

# Getting the balance right: The economic benefits of offshoring



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Think tank of Deutsche Bank Group

**Deutsche Bank Research**



# Agenda

**1**

**Offshoring trends**

**2**

**Macroeconomics:  
Who benefits from offshoring?**

**3**

**The firm: Pay attention to hidden costs**

**4**

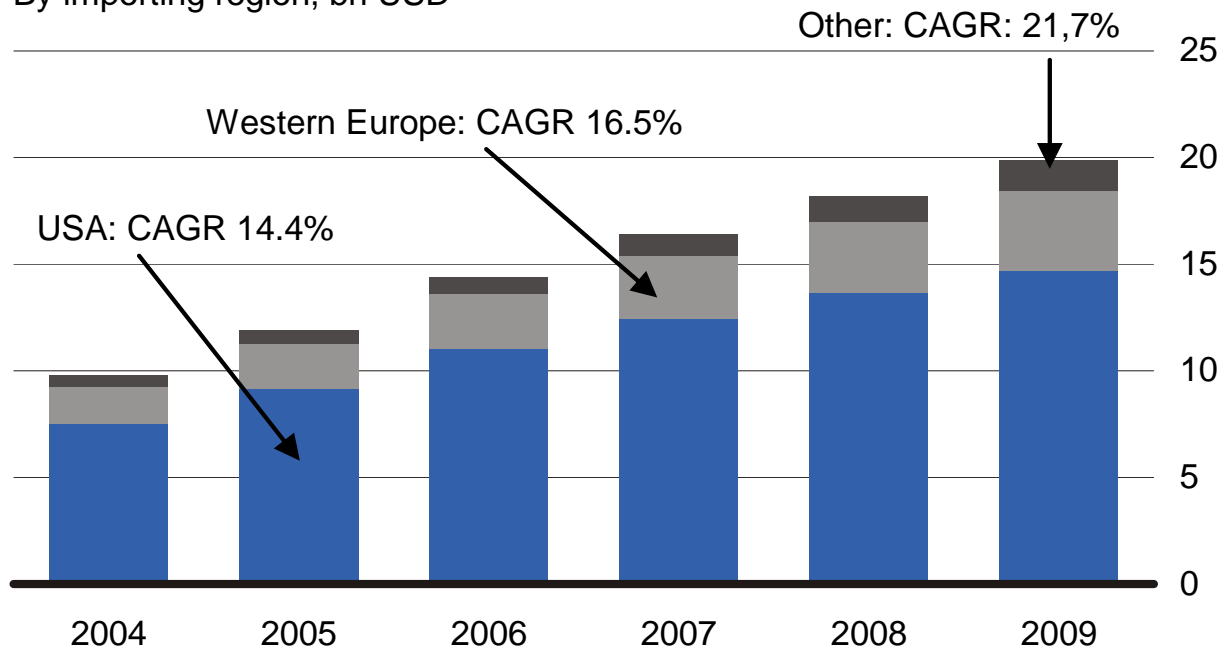
**Outlook: The world is changing fast**



# Offshore IT outsourcing: a dynamically growing market

- ...will reach USD 20 bn in 2009
- ...is growing more strongly in Western Europe than in the US

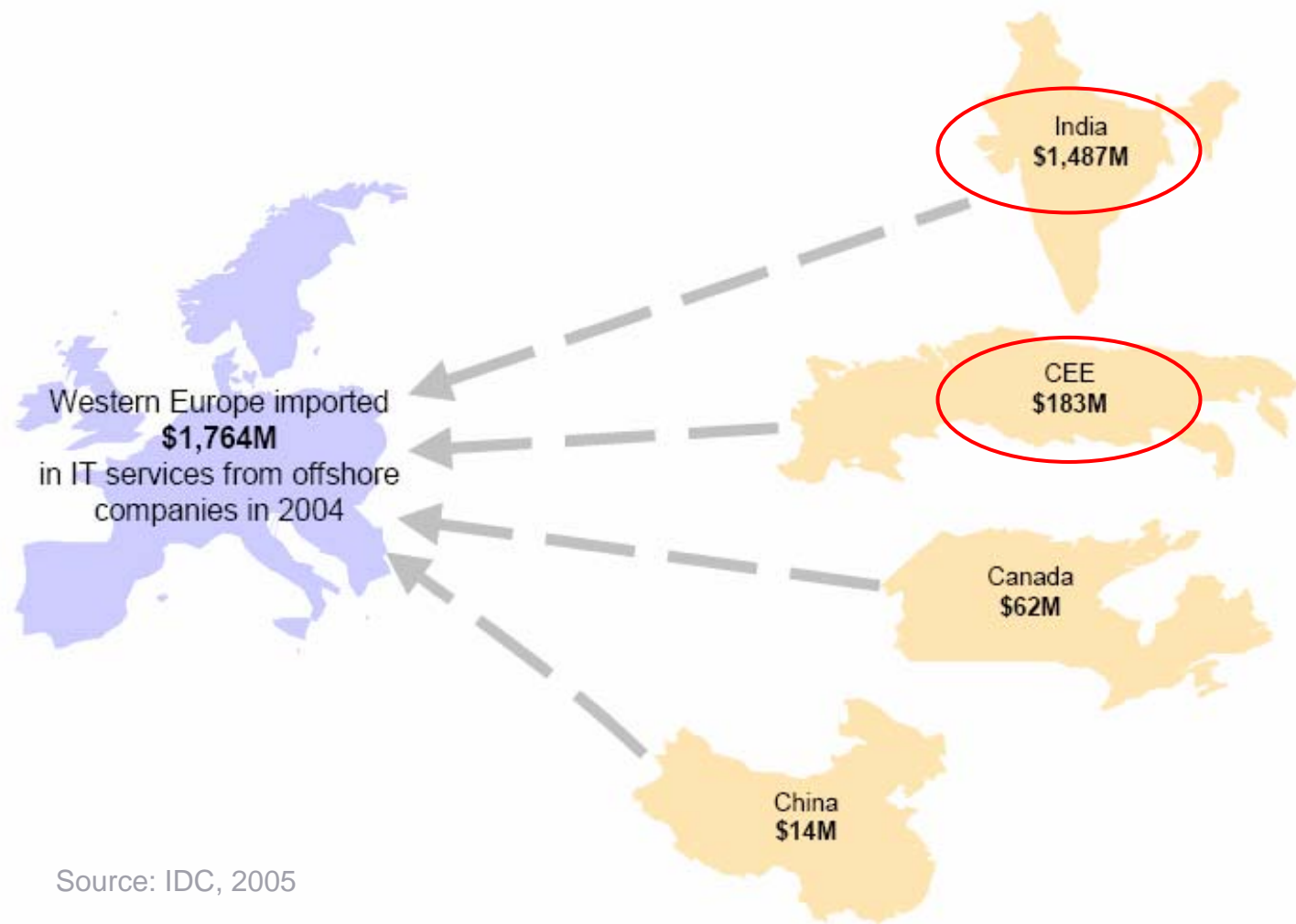
Offshore IT spending  
By importing region, bn USD



Source: IDC, 2005

CAGR: Compound annual growth rate (2004-2009)

## Western Europe: India still the main offshore destination

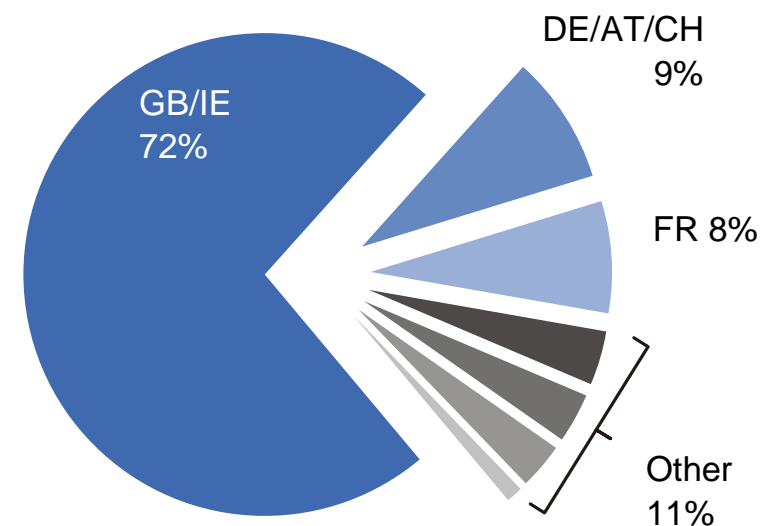


## Western Europe: UK and Ireland most active buyers

- US / UK companies are benefiting from supply structure
  - India: large pool of English speakers
- Backlog demand in continental Europe
  - Outsourcing trend is gaining momentum
  - Attractive market for suppliers from Central and Eastern Europe (CEE)
  - CEE: Advantages e.g. with respect to proximity, language, culture

### Anglo-Saxons dominate

% of European offshoring expenditure, 2005



Source Forrester, 2004



### Friedman: “India vs. Indiana: who is exploiting whom?”

“[...] when the world starts to flatten out and value increasingly gets created horizontally (through multiple forms of collaboration, in which individuals and little guys have much more power), who is on the top and who is on the bottom, who is exploiter and who is exploited, gets very complicated. Some of our old political reflexes no longer apply.”

“If you are against globalization because you think it harms people in developing countries, whose side are you on in this story: India’s or Indiana’s? The India versus Indiana dispute highlights the difficulties in drawing lines between the interests of two communities that never before imagined they were connected, much less collaborators.”

*Thomas L. Friedman, The world is flat. A brief history of the twenty-first century. New York, 2005, p. 207, 208.*

## Productivity: division of labour & specialisation are key

### The rationale

- Division of labour: Comparative advantage through focus on core competencies
- Specialisation: Economies of Scale
- International trade in IT services: Taking advantage of the wage differential

### Macroeconomics

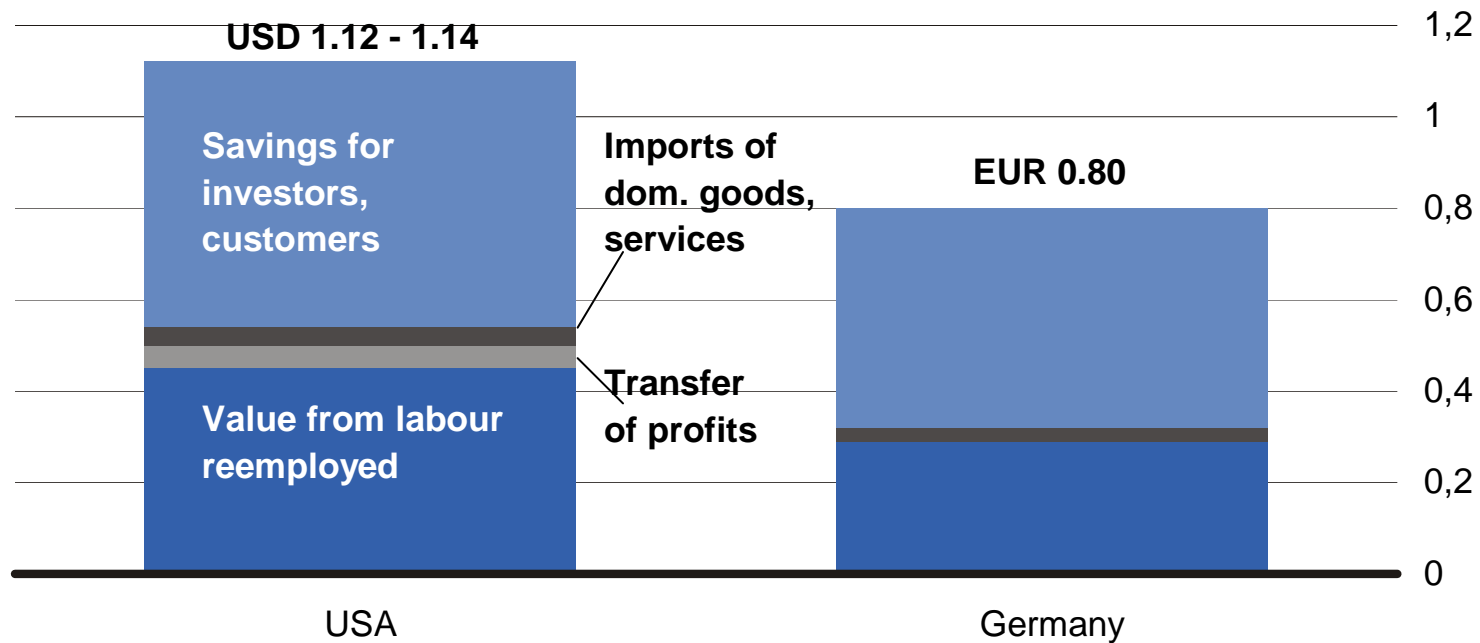
- IMF (2005): Amity and Wei explain about 11% of the productivity growth in the US between 1992 and 2000 with offshoring in the services sector
- Mann (2006): Will the globalization of IT software and services production have a similar effect on structural change as the fall in hardware prices? [chart](#)
- Beware: Not everybody is gaining from structural change!



## MGI: Germany does not benefit

Benefits of US and German spending sent offshore (2002)

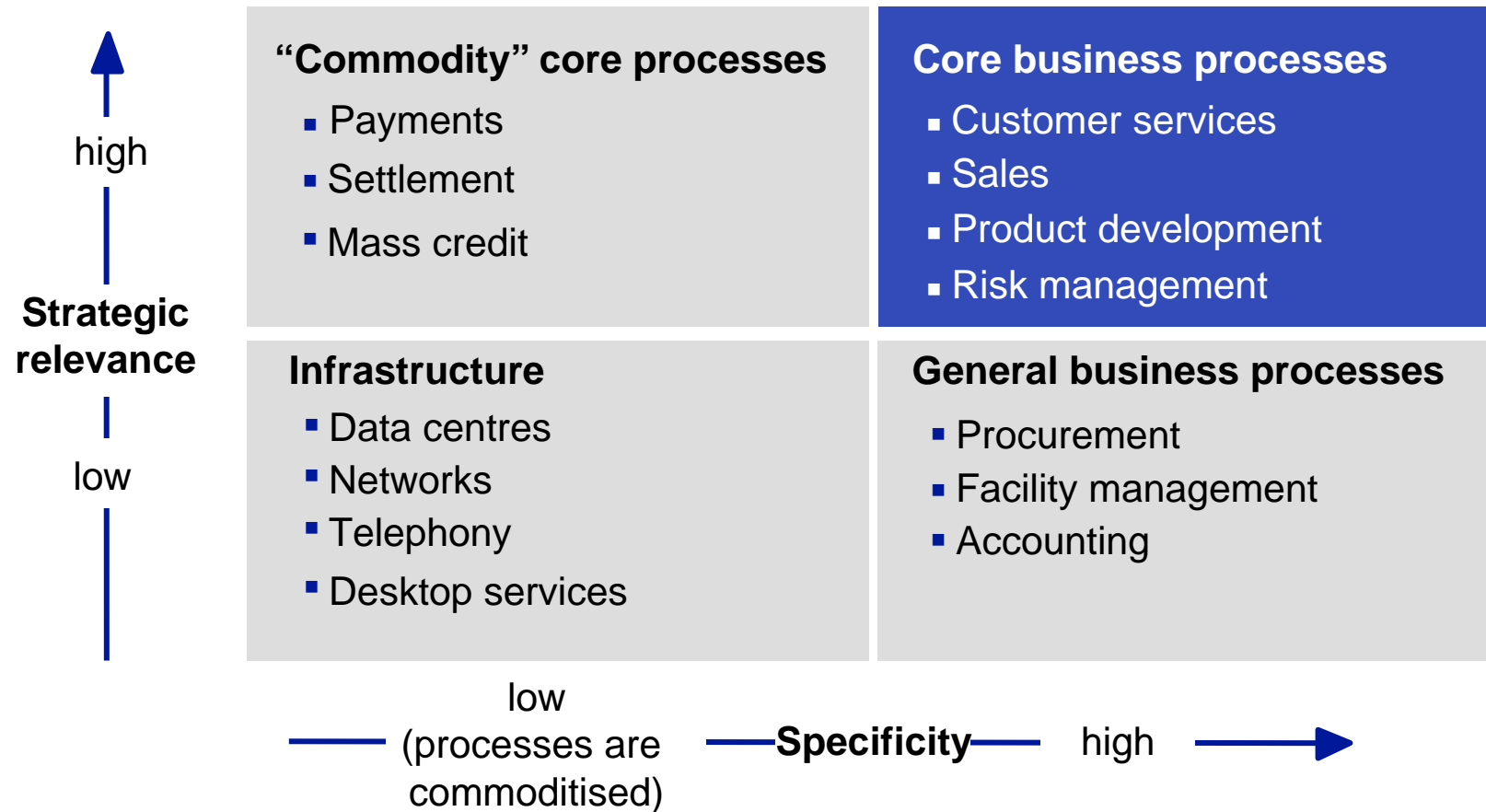
Benefits for every USD or EUR moved offshore



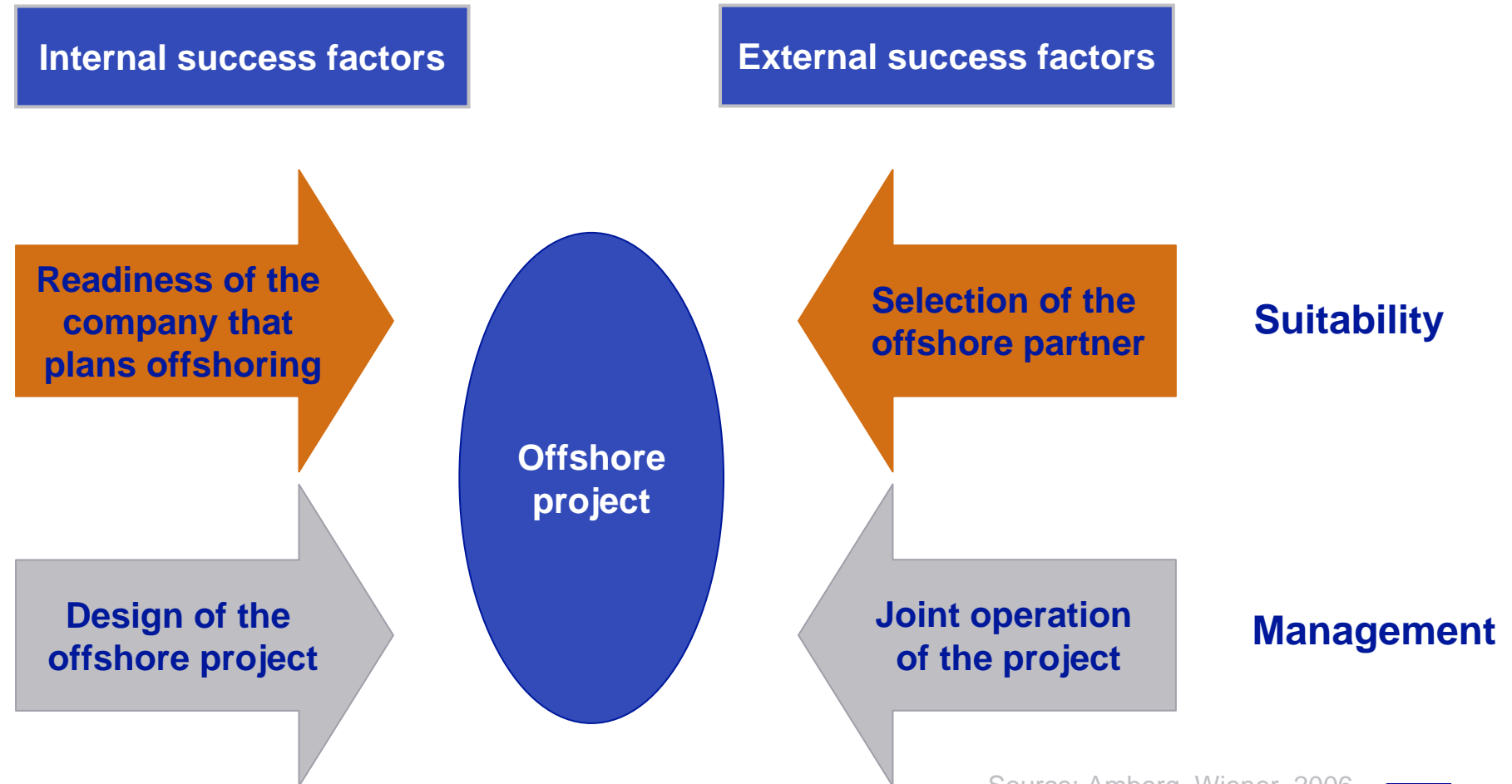
MGI, 2003, 2004



# Keep your core competencies in-house



## Critical success factors to be considered



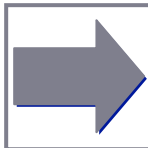
## It's all about costs, stupid?!

### Benefits

- Lower wages and overhead costs
- Access to high quality services
- Access to large, highly-motivated pool of talent

### Costs / Risks

- Transaction costs
  - Selection and monitoring of supplier
  - Migration of business processes
- (Cumbersome) communication
- Training
- Institutional risks
- Less flexibility for new developments, dependence on foreign supplier



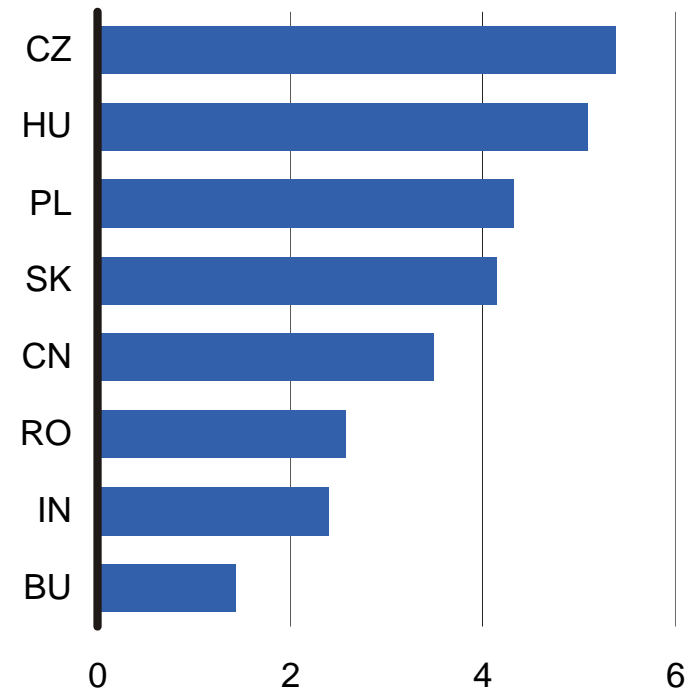
Careful analysis of framework conditions necessary!



## Big differences in wages

- India and China apparently belong to the cheapest locations
- Advanced EU accession countries: Labour costs of 20-25% relative to Germany
- Close correlation between wages and per-capita GDP
- Wages / labour costs are rising fast!
  - CZ: 1996 15% rel. to D, 2004: 25%
  - India: Wages rose by 16% in the IT-offshoring industry and 16-18% in the BPO-industry in 2005

Hourly wage of an engineer  
USD



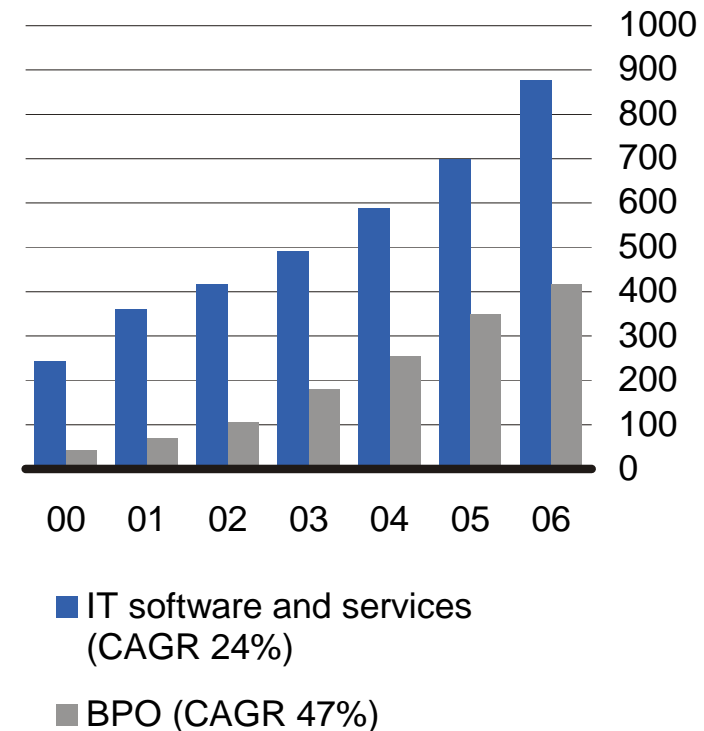
Source: Business Week, 2005



## A large labour pool does tell a lot, but not everything

- India: Famous for large and fast-growing pool of skilled labour
- Most other offshoring locations also have large pools of skilled labour
  - Formal education tells little about suitability for work with international clients today (CN, RU) ...
  - ... but may be a reserve for tomorrow
- CEE: an emerging location ...
  - ... with general strengths ...
  - ... but no particular IT specialisation

India: IT sector employment continues to rise sharply  
Indian IT employees ('000)



Source: DB Research, NASSCOM, 2006

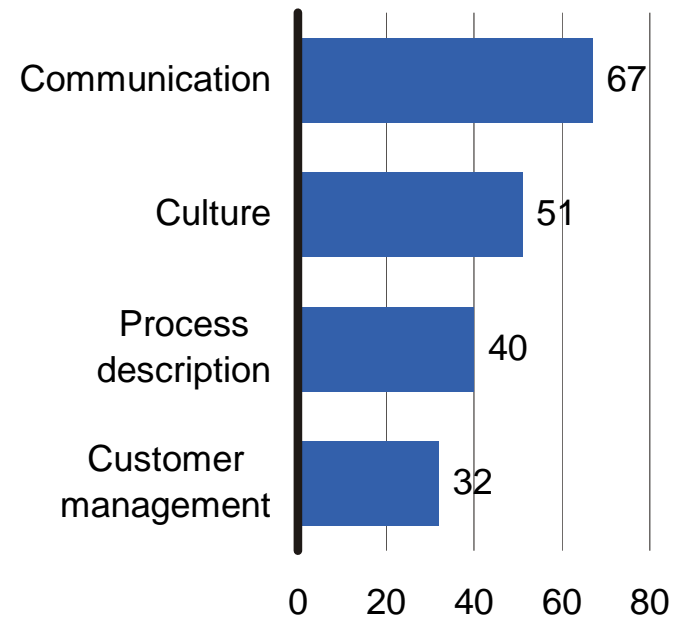


## Communication and different cultures: Major obstacles to offshoring

- Personal contact
  - Solve complex problems face to face!
- Common language
  - Do suppliers have proficiency in the client's language?
  - Especially important e.g. for customer care, processing documents in the client's language
- Culture
  - Do you understand the peculiarities of your supplier's culture and take them into account?
- Nearshoring locations score high!

Biggest challenge:  
Communication

Q: What are the biggest challenges for offshoring, % of responses

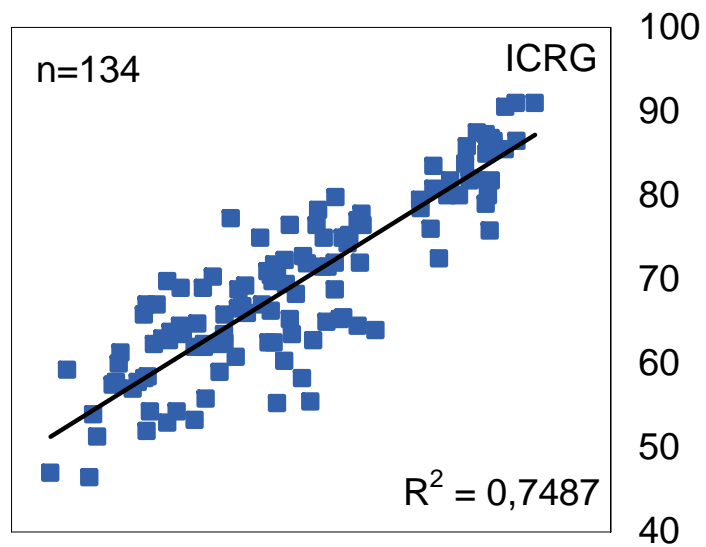


Source: CIO Magazine, 2003



## Pay attention to institutions!

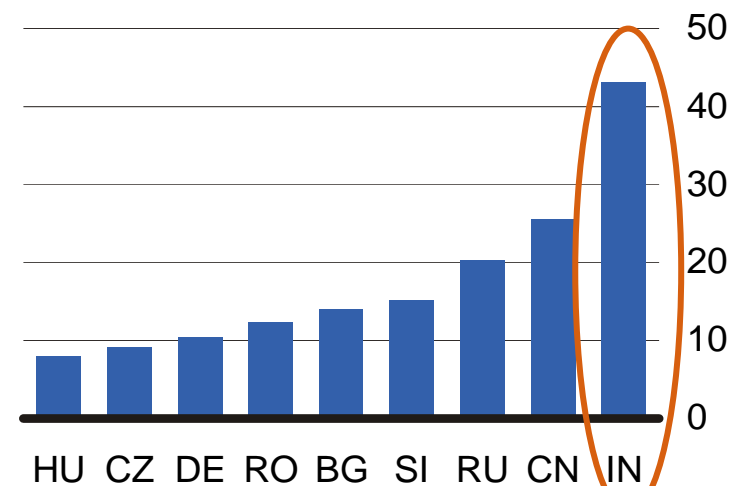
Risk increases with poverty  
2003



Sources WDI, 2004; DB Research, 2006

Cost of contract enforcement

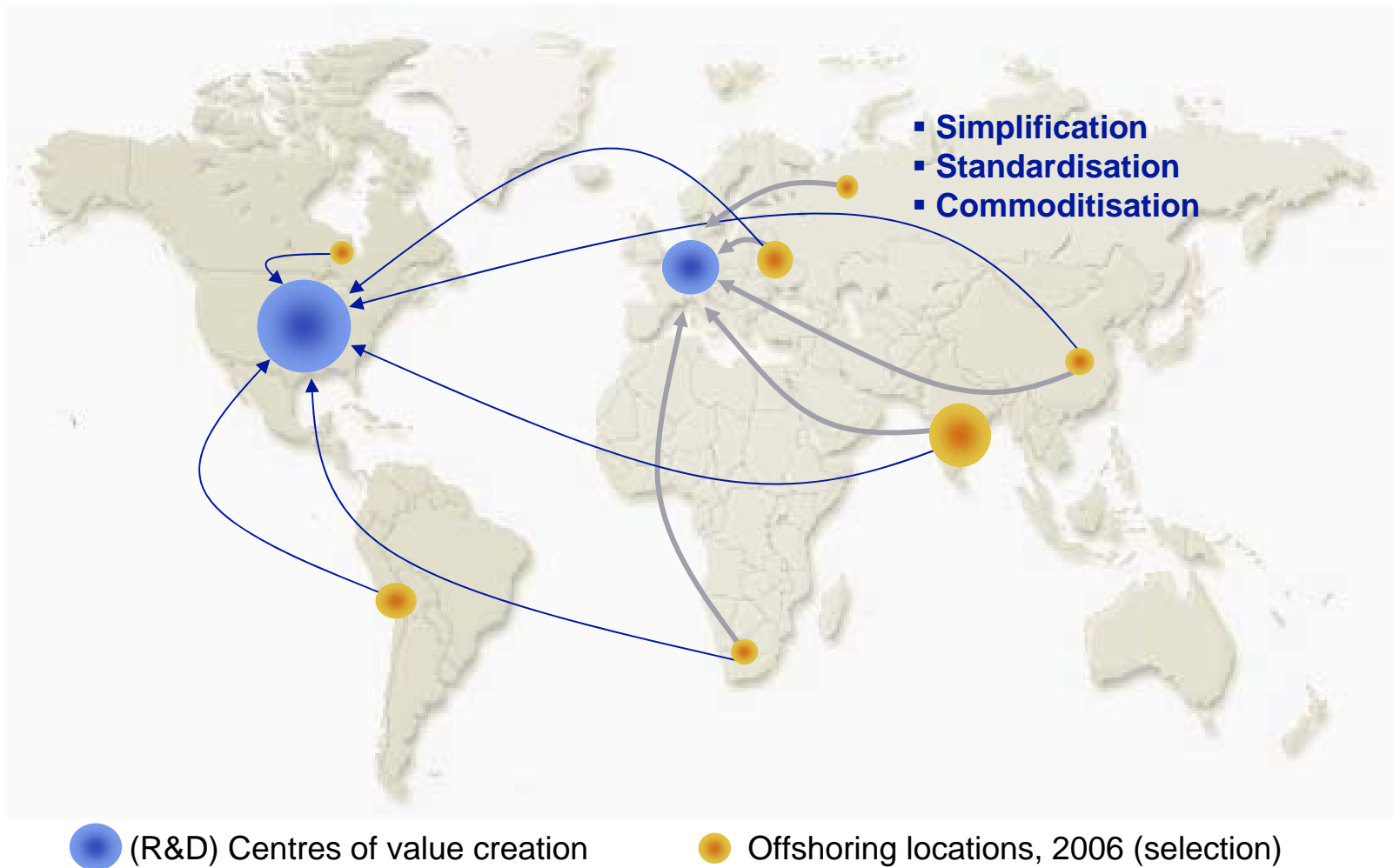
% of debt, 2005



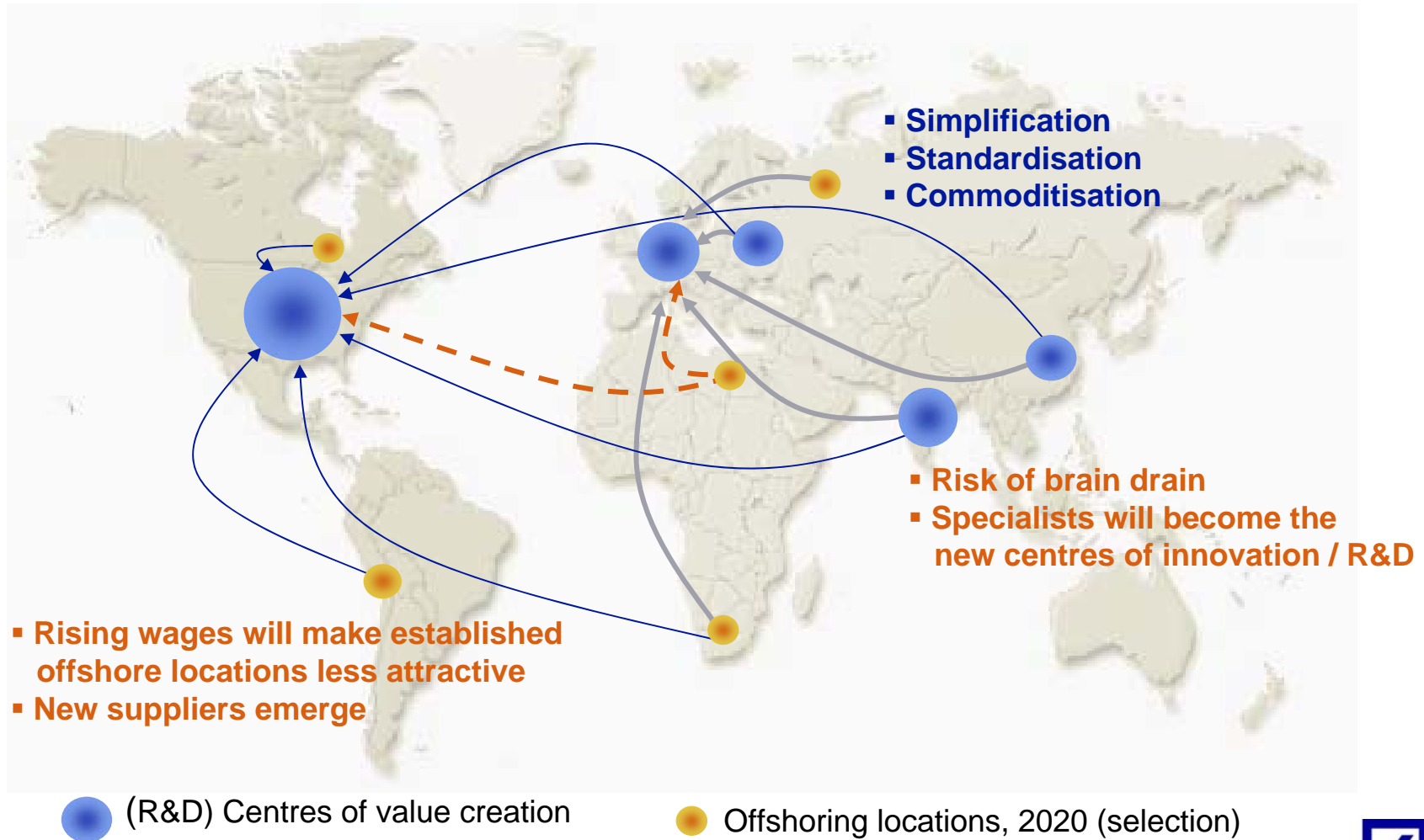
Source Doing Business Database, 2005



## Offshoring of IT und business processes: *A new international division of labour has emerged (2006)*



## Offshoring of IT und business processes: *Core competencies will be reshuffled (2020)*



## Are you ready to (re-)define your core competencies?

### Today

- Does your offshoring decision take future developments into account which can be anticipated already today (e.g. wage inflation)?
- Does the nature of the service limit the expected savings (e.g. privacy concerns vs. economies of scale)?
- Do potentially high (hidden) costs indicate the need for an alternative institutional arrangement (captive offshoring, domestic outsourcing)?

### Today for tomorrow

- What are the domestic core competencies of the future: Service engineering, tailor-made software, training, product management, sales?
- The nature of innovation changes: Open, collaborative, multi-disciplinary, global (Donofrio, IBM)
- Watch out for new competitors!



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