are the calibre and cost of labour, the management quality and costs, and telecom bandwidth, reliability and cost. Several American companies have sourced services from India, thereby cutting costs by 50 to 70 per cent after adjusting for higher telecommunications and management expenses. It has been estimated that GE saves about $340 million a year through its 13,000-strong back office workforce based in India.

The key challenge in sustaining the comparative advantage built by Indian companies is the currency risk. Exchange rates affect exports of services as well as imports of hardware and software. India has shied away from unfair trade practices such as pegging its currency to the US dollar. Increased productivity and low inflation are more sustainable for global competition.

Secondly, Indian companies need to understand the impact of their operations on India's economy and manage the expectations of its key constituents: employees, suppliers and the Government. For every dollar of outsourcing revenue that hits India, about 30 per cent goes to the employees, 27 per cent to the suppliers and 12 per cent to the Federal and state governments; only the balance accrues to the companies. The managers have high leverage to proactively shape trade policies in India.

Finally, Indian companies need to enhance their comparative advantage in terms of the productive labour pool by leveraging a few key factors. These include a large supply base that can withstand fluctuations in demand and the ability to offer more value-added services while maintaining quality.

Cost arbitrage by itself is not a sustainable value proposition, if better quality and better service levels do not accompany it. Indian companies and service centres have focused on quality.

In order for India to become the back office for the world, it needs motivated workers seeking to develop their skills, firms seeking the tools for competing, and a supportive government investing in infrastructure and education. Indian companies should focus on the value propositions that go beyond cost savings to win high-margin businesses. Second, they should team up with US companies to serve markets in Europe, Canada and Japan.

Finally, Indian companies should demonstrate their penchant for fair competition. This would start with being model corporate citizens by hiring local talent, paying local taxes and importing goods from America to reinforce their relationships with the various states they operate in. It is companies, not countries that compete in the global marketplace.

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HOW TO WIN BUSINESS

COST SAVINGS
from lower costs of personnel, overheads.

QUALITY IMPROVEMENT
from best practices and Six Sigma processes.

HIGHER PRODUCTIVITY
from 24x7 operations and 48-hour work week.

ACCELERATED BUILD-UP
from improved training and larger pool of talent.

REVENUE ENHANCEMENT
from improved focus and competitive advantage.

CAPITAL EFFICIENCY
by avoiding capital expenditures.