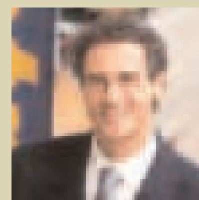
Think Globally Invest Locally: Responding to the Rise of Offshoring

by Daniel Trefler

Offshoring – the practice of outsourcing abroad – has raised the stakes in the global competition game, making it all the more important for Canada to adopt productivity-enhancing domestic policies.



Daniel Trefler

When I set out to study offshoring, I thought it would make sense to have some of the research done by an Indian consulting firm. A Web search quickly turned up the perfect partner. Not surprisingly, the firm had a London-based front end – it is a fact of the industry that many customers prefer to work through a Western intermediary. The job was quoted at $63,000 – about a tenth of what a Canadian management consulting firm would charge, but still much too rich for my academic budget.

In the end, I did the research myself, but this experience taught me two things. First, you can outsource just about anything – from which I conclude that all of our jobs are threatened. Second, that the big money in outsourcing goes to the business analysts who help OECD customers communicate their needs to business process outsourcers in low-cost countries. I conclude from this that offshoring brings remarkable opportunities to us all, and therein lies the paradox: it is both a threat and an opportunity.

Two trends in particular scream out for our attention. The first is the rapid growth of traded services such as back-office IT support that are innovative, technology-intensive and employ high-paid, white-collar workers. In the past, it was unheard of for countries like India to export high value-added services; but nowadays it's common to find Indian software programmers customizing sophisticated software applications for businesses worldwide. This fundamentally alters the way we must think about innovation-based corporate strategy and public policy.

The second extraordinary development is the rise of China as the world's manufacturer. Many, if not most, Canadian firms have yet to wake up to this sea change in their sourcing possibilities. Despite the disruption being wrought by Chinese imports, academic research makes it crystal clear that the rise of China brings net benefits to Canada – provided that the Canadian service sector is able to penetrate Chinese markets. Further, the rise of China means that Canadians will need to care even more generously for our most disadvantaged, because the working poor will bear the brunt of the Chinese offshoring onslaught.

What follows is a reality check on the hysteria surrounding the rise of offshoring. I focus primarily on the IT revolution that has allowed services to be traded on an unprecedented scale and which is allowing low-cost countries to compete head-on with some of Canada's most sophisticated companies. The key message is a confirmation of the recommendations of Dean **Roger Martin**'s Ontario Task Force on Competitiveness, Productivity and Economic Progress, of which I am a member. In particular, the building blocks for globally-competitive Canadian firms are domestic policies that encourage continual investments in upgrading and innovation by individuals and firms.

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The Rise of Service Offshoring: Myths and Projections

The recent spectacular increase in global trade volumes poses significant challenges to businesses, who must adjust to a new level of competition. But this alone does not call for a complete rethinking of Canada's trade policy. What does pose new policy dilemmas is the rise of *service offshoring* – the use of workers located abroad to provide sophisticated services to local customers. Examples include the use of Indian workers to provide back-office services for Canadian banks and radiological assessments for Canadian hospitals. On the flip side, Canadian architects and engineers are providing their expertise to customers from Sao Paulo to Shanghai.

And now for the facts about service offshoring. We had better start by confronting a myth: the fact is that service offshoring is small potatoes. In 2004, Canada exported $40 billion in offshored services and imported $45 billion. This is only a fraction of the nearly half trillion dollars in exports that leave this country annually. Further, despite the hoopla about competition from Indian service providers, the fact is that 85 per cent of the business services that we purchase from abroad are purchased from OECD countries. Only 15 per cent come from poorer countries like India.

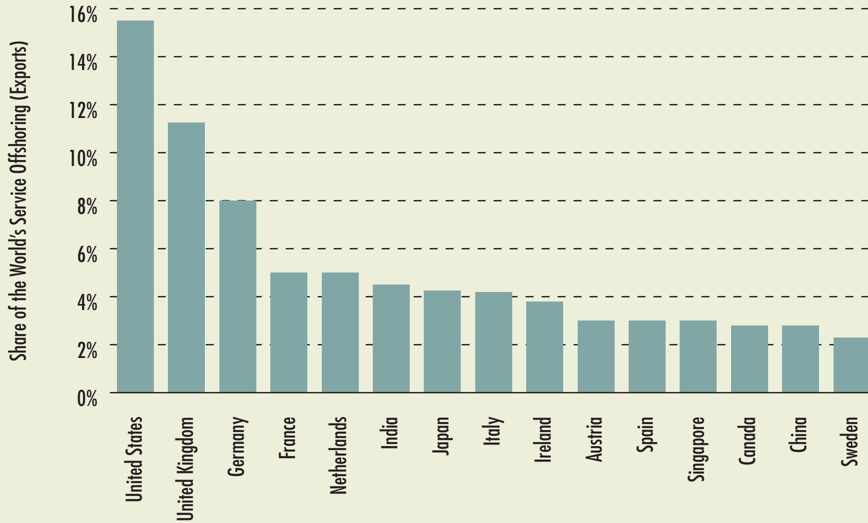
What is not a myth is that in recent years, service offshoring has grown explosively. At its current clip, it will double within a decade and account for one out of every five dollars of exports. Further, our purchases of services from low-income countries are growing even faster. Purchases from India, China and Brazil are growing between 25 and 50 per cent a year! So while current levels of service offshoring – especially from low-income countries – are low, the growth of offshoring is truly spectacular.

Canada's Weak Offshoring Strategy

Service offshoring makes use of the most dynamic modern technologies, and thus has implications for the corporate innovation strategies at the heart of Canada's competitiveness policies. Will Canadian firms be crowded out of the most innovative lines of business? Judging by the popular press, Canada is a powerhouse exporter of business services. Studies by the **United Nations** and **KPMG** touting Canadian successes have caught the media spotlight. Unfortunately, these studies are misleading.

Figure One on page 44 shows service offshoring by country, with Canada ranked just thirteenth in 2002 – down from ninth in 1995. Even more disturbing is that Canadian firms are increasingly positioning themselves at the lower end of the value chain. **Figure Two** on page 44 shows that Canada accounted for a whopping 56 of the 513 new call centres set up worldwide in 2002-2003. Unfortunately, call centre

Figure One: Canada – Sick Man of the OECD?



employees produce some of the lowest value-added in the service offshoring business. In contrast, Canada accounted for only 42 of the 1,336 high value-added projects set up worldwide over the same period. High valued-added projects include IT service centres and regional headquarters. Thus, global companies are looking outside of Canada when it comes to setting up platforms from which to export high value-added business services. Something must be done about Canada's weak corporate strategy in the offshored business services sector.

The 64,000 Job Question: Wither India and China?

Behind the anxiety about service offshoring is a sense that OECD countries are in danger of being overtaken by China and India as *the* places from which to export business services. In the most alarming scenario, these countries have an infinite capacity to absorb OECD technologies and management strategies, to improve on them, and ultimately, to compete head-to-head with OECD countries. In this scenario, China and India – with their newly acquired high-tech status – will continue to have low wages for skilled labour and will use this advantage to create an economic juggernaut that crushes all OECD countries.

There are two reasons why this argument is fundamentally flawed. First, the ironclad economic law of comparative advantage prevents any one country from ever dominating world trade. Second there are institutional reasons to doubt the speed at which this scenario will unfold.

1. The Ironclad Law of Comparative Advantage

In the most alarmist scenarios about China and India, these countries will soon have an absolute advantage in producing all goods and services. With their low wages, what prevents them from exporting everything and importing nothing? If they import nothing, they will be giving their goods away for free. I doubt they would agree to this. In addition, Canadians will need Yuan to buy Chinese goods, and as we demand more of this currency, it rises in value. Eventually, the Yuan would rise so much in value that Chinese wages would no longer be so overwhelmingly competitive. (This is similar to the problem Canada faces as its currency strengthens.)

In real life there are things China can do to slow this process down, but it cannot keep the Yuan undervalued forever. This is an ironclad law. Countries such as Germany in the 1960s, Japan in the 1970s, and Korea in the 1990s ran afoul of the comparative advantage police. They ran huge trade surpluses that threatened to destroy North American manufacturing. Over time, however, their currencies strengthened to the point where these countries ceased being low-cost producers. In this context it is important to remember that in 1960, Japan had a highly skilled and disciplined labour force that was paid 10 per cent of Canadian wages. Japan in 1960 was, from the limited perspective of offshoring, not that different from China today. Yet Japan never was able to dominate world manufacturing. Why? Because it succumbed to the comparative advantage police by steadily revaluing the Yen.

The same will eventually happen to China. It does not matter that they have hundreds of millions of citizens ready to work for next to nothing. If we buy too much from them, their currency will rise to the point where their low Yuan-denomi-

Figure Two: Export-oriented FDI Projects Worldwide, 2002-2003

Country	Low Value Added	Country	High Value Added
Total	513	Total	1,336
India	60	India	168
Canada	56	UK	144
UK	43	USA	108
China	30	China	102
Ireland	29	Singapore	79
Germany	20	Germany	57
Australia	19	Australia	53
Singapore	16	China & UK	51
USA	15	Ireland	48
China & HK	2	Canada	42

nated wages are completely offset by a rising currency. It does not matter that Chinese workers are paid four Yuan an hour, unchanged over the next hundred years. If the Yuan strengthens, Chinese dollar-denominated wages will rise. Like the Mounties, the comparative advantage police always get their man.

2. Institutions and Good Governance

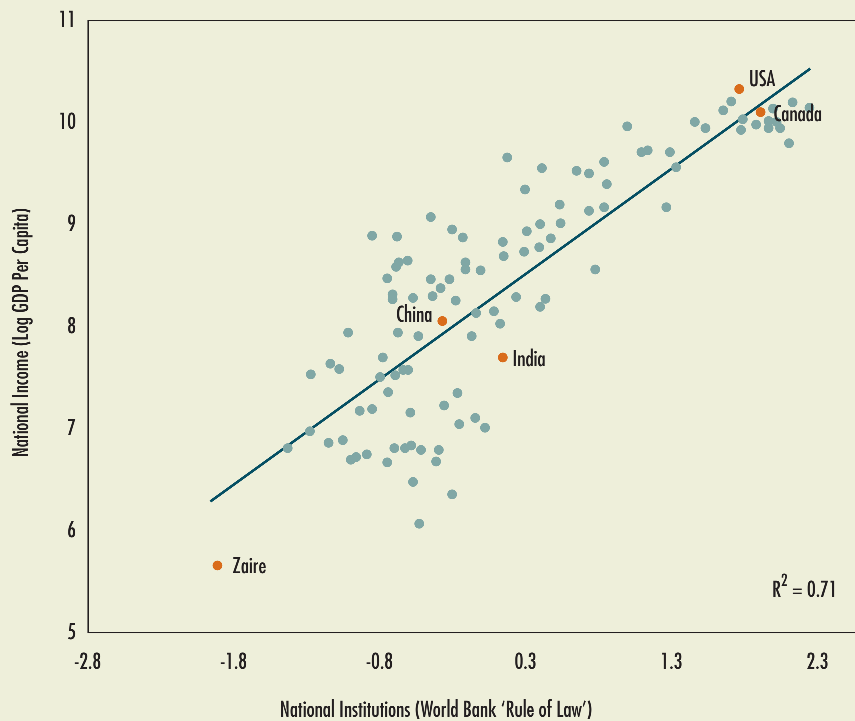
The comparative advantage police eventually ticket any country that exports without importing. However, it remains possible that China and India will focus their exports on high-tech goods and services, leaving Canadians to tailor the suits of visiting Chinese business executives. What prevents this? Good institutions.

Current thinking about innovation-based, long-term growth emphasizes the crucial role of institutions, which include:

- protecting investors from preying politicians and bureaucrats;
- providing a fully-functioning legal framework for arm's-length transactions; and
- balancing the needs of innovators inside the corporation against the needs of investors outside the corporation.

Figure Three illustrates this point with a graph that I predict will eventually earn the Nobel Prize for its originator, **Daron Acemoglu** of the **Canadian Institute for Advanced Research** (CIAR). Each dot is a country; countries with the good institutions just listed lie to the right of the scatter plot. (The measure of good institutions comes from the **World Bank**'s *World Investment Report, 2004*.) These countries also have high levels of income (as measured by GDP per capita). In short, good institutions are the handmaidens of economic success.

Figure Three: Institutions Matter



Fortunately for Canada – and discouragingly for India and China – there are virtually no countries that have moved rapidly up the line in Figure Three. The process of institutional change is glacial. Only a very small number of countries, such as Hong Kong, have been able to rapidly improve their institutions. Institutions are beginning to be reformed in China and India, but it is unlikely that they will improve quickly, even over a quarter-century time horizon.

These two arguments – that the comparative advantage police are ready and willing to ticket China and India and that good institutions evolve only glacially – suggest that we should not panic about the downside of offshoring. Yes, it is absolutely true that extraordinary things are happening in India and China. But it is *not* true that these developments will destroy the Canadian economy.

Think Globally and Invest Locally

The rise of service offshoring to low-cost countries presents Canada with a choice: it can insulate itself from global competitive pressures, thus protecting its firms and workers in the short run. However, just as the high tariffs that insulated Canada before 1989 retarded Canadian productivity growth, so too will future attempts at insulating Canada from the adverse effects of offshoring. In addition, insulating policies will likely encourage foreign countries to deny us market access – and considering that Canada is a major exporter of traded services, insular policies are about as useful as a blowdryer in an igloo.

The right response to the offshoring threat/opportunity is domestic framework policies that promote competitiveness. We must pressure Canadian firms to be more competitive by forcing them to face the new offshoring challenge. At the same time, we must support Canadian firms and workers by providing a climate that encourages investment and innovation. The right policies would encourage productivity-enhancing investments both by individuals (e.g., in human capital) and by firms (e.g., in R&D and advanced technologies).

In the end, the appropriate public policy response to offshoring boils down to this: think globally, invest locally.

Daniel Trefler is the J. Douglas and Ruth Grant Canada Research Chair in Competitiveness and Prosperity and a professor of Business Economics at the Rotman School of Management. For a copy of his complete paper on this topic, send an e-mail to christen@rotman.utoronto.ca

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