CII thinkpiece

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Outsourcing: Continued Prosperity Despite the Global Economic Crisis?

Vanessa Rossi and Nora Burghart

Summary

- Will outsourcing be a winner and loser in the economic crisis? Few sectors of activity can escape the harsh impact of the global recession, and firms around the world including those in the insurance industry are being pressured once again to cut costs and spending while limiting the public relations risk of moving jobs far offshore.
- Early analysis of the recession paints a very mixed picture. While the outsourcing industry expanded through 2008, further analysis indicates a sharp plunge in the number of contracts as the recession tightened and the number of major deals have taken a severe hit.
- Therefore, for a variety of reasons, expansion of outsourcing activity is likely to remain subdued for the next few years, limited to cheaper and more basic deals.
- The destination of outsourcing is also changing. Traditional destinations are beginning to be overtaken by near-shore locations due to a combination of rising costs, high-profile scandals underscoring the need for enhanced due diligence requirements, and the political/cost pressure of moving jobs far offshore.
- Overall the outsourcing and offshoring boom seems to have passed its peak. These businesses were already maturing prior to 2008 and the recession may have accelerated the slowdown. Nevertheless, once a post-crisis recovery is firmly established, a resurgence in service trade will take place, offering a timely opportunity to reassess risks and premiums in the sector.

Number 22 (August 2009) **International Series Number 5**

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CHATHAM HOUSE

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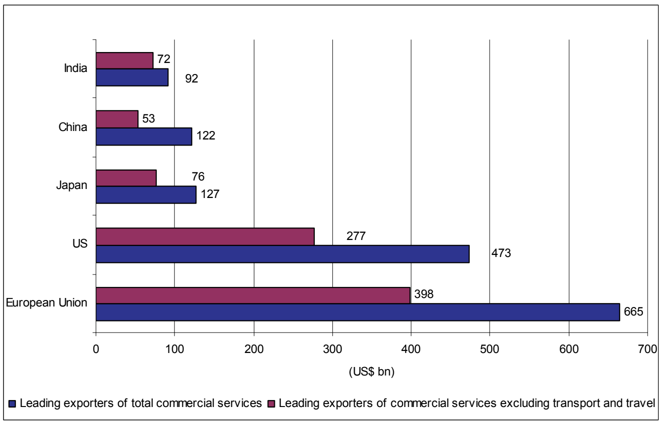
CII Introduction: Will outsourcing be a winner or loser from the global crisis? This sector has been a major beneficiary of the boom in business services trade since the mid-1990s, coinciding with the rise of emerging market economies. This growth survived – indeed was arguably a beneficiary of – the last recession in 2001-2002, as companies looked for new sources of labour and ways to reduce costs. But this time around it has been hit by the savage downturn in the global economy and the outlook for growth is less assured for a number of reasons, as discussed in this article.

Epitomising the development of outsourcing and trade in business services has been the boom in India, with software-related exports alone rising from virtually zero in the early 1990s to an industry estimated to generate over $45 billion in export earnings (in 2008), representing 16-17% of total exports and over 4% of GDP. In total, commercial services exports for India were almost $92 billion in 2007, more than 8% of GDP and about 60% of the value of merchandise exports. In 2006 and 2007, although growth had started to slow from earlier peaks, India's exports of commercial services still increased by an impressive 35% and 22% respectively with IT, business, financial and communication services as the main drivers of growth.

While India is a long way down the rankings in world trade (it contributed roughly 1.1% to world exports and 1.7% to world imports in 2008), it is clearly in the top tier as an exporter of business services. In the five years from 2002 to 2007, India has overtaken Singapore and South Korea and is now the fifth largest commercial services exporter in the world. Indeed, excluding transport and tourism (where India is still underachieving), it overtakes China and is the fourth largest exporter. Apart from the big five, depicted in Chart 1 below, other countries with important outsourcing operations include the Philippines and Malaysia.

However, few sectors of activity can escape the harsh impact of the global recession, which has had a particularly devastating effect on world trade and investment. At the end of 2008, both exports and FDI were estimated to have fallen by about 20% versus the previous year. Companies around the world are threatened by poor business conditions. Although they will be looking for further opportunities to cut costs, spending on new investment and projects will be curtailed even if some of this investment could help reduce long-term expenses. So does this mean cutbacks in outsourcing or a boost, similar to 2001-2002? Are reactions different this time round?

Chart 1: Leading exporters of commercial services (2007 data, $bn)



Source: WTO. Note: Data for other commercial services excluding transportation and travel calculated from WTO data

One factor that has changed radically is the attitude of US and Europe to job losses. As recession has destroyed the scope there to build new opportunities to replace jobs lost to external competition and outsourcing, governments are under increasing pressure to protect domestic jobs and industries. This will limit growth in the outsourcing market globally and hurt the outsource-dependent economies over the next few years. Even without direct government controls or barriers, in the current climate, offshoring business activities to overseas locations may prove too politically sensitive for companies, suggesting they will hold back from moving more jobs to cheaper locations until the recession is over and a recovery is firmly established. Indeed, adding to pressure to curb outsourcing in the US for fear of a political backlash, there have been suggestions that the new US administration sees this as a loss in potential tax revenue as well as jobs.

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Nevertheless, it is important to recall that outsourcing was viewed as a beneficial trend a few years ago – especially in Europe where lack of population growth is seen as restricting access to labour, risking shortages in the near future. New job opportunities were also very important to the emerging market countries involved: they were eager to generate higher-quality jobs and raise export earnings in order to assist in their development goals. While China is a world-beater in goods production and trade, India came to be seen as competing not through goods but services. This trend offered benefits for a number of other countries that were limited in their ability to compete in goods markets yet had a readily available well-skilled and flexible workforce. Chile, for example, has expanded its services exports and Argentina has seen growth in back offices operations for the US financial sector.

In principle, outsourcing and services trade in general is useful to both sides of the exchange and should enable improved global productivity in the services sector. This implies that once the recession ends and employment growth eventually picks up again in the OECD economies, there should be a return to rapid growth in services trade and outsourcing.

However, this upturn could take some time to emerge as the jobs market typically lags behind recovery in production and demand by at least two to three years. According to the International Labour Organisation, the 1991 and 2001 recessions had a severe long-term effect on US employment: although the economy started to recover after about eight months in both cases, recovery in the labour market took as long as 30 months and 48 months respectively.[1]

Is outsourcing "recession-proof"? The evidence so far…

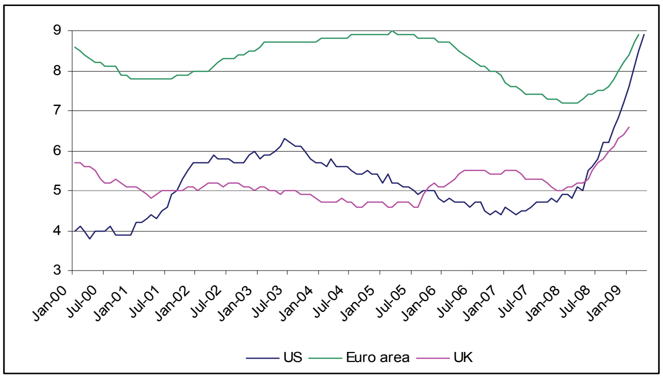
The outsourcing industry actually expanded through recession-hit 2008 although most deals took place in the first half of the year. According to Gartner, an IT research and advisory company, the total value of major outsourcing deals jumped by $5.1 billion to $17.1 billion from 2007 to 2008.[2] However by the first quarter of 2009 the aggregate contract value measured by the TPI Index (a quarterly index of commercial contracts greater than $25 million) was down by over 20% for quarterly as well as annual comparisons with only 141 contracts concluded.[3] When the recession really started to hit in the autumn of last year the number of deals took a sharp plunge. In particular, big outsourcing deals have been scaled back: deals valued at over $1 billion dropped sharply from 12 in the first half of 2008 to just three in the second half of the year. Companies are refocusing attention on core and essential support activities as funding is tight, with new projects and innovation the main casualty of cut backs in spending.

"The recession has put added pressure on firms to rein in costs, companies will review contracts and demand yet more efficient, cheaper and possibly more basic services from outsourcing providers."

In fact, even before the impacts of recession struck, companies were becoming more demanding and cautious in their outsourcing operations and contracts. The outsourcing sector has matured over the last few years from carrying out basic business operations and transactions to more sophisticated and strategic activities and many offshore locations, such as India, have moved up the value chain. However as the recession has put added pressure on firms to rein in costs, companies will review contracts and demand yet more efficient, cheaper and possibly more basic services from outsourcing providers.

Companies must also weigh the cost benefits of outsourcing against potential risks. Western governments are increasingly concerned about rising unemployment as the recession deepens, thus companies that aggressively offshore jobs could face a public relations backlash. Unemployment rates have skyrocketed in many advanced economies: the US figure shot up from 6.8% in November 2008 to 8.9% in April 2009.

Chart 2: Unemployment



Source: Eurostat, Federal Reserve and US Bureau of Labor Statistics

According to Ian Cramb of Citigroup "People do not want to hear that 1,000 jobs are moving out of the country because unemployment is rising rapidly". A possible result may be a higher number of deals signed with onshore or near-shore outsourcing providers that are less politically sensitive. In addition, advanced economies are becoming more cost competitive, at least during the recession, reducing the incentive to outsource or at least delaying it. Cramb notes that "The offshoring model will move around, there are certain parts of the US that are now cheaper than India from an IT perspective. Companies are not going to be looking at the same countries as before".

India has long been the prime offshore location for multinational companies seeking to cut wage costs of IT and other back-office operations. India's outsourcing industry is estimated to be worth about $50 billion and growth rates have been astonishing over the last decade. But growth is slowing in the industry as the recession is taking its toll and estimates for 2009 are in the region of 4% to 7% growth, down significantly from the impressive 35% and 15% growth rates in 2007 and 2008 respectively.[4] And to make matters worse, India's image as the outsourcing centre of the world has suffered badly over the first few months of 2009 from a scandal involving one of its top outsourcing

[1] ILO (2009), "The financial and economic crisis: A Decent Work response".

[2] Garter Group (2009), "Outsourcing Contracts Annual Review, 2008, Shows Outsourcing Growth - But Signs of Change".

[3] TPI (2009), "2Q09 Global TPI Index".

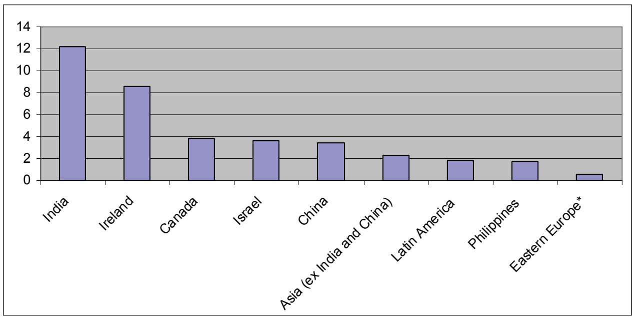
[4] NASSCOM (2009), "Indian IT-BPO industry shows resilience to grow by 4-7 percent in FY09-10", Press Release, 29 July 2009.

providers, Satyam. Fraud and mismanagement at India's fourth largest outsourcing company have shocked companies and markets and dented the image of the popular offshore outsourcing industry in India itself. Ashok Bakliwal, one investor, argues that "This will put the spotlight on Indian companies, and overseas investors will be wary of putting their money here without taking a good, hard look at the company's books". Increasing demand for greater cost efficiency and productivity has put pressure on offshore service providers in a highly competitive industry and is one deciding factor in the Satyam fraud case. Satyam has been one of the main beneficiaries of the boom in India's outsourcing industry but clients such as Nestlé or BP will without doubt reconsider their options.

"The current climate sees a slowing—perhaps even reversing—of the boom in outsourcing. However in the longer run, Europe's new member states will pick up some of this international business, perhaps gaining advantage over more distant options."

Due diligence requirements for Indian outsourcing providers will intensify in the wake of the scandal. On the other hand, international outsourcing providers such as Accenture might benefit as a result and international service providers such as IBM and Infosys have reported in their biannual results that they have remained relatively robust throughout the economic slowdown in late 2008 and early 2009. Although this represents a sharp drop from previous deal rates, Accenture reportedly signed new deals worth over $2 billion in the last quarter of 2008. Concern over India will probably benefit these global services providers as well as other less distant offshore locations, possibly including Eastern Europe and Ireland.

Chart 3: The size of the market for offshore IT and Business Process Outsourcing ($ bn)



*Includes Poland, Romania, Hungary, Ukraine and Czech Republic
Source: McKinsey (2005)

Onshore or near-shore outsourcing poised to benefit from recession

Low-wage economies in the developing world have provided the majority of offshore labour and Asia (20% of the total global outsourcing market) is particularly popular for offshore IT and engineering-based services. India, with a 12.2% market share, is the leader, well ahead of China (3.4%) and the Philippines (1.7%) – see Table 1 below.

Table 1: Global Services Location Index 2007/2009

	2007	2009
1	India	India
2	China	China
3	Malaysia	Malaysia
4	Thailand	Thailand
5	Brazil	Indonesia
6	Indonesia	Egypt
7	Chile	Philippines
8	Philippines	Chile
9	Bulgaria	Jordan
10	Mexico	Vietnam
11	Singapore	Mexico
12	Slovakia	Brazil
13	Egypt	Bulgaria
14	Jordan	United States
15	Estonia	Ghana

Source: A.T. Kearney (2009), "Global Services Location Index"

Eastern European economies have also attracted multinationals as these locations allow for cost reductions while taking advantage of a fairly high-skilled labour force and proximity to developed economies. With political pressures influencing location decisions, Eastern European outsourcing providers were seen as the more "digestible" low-cost option within the EU. However, the recession is making even this offshoring activity deeply unpopular – possibly implying some short run reversal in this trend. Rows have broken out at the highest level over company decisions about which European industrial plants are to close down in the midst of the collapse in orders and activity over the last six months. The spotlight has been on the car sector more than others such as office operations.

In all, the current climate sees a slowing—perhaps even reversing—of the boom in outsourcing. However in the longer run, Europe's new member states will pick up some of this international business, perhaps gaining advantage over more distant options. The impact of the crisis on currencies may also have made a number of East European countries more competitive with Asia than before. This should provide some hope for battered Eastern European economies as they fight with the deep 2009 recession and domestic financial crises.

Another interesting development in the outsourcing industry over the last few months has been the revival of interest in onshore service providers. With costs rising in many established offshore economies, the major economies, including the US and UK, are once again becoming cost competitive for back-office service operations. Recent *Financial Times* research highlighted that only about 4,000 jobs have been lost in the UK due to offshoring since July last year, a tiny proportion of total recent redundancies.[5] Ian Cramb of Citigroup recently remarked that "Whereas (offshoring) might have been 50% of the cost (of in-house) five years ago, that number is currently only 15% cheaper because we have made ourselves more efficient at home. (…) There is a lot of excess fat that has been trimmed off organisations. They have made themselves more efficient and will continue to make themselves more efficient and things will come back".

Public institutions in particular are looking at national outsourcing providers for cost saving exercises. Glasgow City Council for example entered into a 10-year, £265 million outsourcing joint venture with Serco, a provider of service operations, last year to improve IT and property services for the public.[6] The advantages to the council are clear: Serco will drive down costs of back-office operations, saving the taxpayer money in the long run while also improving efficiency of services. Such outsourcing partnerships can be extremely successful in retaining domestic jobs. The join venture operation will ensure that staff is transferred from the council to the joint company, avoiding redundancies in a time when fears of rising unemployment dominate the headlines.

The insurance sector hit twice by the impact of the outsourcing slowdown

What are the business implications of the new trends in outsourcing? To summarise the recent changes, outsourcing has been hit badly by the current global recession, with new projects in particular being held back. Unemployment is rising everywhere and has not yet peaked – it will take several years before the increase in rates starts to reverse. This means that, for a variety of reasons, expansion in outsourcing is likely to remain relatively subdued for the next two to three years. Pressure on companies to curb investment expenses and keep jobs in their home base will remain strong. However, trends should be more favourable for onshore and near-shore outsourcing than offshore. Cheap, basic level outsourcing may also be relatively firm.

The recession in outsourcing will impact on the insurance sector in two specific ways. Firstly, outsourcing in the insurance sector itself will see similar problems to those illustrated for outsourcing in general: pressure to cut costs, including the cost of investment in outsourcing, and political pressure to avoid moving jobs offshore. Secondly, those companies specialising in providing outsourcing-related insurance services will see such business curtailed through clients scaling back on non-essential activities and seeking cost reductions (in spite of possible increases in outsourcing risk, which might normally raise premiums).

While outsourcing and offshoring have been areas of strong business growth, the peak is past. These businesses were already maturing but the recession has accelerated the slowdown. Enthusiasm will wane. Nevertheless, once the global economy has moved far enough into recovery to generate a fall in unemployment, the expansion of services trade will also recover. Offshore outsourcing will see growth return even if the next couple of years are slow going. This pick up should offer a timely opportunity to reassess risks and premiums in the sector, taking on board new information provided during this exceptional global crisis experience.

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[5] "Recession sparks sharp drop in offshoring of jobs", *Financial Times*, 3 June 2009.

[6] Glasgow City Council (2009), "Glasgow City Council drives innovation with pioneering partnership", News 19 Feb 2008.

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