

## Is the World Still Flat?

In his bestselling book "The World Is Flat", Thomas Friedman popularized the notion that the world is moving toward a globally integrated supply chain where workers from industrialized and developing nations will compete with one another on an increasingly level playing field. This month's 'View from the Bridge' provides our perspective on the impact of the current economic crisis on the development of this globally integrated supply chain - in short, is the world still flat? We approach this question primarily from a US perspective.

Global sourcing, the search for the best combination of cost and capability wherever it may exist (a.k.a. offshore outsourcing or offshoring), came into its own in the US during the economic expansion that began in late 2001 and ended in 2007. Conditions during this period, essential in our view to the growth of global sourcing, were characterized by:

- Relentless innovation in the development and use of technologies that made it possible to shift work offshore largely transparent to the service's consumer
- Low unemployment in the US, averaging just 5.3% of the labor force
- A strong dollar and stable prices
- Economic policies in the US favoring free trade
- Economic policies in key developing countries, notably China and India, designed to encourage rapid industrialization via export-driven growth

During the course of this expansion, the trade deficit in goods and services grew to exceed 6% of US GDP, more than twice the economy's potential growth rate. Services imports, a conservative proxy for the shifting of services to offshore locations, grew at over 9% per year.

By 2007, the conventional wisdom in many parts of the insurance industry was that companies unwilling to move work offshore would struggle to be competitive on cost, and potentially quality and innovation as well. With the onset of the current economic crisis, this conventional wisdom has been called into question.

In forming our view on how the present crisis is likely to affect the development of a global services supply chain and the economics of moving work offshore, we decided to examine its effect and the probable aftermath on each of the conditions cited above as essential to the growth of global sourcing.

### Innovation in the Development and Use of Enabling Technologies

The essential technology-related building blocks for global sourcing are already in place. Innovation in technology is a constant, and Web 2.0, cloud computing, advances in collaboration technologies, and the ongoing upgrade of telecommunications and computing infrastructures are sure to make it ever easier for individuals across the globe to interact and work together, in many ways we can't even anticipate now.

Impact [on the continued growth of global sourcing]: 

### Employment Conditions in the US

Unemployment in the US is high (8.5% as of last month) and going higher. This will create political and potentially even consumer pressure to keep jobs onshore. It will also create downward pressure on wages, relieving at least some of the motivation for moving work offshore. These are the near to medium-term factors. Taking the long view, however, paints a somewhat different picture. Although the labor force in the US, different from that of many other developed countries, continues to grow, the rebalancing of international trade and capital accounts that must necessarily occur in the coming years should favor high levels of employment over the long haul.

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### Exchange Rates and Their Impact on Prices

The current economic crisis is hastening the realization on the part of surplus countries like China that mercantilist policies resulting in the accumulation of large cash (USD) surpluses cannot continue forever. The table below shows the extent to which the currencies of key trading partners of the US are undervalued relative to the dollar on the basis of purchasing power parity (PPP).



This table and well-documented trade imbalances between the US and each of these countries suggest that exchange rate movements are likely to go against the dollar over time. Add persistent fears that the Fed's actions to repair the banking system and get lending started again will lead to inflation, and you have a formula for significant weakening of the dollar once the credit crunch and concomitant flight to the dollar as safe haven have passed. The result will be higher dollar prices for both goods and labor provided by other countries.

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### **US Government Policy on Trade**

Government policy is influenced by politics and thus cannot be predicted with certainty. There are both positive and worrying signs on the direction US government policy on trade may take. Among the worrying signs are leftover rhetoric from last year's presidential campaign critical of free trade, inclusion in the recent stimulus package of provisions favoring domestic producers at the expense of trading partners, and the raising of trade barriers in the form of subsidies for domestic auto makers and financial services companies. Among the more positive signs are the economic team the current administration has assembled and its recent statements on NAFTA ("stronger labor and environmental provisions should not require its renegotiation") and pending free trade pacts with Columbia and Panama. Our belief is that the lessons on trade of the Great Depression have been learned and that when all is said and done, the Obama administration will be broadly supportive of free trade, notwithstanding the occasional need for combative rhetoric on the topic.

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### **Economic Policies in Developing Countries**

The preoccupation of developing countries that are important trading partners of the US will continue to be meeting domestic expectations for rapid economic advancement and a higher profile on the international stage. For the past decade, it has been possible to do this while stockpiling bilateral surpluses with the US against a recurrence of the Asian contagion of 1997 or a renewed spike in the price of energy. That is no longer the case. Continued advancement will entail stimulating domestic demand and raising living standards. The good news is that this is in everyone's interests. It will provide workers in developing countries with equal value from trading partners in return for their labor. It will enable the US to bring its trade accounts back into balance and increase demand for US-produced goods and services. And while wage arbitrage opportunities will diminish, the increased capabilities of offshore workforces and ongoing specialization of countries in what they do best should prove a more than adequate offset. As an example, we are already seeing US companies select India-based IT service providers not simply because they are low cost but because, in certain situations, they bring the best skills and experience to the table.

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### **Conclusion**

The world may not be entirely flat, but the long-term trend will continue to be in that direction. Work will, from the US perspective, continue to move offshore, driven increasingly by specialization rather than wage arbitrage. That, however, is far from the end of the story. For trade accounts to come into balance, other countries must come to rely on US goods and services in equal measure. In short, the US will see significant increases in both import and export of services, where the US is already in surplus with the rest of the world.

Our advice to insurance companies is that global sourcing continues to present opportunities for competitive advantage. Those with existing plans and investments should not abandon them, and those open to the idea should give it serious consideration. We also believe that insurance companies with relatively standard business processes, modest scale, and limited strategic need for an enhanced global presence ought to partner with an outsource vendor with its own offshore presence and allow the vendor to deal with the complexities of managing an offshore workforce. Most importantly, whether working through an outsource vendor or doing it on one's own, companies should make decisions based on the durable advantages that a given location is likely to have rather than chase ephemeral cost advantages from country to country as wage levels and exchange rates fluctuate over



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