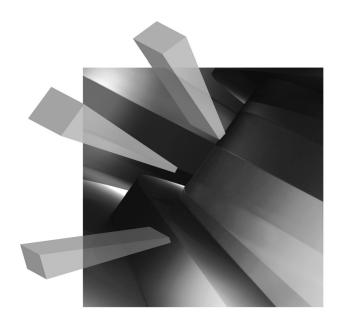
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### Piotr Stanisław Chłopek

Wrocław University of Economics

# OFFSHORING TRENDS AND FOREIGN DIRECT INVESTMENTS IN THE MIDDLE EUROPE AND BRIC AREA

**Summary:** The changes we are witnessing have a crucial role in the nature of the global economy. Continuous globalization processes and the blurring of boundaries between countries allow businesses operate in a never seen before scale. One important effect of the increasing integration of the world economy is a rising importance of possibilities to offshore and outsource value-creating activities. In many industries, firms are able to disaggregate their value chains into smaller parts. This process allows for a less path-dependent approach to the firm's ideal location profile (through offshoring and relocation) and control strategies (through outsourcing). Undoubtedly, offshoring based on information and communication technology now experiences its heyday. The main aim of this article is to show importance of offshoring and foreign direct investments for developing countries such as Poland, Czech Republic, and more generally speaking the Middle Europe and BRIC area. The article explains the concept of offshoring and its prospects, giving examples of companies like Apple, HP, IBM, Credit Suisse, UBS, Irevna, McKinsey & Co., Siemens, Google and Microsoft. Offshoring advantages and disadvantages were highlighted.

**Keywords:** offshoring, outsourcing, globalization, virtual teams, foreign direct investments.

#### 1. Introduction

Globalization, understood as increase of international connections in such fields as trade, capital and others between countries, is not a new phenomenon. The last century is the period of tumultuous development of international trade. Nowadays more and more production's and service's processes demand coordination from the level of different countries. It is interesting that an average worth American car comes from combining processes in Korea (30%), high-tech solutions and sophisticated parts produced in Japan (17.5%), from design in Germany (7.5%), noncrucial parts from Singapore and Taiwan, marketing processes and advertisement in the UK. That means that only ca. 40% of the worth of American car comes from the USA [World Trade Organisation 1998]. As it was stated not only production processes are crucial for globalization, but nowadays services become more impor-

tant. No single business does everything that is required to produce its product and services. That is the main reason companies decided to focus on crucial and trouble spot of their operations, outsourcing or offshoring remaining.

Offshoring is one of the most frequently debated topics in the international business. It is loosely defined in the popular press as a relocation of business processes to foreign countries to take advantage of a supply of skilled and relatively cheap labour [Mudambi, Venzin 2010]. In academic literature, offshoring has been defined as "the transnational relocation or dispersion of activities" [Doh et al. 2009].

Outsourcing is a transfer of orders, production, and services or generally speaking business processes or some parts of them to other company [Rybiński 2008].

To sum up those definitions, outsourcing means deciding to buy-in products or services rather than perform the activities in-house. Offshoring means obtaining products and services from operations that are based outside one's own country. Those two concepts are related to each other, what can be seen in Table 1. One stream of academic literature share the popular perspective that the primary objective of offshoring is cost minimization through therelocation of business processes to low-wage locations [Bock 2008; Grote, Täube 2007] such as Poland, the Czech Republic, BRIC area (Brasil, Russia, India and China). Another stream of literature views offshoring as a more generallocation strategy that incorporates cost minimization and knowledge seeking [Demirbag, Glaister 2010; Lewin et al. 2009; Maskell et al. 2007]. From my perspective the first concept has greater influence on offshoring decisions. It is the money the corporations would like to save and of course the easy access to well educated people is an additional advantage. Nevertheless most young people are willingto migrate to other places if their standard of living would sufficiently increase. In this article the cost efficiency is a crucial reason for offshoring, but the others are not passed over.

Table 1. Offshoring and outsourcing.

Ownership of operations	Do not own the assets	Outsourcing  Domestic supplier delivers products and/or services	Offshore outsourcing Overseas supplier delivers products and/or services		
	Own the assets	Domestic operations Focal operation performs activities itself	Offshore operations Focal operation's overseas operation delivers products and/or services		
		Domestic	International		
		Location of operations			

Source: N. Slack et al., Operations and Process Management. Principles and Practice for Strategic Impact. Prentice Hall, Harlow 2009, p. 77.

Many researchers think that the firm should retain control over the components or processes that enable it to create and appropriate the most value. Conversely,

operations through which the firm can create and appropriate less value should be outsourced [Ricketts 2002]. It is important to realize that according to the research made by Aubert and Sillar in 2005, more frequently work is transferred from developed countries to other developed. For some firms, the logic of transaction cost analysis pushes them towards exercisinghigh control over resources and concentrating on specific process components [Calantone, Stanko 2007]. Other firms tend to exercise greater control over the entire valuechain and have much less outsourcing. Such differences across firms tend to persist forextended periods of time. Working at a distance does not mean that virtual team members do not meet each other. Based on a trial consisting of 72 managers leading people from a distance in Lower Silesia area (Poland), about 87 per cent of them meet face-to-face. Those meetings are organized regularly, at least twice time a year.

# 2. Offshoring development trends

It is believed that the main factor which lead to offshoring development and spread across the world is ICT (Information and Communication Technology), and Internet. According to the Garner [Garner 2004], the fee for wideband connection between Japan and the USA in years 1998-2002 decreased ten times, and countries like India obtained higher capacity of Internet broadband comparing to telephone ones.

In the increasingly competitive global area, firms in all industries are using thegeographical dispersion of their value chain activities as a means to create and maintaincompetitive advantage. The offshoring of value chain activities is the natural outcome of such enhanced competitive pressures. The cost-based advantages of offshoring to emergingmarkets and developing countries have been recognized in the literature. However, the leveraging of competence-based advantages by offshoring activities to global centers of excellence, often in advanced market economies, might be a more important aspect of offshoring [Mudambi, Venzin 2010]. Sir Keith Whitson, former HSBC's Chief Executive, caused controversy whenhe said of Indian call-centre staff: "They're quicker at answering the phone, highly numerate and keen to come to work every day. Staff is hugely enthusiastic about their jobs, they dress well. A lot have degrees". Most companies tread offshoring a lot more carefully, because they areworried about a backlash, either from clients or the workforce. The National Westminster Bank boasts in its television advertisements that it has "UK-only call-centres" [Smith 2006].

According to the research carried out by Nirupam Bajpai of the Earth Institute at Columbia University [Bajpai et al. 2004] the overwhelming motivation, mentioned by 70 per cent of firms surveyed, is to cut costs. Other factors, such as increasing capacity taking advantage of offshore labour, gaining access to better technology and systems and improving service levels, come well down the list. For most companies' ca. 75% – the savings are between 10 and 50 per cent compared

with the costs of carrying out the same operations at home. For a few there are even bigger savings.

The comparative advantages are changing over time. Decisions about the location and control of value-creating activities therefore need to be made on a profound understanding of the dynamics of international competitiveness. Many different factors determine the competitiveness of a nation, and hence its comparative advantage. Corporations could base on world rankings like World Competitiveness Index [IMD 2009]. This report demonstrates that it is not unusual for nations as a whole to gain (or lose) up to ten positions in one year, e.g. in 2009 Greece dropped from position 42 to 52. In Figure 1, there is presented a comparison of the index for Middle Europe and BRIC area. According to the Global Competitiveness Report 2011-2012 the best quality of education (among considered countries) is in Estonia and the lowest in Russian Federation and Brazil (Figure 2). Taking into account that the first 20 countries are considered as highly developed (e.g. first place Switzerland) there are about additional 50 countries in the world which are considered to be a great place to offshore in terms of cost efficiency but not only.

Country/Economy	Rank _	Score
China	26	4.90
Estonia	33	4.62
Czech Republic	38	4.52
Poland	41	4.46
Lithuania	44	4.41
Hungary	48	4.36
Brazil	53	4.32
India	56	4.30
Latvia	64	4.24
Russian Federation	66	4.21
Slovak Republic	69	4.19
Romania	77	4.08

Figure 1. Global Competitiveness Index 2011-2012

Source: http://gcr.weforum.org/gcr2011-The Global Competitiveness Report 2011-2012.

There are no clear and universal development stages during offshoring process nevertheless it is advisable to make program for migrating centers from early development to the level where the kind of innovation is visible. Dell India could be a good example. The company implemented a four-stage journey that it had been defining for themselves. Stage one was proof of concept: just proving that they could provide the same customer experience – the same close rates and quality – in these centers in India as provided elsewhere. When they meet the same metrics then they went to discover further.

Stage two was getting credibility by becoming best of breed within Dell. The company has 40 centers making the same thing, yet what they made there was better than all of those elsewhere, based on our hourly metrics. To do that, they had to make sure that employees could understand the process and that they would stay with Dell. And then they had to look at productivity and standardization, which would ensure consistency.

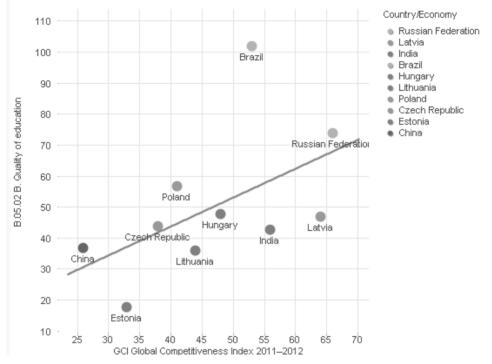


Figure 2. Global Competitiveness Index 2011-2012 vs. quality of education

Source: http://gcr.weforum.org/gcr2011-The Global Competitiveness Report 2011-2012. The lowest number better the quality of education or the GCI Global Competitiveness.

The third stage was excellence from reengineering, which only comes with deep domain knowledge, and that happens when you have the best brains working on it. And one way to prove you are doing that is to become a talent exporter. Dell was setting up new centers in Manila and Ottawa and El Salvador, and a lot of employees who set up theirs centers in India went to help set up the new ones.

The fourth stage is leadership, which is about creating a completely new "product" that does not exist today. You can only create it because you leverage what you have built [McKinsey 2006].

At the beginning of 2012, many companies see their chance competing with others by using offshoring to other countries like BRIC area or Middle Europe.

Among those companies we could find: Accenture (Łódź, Warsaw), Hewlett-Packard (Wrocław, Łódź, Warsaw), General Electric (Łódź), GlaxoSmithKline (Poznań), Lufthansa (Cracow), IBM (Cracow, Wrocław, Warsaw), Capgemini (Cracow, Wrocław), ABN Amro (Warsaw), Oracle (Warsaw), Siemens (Wrocław), Irevna (Wrocław), Volvo (Wrocław), UPS (Wrocław), Credit Suisse (Wrocław), Ernst & Young (Wrocław), Intel (Tricity), Alstom (Elblag, Wrocław).

# 3. Offshoring's advantages and drawbacks

Offshoring when undertaken in foreign subsidiaries (as opposed to foreign arm'slength vendors) is a subset of foreign direct investments. However, the study of offshoring goes beyond traditional FDI theory, or exploiting for each specific country advantages. Offshoring, in a fuller sense, is the building of a global network whose strategic objectives go well beyond serving a local market, to a focus on global network efficiency and coherence. Offshoring similarly like other activities has its advantages and disadvantages. From the global point of view it has much more pros for corporations and society. Advantages from corporation points of view are [Mudambi, Venzin 2010; Farrell 2005]:

- The lower costs and, to the extent that there is a flow of these jobs overseas, lower inflation. In raw terms, an Indian call-centre worker gets paid a tenth of his UK counterpart or Poland financial analyst gets paid an eight of his UK colleague. Even adjusting for purchasing power parity, Indian IT professionals are paid about a third of their UK counterparts and a quarter of the going rate in America. Not mentioning Poland where the situation is worst (very low purchasing power). These labour cost differences exaggerate the full cost saving. Even so, after allowing forrelocation costs and productivity differences, few companies would shiftoperations overseas if they were not saving at least 20 to 30 per cent.
- Secondly, companies (which offshored) increased their flexibility to respond to changing market conditions. Because of strict laws that constrain the ability of employers to lay off workers and to create new job occupations, e.g. German companies have more difficult time adjusting their labour usage comparing to American ones. As a result, they are more likely to face sub-optimal utilization rates and imbalances in supply and demand. Taking advantage of foreign labour gives German companies more flexibility to experiment with new ideas and respond to market changes.
- Cheaper capital equipment. Some service providers in BRIC and Poland are using low-cost local labour to develop their own software instead of purchasing more expensive branded products from the global software giants. American Express, for instance, hired programmers to write software to reconcile accounts, and the software now reconciles over three-quarters of them, or more than half a million every day.

- Fourth, companies move business services offshore because they can become more profitable and competitive by doing so. This ultimately protects existing jobs and allows companies to invest more in the next generation technologies and business ideas that willcreate the jobs of the future.
- Offshoring could increase innovative perspective of the company which employs people form may different cultures, societies, with different problem solving approach.
  - Advantages for society [Mudambi, Venzin 2010; Farrell 2005]:
- Shift of overseas jobs enables workers to be moved into higher value-added/higher productivity jobs. As noted earlier, people seem unprepared to accept the same logic for services they were happy to do for manufacturing. Routine tasks can be outsourced, allowing workers to be redeployed up the value chain.
- The second gain is in real incomes. A popular view is that all the income gains are moved to the host country. In fact, and this is where economics has to work quite hard, all the studies suggest that most of the gains, perhaps 70 to 80 per cent, go to the offshoring country. That is hard to explain to somebody whose job has just been displaced. The real income gains, come directly from lower prices and, indirectly, through the boost to corporate profits and therefore dividends.
- Even where countries have relatively high unemployment they usually suffer from specific shortages of particular types of labour. That is not always the main motivation for outsourcing but it is certainly a significant factor. When unemployment is low, that point is even stronger.
- Developed countries face a coming labour shortage due to an aging population. For example, the overall population in Germany will decrease by nearly 10 per cent by 2030, which means nearly 6 million fewer workers than Germany has today. Thus, as developed country populations age, we will have no choice but to look abroad for workers to maintain the steady supply of low-cost goods and services the country needs to maintain or increase its standard of living.
- The fifth reason is that offshoring gives opportunity to young well educated people, who know foreign languages to be employed and to utilize their skills. They could learn from their colleagues from more developed countries and in future contribute to the development of their country e.g. by setting up new companies. It helps creates a new aim for them, according to Confucius words: "A man who has no aim, does not know what is important".

Looking on the only one side of the coin would not give the "big picture" of the offshoring situation that is why a drawback has been examined as well. Corporations could identify the following disadvantages [Ang, Inkpen 2008; Ciesielska 2009; Cobb 2009; Farrell 2005; Moules 2004]:

- Many companies have difficulties with management because offshoring demands series of adjustments, which has an influence on corporate actions made by top managementor "headquarters". Mostly people have to learn how to cooperate with different parties via telecommunication technology.
- Second, cultural differences are playing a huge role in a future collaboration. Without understanding from both sides the offshoring process would fail, or would not be so effective and consistent. That is why countries with huge "trust" to others work much better on the distance than others.
- Increasing labour inputs some companies have gone a step further, using workers for tasks that would normally be automated at home. A telemarketing firm, for example that would use expensive automatic diallers in a high-wage country might have workers make their own calls instead.
- Electronic communication does not always substitute well for face-to-face communication, and some companies are concerned about quality issues.

  Disadvantages for society are [Ang, Inkpen 2008; Ciesielska 2009; Cobb 2009; Farrell 2005; Moules 2004]:
- Continued criticism has been placed on the world of offshore finance whether it be for issues of tax avoidance, money laundering, or unfair, harmful tax practices [OECD1998a]. In 1989, in response to mounting concern over money laundering, the Financial Action Task Force (FATF) on money laundering was established by the G-7 economies. Money laundering is recognized by the FATF as the processing of illegal profits from a variety of activities including: illegal arms sales, smuggling, drug trafficking, prostitution and other activities of organized crime as well as such white collar crimes as embezzlement, insider trading, bribery, and computer fraud schemes. In addition, in the post 9-11 era, tensions between the onshore and offshore world have increased further due to the concerns related to the use of money laundering to fund terrorist groups.
- It is also important to note that the vast majority of jobs in the industrialized countries are in service industries such as retailing, catering and personal care. This work by its very nature cannot be moved abroad.
- Electronic communication does not always substitute well for face-to-face communication, and people working for a long period in that way have psychological problems (e.g. feel alienated, depressed).

# 4. Foreign direct investments and examples of offshoring

In 2010, after 2 years of decrease in global FDI flow the trend has finally changed. The FDI flow in 2010 equaled USD 1.24trillion, compared to USD 1.14 trillion in 2009 (change by 8.8%). However, the FDI level is still 15 percent below the precrisis average. The value of FDI inflows to the 12 new EU members was 34.3 billion USD, a significant growth from 21 billion USD in 2009 (Figure 4). Among the

new EU member states Poland, which has recorded the highest level of FDI inflow, was followed by the Czech Republic, Cyprus and Romania [Polish Information and Foreign Investment Agency 2011]. On the other hand when we compare Poland FDI per capita, the Czech Republic was much better.

Analyzing Figure 3, there could be seen that taken into account GDP per capita India is far away the rest of the countries like China, when taking into account country from Eastern Europe India's GDP is about 5 times lower. The GDP dynamic and estimated population lead to the prediction that in the next 20 years India and China would be two most powerful economies and countries like the USA could compete with them putting everything on R&D.

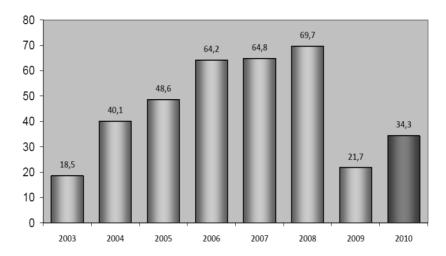


Figure 3. Inflow of FDI to the new EU member states in 2003-2010 (USD billion)

Source: World Investment Report 2011.

The Apple Inc. could be a good example. Apple is a recent entrant into a mobile handset industry, with its iPhone debuting in 2007. The company focuses on the intangible aspects of its product offering. From its earliest days, Apple recognized that style and ease of use are as important as substance in terms of developing a brand. This strategic approach implies that it is crucial to control design and marketing. On the other hand, manufacturing is less important for such a firm. In the mobile handset industry, Apple's well-known iPhone provides an apt illustration of the implementation of this strategy [Cusumano 2008]. Apple controls R&D intensive activities on the upstream end of the value chain and marketing-intensive activities associated with brand management on the downstream end. The manufacturing and application-oriented activities in the middle of the value chain are outsourced. Apple outsources higher value-added activities to developed countries,

such as UK or Germany. Marketing support activities on the downstream end are located in the USA. Routine manufacturing and assembly are undertaken in Taiwan. Relatively complex items, such as chips, are manufactured to design specifications by Samsung in Korea and NXP Semiconductor in the Netherlands [Mudambi, Venzin 2010].

Table 2. BRIC and major Middle Europe's offshoring localizations

	India	China	Brazil	Russia	Czech	Slovakia	Hungary	Poland	Latvia
Population (2011) (mln)	1.189,17	1.336,72	203,43	138,74	10,19	5,48	9,98	38,44	2,20
GDP per capita (2010) (\$)	3.500	7.600	10.800	15.800	25.600	22.000	18.800	18.800	14.700
Export (2010) (\$ bln)	225,6	1.581	201,9	400,1	116,7	68,0	93.3	162,3	9,0
High-technology exports as a % of manufactured exports (2010)	7	28	11	9	15	7	24	7	8
Stock of direct foreign invest- ment – at home (2010) (\$ bln)	188,6	529,2	368,4	297,4	129,9	50,68	71,47	193,1	12,0
Research and development	0,80	1,44	1,10	1,03	1,47	0,47	0,96	0,61	0,61
expenditure as a % of GDP	(2007)	(2007)	(2007)	(2008)	(2008)	(2008)	(2007)	(2008)	(2008)
Researchers in R&D	1,37	10,71	6,94	31,91(	28,86	23,31	17,33	16,23	19,35
per 10 000 people	(2007)	(2007)	(2007)	2008)	(2008)	(2008)	(2007)	(2008)	(2008)
Internet users per 100 people (2010)	7,8	34,4	40,7	43,4	68,6	79,8	65,1	62,5	68,7
Fixed broadband Internet subscribers per 100 people									
(2010)	0,94	9,44	7,23	11,08	14,61	16,14	19,55	13,21	19,36
Mobile cellular subscriptions per 100 people (2010)	64	64	104	168	136	109	120	120	103
Public spendingon education as a % GDP	3,1 (2006)	1,9 (1999)	5,1 (2007)	4,1 (2008)	4,1 (2008)	3,6 (2008)	5,1 (2008)	4,9 (2007)	5,7 (2008)

Source: CIA World Factbook (https://www.cia.gov/library/publications/the-world-factbook/index.html); World Bank's Indicators(http://data.worldbank.org/indicator).

Further offshoring example of the separation of high and low value creating processes appears in investment banking. Large financial services firms, such as Citigroup, JP Morgan, Credit Suisse or HSBC, use equity research business process outsourcing (BPO) or knowledge process outsourcing (KPO) [Mudambi, Tallman 2010]. Suppliers of these services – firms that specialize in offshore investment research, such as Office Tiger (acquired by RR Donnelley) and Irevna are located in India (nowadays even in Wrocław, Poland). This shows that even in knowledge-intensive service industries, it is possible to identify value chain activities that can be standardized and offshored.

However, the higher value creating activities of investment banking, such as raising money by issuing and selling securities in the primary market, assisting

public and private corporations in raising funds in the capital markets, and providing strategic advisory services for mergers and acquisitions, are still located in the advanced market economies.

#### 5. Conclusions

Business and political leaders should view offshoring not as an economic threat but as an important opportunity for their nation's businesses, consumers, and share-holders. Rather than trying to stop offshoring from happening, policymakers and companies should focus on labour policies to ease the transition to a global economy. The article explains the concept of offshoring and its prospects for developing countries. Seeking knowledge and efficiency are two most important explanations for international activityin information-focus industries. In less information-intensive industries, market seeking and the search for low-cost export platforms are the dominant motivations for FDI. Huge inflows of FDI to Middle Europe and BRIC are stimulated by following factors [Chilimoniuk, Radlo 2008]:

- education,
- infrastructure (office spaces, access to international airports),
- quality of life,
- localization

In future BRIC area and Middle European countries would improve their global position and importance, being opened for international collaboration and possessing not only cheap work force, but as well, educated people. Taking into account social point of view working at a distance could be something that gives educated people from lower developed countries a chance to learn and work with usage of high-tech equipment, latest computer programmes. That increase productivity of specified countries, but could lead to a situation where only "service and production" would be transferred, and research and development departments remain only in well developed economies. Emerging markets should implement policy in which they would strive to encourage as many FDIs as possible but in the same time invest in research and innovation by themselves.

Corporations working globally have a huge bargaining power and when located in specific area could give an advantage e.g. for Prague in the Czech Republic or Pune in India. In those regions local entrepreneurs are able to expand their business quicker, which lead to the wealth increase in an investment localization.

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#### TRENDY OFFSHORINGU I BEZPOŚREDNIE INWESTYCJE ZAGRANICZNE W EUROPIE ŚRODKOWEJ I BRIC

Streszczenie: Zmiany, których jesteśmy świadkami, są kluczowe dla gospodarki światowej. Nieustanne procesy globalizacyjne i zacieranie się granic pomiędzy poszczególnymi państwami umożliwiają przedsiębiorstwom działalność na niespotkaną dotąd skalę. Jednym z efektów integracji światowej ekonomii jest rosnące znaczenie możliwości offshoringowych i outsourcingu. Przedsiębiorstwa działające w wielu sektorach są w stanie podzielić swoje łańcuchy wartości na mniejsze części. Ten zabieg pozwala na zmniejszenie zależności od *stricte* utartej ścieżki, dając możliwości zmiany lokalizacji oraz całej strategii procesowej. Offshoring, bazujący na technologii informacyjno-komunikacyjnej, przeżywa teraz swój rozkwit. Celem artykułu jest ukazanie oraz podkreślenie jego znaczenia dla krajów rozwijających się, np. Polski, Czech czy – bardziej ogólnie – państw Europy Środkowej oraz BRIC. Wyjaśniono pojęcie offshoringu oraz kierunki jego rozwoju na przykładzie firm, które już go zastosowały, m.in. Apple, HP, IBM, Credit Suisse, Irevna, McKinsey & Co, Siemens, Google czy Microsoft. Zostały również uwypuklone zalety oraz wady offshoringu.

**Słowa kluczowe:** offshoring, outsourcing, globalizacja, zespoły wirtualne, bezpośrednie inwestycje zagraniczne.