

The myth behind India continuing as the offshoring Maharaja

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Having become the call-centre capital to the world, is India poised to storm the bastions of its technology services and business process outsourcing industries? India's abundant cheap skilled labour, and her determination to succeed make it only a matter of time before it grows into a formidable "knowledge economy". Right? As always, truth is far from the hyped up picture. Early signs are there for European and US companies to consider evaluating other viable alternatives to India as offshore destinations when crafting their sourcing strategies. Here is why.



India's steady rise in gross domestic product (GDP) – on average 6% per year for two decades - has made the country one of the world's top growth performers. But this growth has also been unusual. It has been driven primarily by private sector services companies in technology related areas. With the debate about India's emergence as a global leader in technology service exports dominating the news headlines, and hyped up by vested parties, it may sometimes be overlooked that India remains a relatively closed economy.

The Indian economy expanded by 8.2% in 2004, only slightly behind China's growth of 9.5% and nearly triple Britain's rate of 2.8%. However, exports of goods and services account for only about 15% of GDP and, while goods exports have been growing at an average annual rate of 12% in 2000, India still accounts for less than 1% of the world's exports^[1]. Much of India's recent export growth has been fueled by trade with Asia, in particular China, where trade has grown from \$3 billion to nearly \$14 billion over the last five years. In other relevant high-growth economies such as China, Indonesia, Malaysia, South Korea and Thailand, the share of industry doubled between 1960 and 2002 to reach 40% or more of GDP. This expansion was powered by exports of labour-intensive manufactured goods. In contrast, India has not had a broad-based industrial revolution: industry's share of GDP rose from 20% in 1960 to only 27% in 2002. In addition, industrial development was capital-intensive and inward-looking and India did not have an east Asia-style export boom. The consequences for employment have been significant. In the past 10 years, employment in the organised manufacturing sector has fallen; in services, it has barely changed. Total employment, which includes informal, un-organised jobs, has done somewhat better and has risen by about 1% per year in the last decade.

But this must be put into perspective by noting that first, there remains a large amount of unemployment and low-productivity employment, and second, that the labour force is projected to grow by 2% (8 million people) per year for the next 25 years while the composition of the population shifts towards adults of working age. This "demographic bonus" could boost growth but only if the rapidly growing labour force is productively employed^[2].

Could India achieve its objective of faster growth of employment and output by continuing along its present path by exporting business process outsourcing (BPO) and other information technology enabled services (ITeS) to the western countries? It is doubtful. Many people think that the ITeS sector could be India's saviour. But its quantitative significance in the near term is limited. India's growth is being driven by its population of more than one billion people. They offer a huge pool of college educated but cheap labour for international companies. IT-related output is currently less than 1% of GDP. More significantly the sector employs less than 1 million people. This could increase to 2 million by 2010 [see Figure 1]. While undoubtedly helpful, it pales into insignificance when one considers that India's labour force will rise by 40 million by 2010 to an estimated 450m people (and much of the rise will occur in backward states, like, Bihar, Madhya Pradesh, Himachal Pradesh, Punjab, Rajasthan, and Orissa). We must also remember that growth of the IT sector will be constrained by the rate at which the supply of educated labour can be increased. Since, only 5% of India's relevant age-group receives college education, it will have a profound effect in the near future on the so called "cost advantage" that India currently enjoys against its main competitors in central and eastern Europe (e.g., Czech Republic, Hungary, Poland, Russia, and Slovakia), the Philippines and Vietnam.

Early signs are there for European and US companies to consider evaluating other viable alternatives to India as offshore destinations when crafting their sourcing strategies.

Salaries of Indian technology workers continue to rise

India had the highest average salary increase in the Asia-Pacific region in 2004, beating China, Korea and Japan [9]. According to a survey published in October 2005 by an employee benefits consultancy, Mercer Human Resource Consulting, workers in China, India and eastern Europe are expected to receive the largest increases in real pay levels in 2006. The jobs covered by the survey comprised operations, administrative, IT staff, managers, and senior executives. They forecast that the average salaries globally would rise by 2.4% above inflation but employees in India would receive the highest pay hikes in 2006, above 11.3%, compared with inflation of 4%. But this abnormal pay rise in Indian technology sector is not confined to junior and mid-level managers. In China, employees can expect salary rises on average of 7.8% against inflation of 3%. The survey states that companies recruiting employees with specialist skills in India need to offer higher salaries as the pool of skilled workers is relatively limited [9]. Workers in the new East European members of the EU would also receive high real increases, the survey showed. In Lithuania, for example, salaries are expected to rise 8.5% compared with

inflation of 3%, while Estonia, Slovakia and Latvia will also have high rates of growth. Poland will not benefit, however, with salaries that are expected to rise by only 3.1% while inflation will be 2.6%. A similar survey by Hewitt Associates in September 2005 stated that Indian workers, particularly with high-tech and administrative jobs, are projected to take home some of the highest pay raises in Asia in 2006. The pay of Indian workers across 24 industries, it had said, will rise an average of 14% in 2006.

High attrition rates impact Indian workers productivity and quality

In terms of attrition rate of ITes and BPO workers, India again tops the table [see Figure 2]. High employee attrition is not uncommon in the Indian ITes and BPO sectors. For example, Wipro's attrition rate has been rising steadily and reached 18 % for the quarter ended September 2004. The attrition rate in Indian BPO sector is even higher, often over 50% for voice-based processes. Wipro's BPO arm reported that in the 3rd quarter (July, August, and September) of the fiscal year ending December 2004, it hired 4,800 employees in the quarter but lost 3,473 employees [4]. Among other Indian ITes companies, Infosys managed to keep its attrition level at 10.4% during the September 2004 quarter. Hyderabad based software services company Satyam Computers has also faced an attrition rate similar to Wipro. Satyam reported an attrition rate of 18 % during

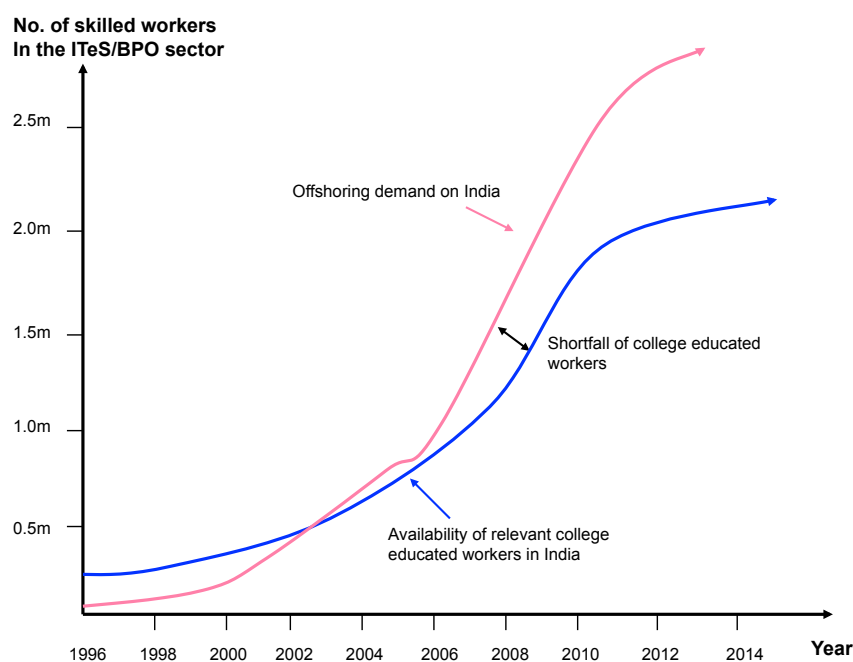


Figure 1: Offshoring demand on India and supply of college educated skilled labour [Source: Sirius & Co Analysis]

the September 2004. Banking software company i-flex Solutions has been able to bring down its attrition from 19% for the quarter ended June 2004 to 16% for the quarter ended September 2004. New Delhi based HCL Technologies attrition has been 15.1 % for the quarter ended September 2004. Tata Consulting Services (TCS), the largest of Indian ITeS companies, managed an attrition rate of 16% for the quarter ended September 2004.

High attrition has a tremendous adverse impact on the DMOQs (Delivery Model of Quality) which require an agent to pick up a phone within three rings. The C-Sat (Customer Satisfaction) scores also deteriorate. The AHT (Average Handling Time) shoots up when an entirely new person is employed to handle calls. A call centre agent starts becoming productive only after six months of taking calls. And if he is replaced by a new trainee, the productivity levels depreciate sharply. In the short to medium term, supply and demand indicators suggest that salary rise and high attrition rates will continue within the Indian ITeS and BPO industry, which will have a profound effect on productivity, quality and cost. According to a study by the HayGroup, the total cost of attrition is around 27% of operating expenditure and it is expected to rise steeply in coming years.

In order to address this abnormally high level of attrition, Indian BPO companies have stepped up efforts to allay concerns of parents about career and job opportunities for their children in that industry. Most of the Indian BPO and ITeS companies have devised novel ideas to halt attrition. For example, Gurgaon-based Convergys Corporation, which has an employee base of around 10,000, twice-a-month invites the parents of new recruits for a walk-through across their office to reassure them about the workplace, work conditions and culture, so that parents can influence their offspring to stay with their BPO employers^[5]. Similar initiatives have been undertaken by other India BPO and ITeS companies.

Having become the call-centre capital to the world, is India poised to storm the bastions of its ITeS and BPO industries? Some “experts” predict India may rival US and the Europe in IT leadership within a decade or two. India’s abundant cheap skilled labour and her determination to succeed make it only a matter of time before it grows into a formidable “knowledge economy”. It’s software engineer’s caliber and relatively low cost that have spurred western companies such as General Electric, HSBC and Prudential to set up processing centres. Other European companies, such as Aviva, Axa, Lloyds TSB offshored services to Indian call centre specialists. But, India’s ITeS and BPO companies have very formal structures and inexperienced

management. That may change as some foreign-trained Indian software engineers with exposure to foreign business return from abroad. However, they face big barriers to disseminating technology across industry. Not only are foreign companies operating in India increasingly careful to keep core technologies to themselves but Indian ITeS and BPO companies collaborate little with each other or with universities and technology institutions.

Flawed education system produces poor quality graduates

Despite the sound bites from policymakers and people with superficial knowledge of India and vested interests, what is clear is that there is an acute shortage of quality skilled graduate workers in India. The question is: how can this be when half the Indian population of over 1 billion is below the age of 25? Every “expert” on Indian offshoring reminds us that India produces millions of graduates every year yet only 2% of the population reads and writes English^[13]. The common rhetoric is that India’s biggest advantage, as it attempts to secure further offshoring businesses from the western companies, is that it has the largest and youngest workforce in the world. However, this workforce is only an asset if it is well educated and properly skilled. According to the India Science Report, India produces 3.6 million graduates every year.^[12] But, Indian industry estimates indicate that only 25% of these graduates are employable^[11]. Because of the poor quality, many call centre managers across India take on one in every 20 graduates. Poor quality graduates do not help Indian technology companies, such as TCS, who find themselves with no alternative but to run in-house training programmes for months before their new graduate recruits become productive. It may not be politically correct to say, but the main reasons are: graduates’ lack clear reasoning, problem-solving, complex thinking, basic analytical skills, teamwork, creativity, and fluency in English. The fact remains that world class quality graduates never came cheap to any company, and the current evidence suggests that it is highly unlikely to come cheap to Indian ITeS and BPO companies.

Weak data protection laws are a self-inflicted handicap

Weak intellectual property and data protection laws, long assailed by western companies, are also a self-inflicted handicap because they provide no rewards for innovation. India’s international patent applications are still miniscule

compared to that of the total filed in the US and Europe. And while start-up companies abound in India, they are poorly supported by its financial system. Its state-controlled banks turn their back on start-up companies; venture capital is in its infancy, and the country's immature and fragile equity market fails to offer the dependable exit route demanded by sophisticated early-stage investors. That compels many company founders to rely on funds raised from relatives. India's model of family-based capitalism is a shaky foundation for enduring corporate structures, and the recent tug-of-war between two brothers of Reliance Industries is a clear example.

Corporate India ignores diversity at its peril

If Indian companies were truly performing to the very best of their potential, one might expect their boards to resemble either the Spanish first division or England's premiership football teams. They would be picking the best talent from around the world. Like the managers of the top football clubs, the CEOs would be drawn not just from India but from across the overseas locations from where bulk of the revenue and profit of these companies come.

The reality, however, is startlingly parochial and inward looking. The US, Germany and Britain are the only countries where foreigners have made some inroads and it shows when one considers the world's most valuable and top companies. Corporate India is unlikely to go wrong following in the footsteps of some of the great companies from the US, UK, and Germany. For example, in Germany, foreigners head 12 out of the 75 organisations. Of the UK companies, 26 are led by foreigners ^[15]. What accounts for these differences between countries? Clearly, language is an important factor but it does not explain fully why top managers in the US or UK are far more cosmopolitan than most of their Indian companies' counterparts. The US or UK companies seem more open to foreign involvement and they are more likely to have shareholders who expect top appointments to be made on merit. For example, the UK's Vodafone, whose CEO is Indian born. The banking organisations, Standard Chartered and Abbey National, had CEOs of Indian origin in early 2000. It is nearly impossible to find women who sit on Indian companies' boards, despite the fact that India had her first woman prime minister long before some of the developed countries.

Indian ITeS and BPO companies lack leaders who are effective across national boundaries because they have limited international experience. In order to serve western global companies, Indian ITeS and BPO companies need to grow

beyond their roots ^[10]. Most of the top tier Indian technology companies have been in existence for over two decades, yet senior managers of their foreign offices are exclusively Indians. Indian technology companies may take a leaf out from the global champions they hope to emulate such as IBM, Microsoft, Oracle, all of whom have significant operations in India, and the people who lead these companies' Indian operations are local talented executives with international experience. To fulfill India's promise in the global marketplace, corporate India needs an infusion of exceptional talent pool at the top regardless of their nationalities and who are effective beyond their national boundary.

Corporate governance in India – Mum is the world

Since April 2005, all listed companies in India are required to comply with the newly-amended Clause 49 of the listing agreement that they sign with stock exchanges to stay listed. The capital market watchdog in India, Securities and Exchange Board of India (SEBI) uses the listing agreement to enforce corporate governance rules.

However, the most gripping and longest-running business soap opera in recent Indian history reached its denouement in June 2005. Thanks to mediation by their mother, the seven-month feud between the two Ambani brothers heading Reliance Industries, has been resolved by an agreement to split the group between them. The outcome was a relief to shareholders and to the Indian government, which had been transfixed by the spectacle of the country's largest company tearing itself apart. Keeping things in the family might be acceptable in a company wholly privately owned, but Reliance Industries is a publicly quoted group that makes up 12% of India's stock market index. Ambani family members own barely a third of its shares, yet their behaviour suggests that they view it as a personal fiefdom (see [Linking CEOs Corporate Governance agenda to CIOs agenda](#) by Pal). That attitude, unfortunately, has long been characteristic of the group and, indeed, of the dynastic model of capitalism common in much of India. Such complacency does not befit a country that prides itself on justice and the rule of law. Nor does it serve India's economic ambitions.

Fulfilling India's promise

The ITeS and BPO industry does not answer the employment needs of millions of aspiring young people in India. They require industrial blue-collar work with most training received on the job. Of course, labour-intensive

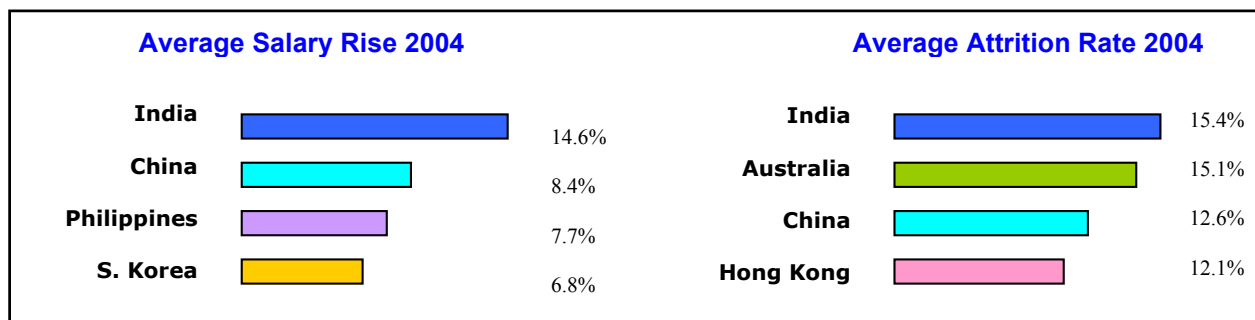


Figure 2: Economic factor – salary and attrition rate in Asia-Pacific region

(Source: Economic Times of India, 9 November 2004; and Sirius & Co Analysis)

manufacturing is not a panacea. Thriving agriculture and services are vital for balanced growth. India's capital-intensive and skill-centric industries and services can and should continue to grow fast, provided they are efficient and internationally competitive – which they are not because of India's broadly closed economy. The policies required to make labour-demanding growth possible are easy to specify but politically difficult to implement – that is the main challenge India face. Key policies that require implementation include: -

- Arcane labour laws that hinder employment must be reformed. Existing labour laws prohibit companies with more than 100 employees from sacking workers without state permission and from employing contract staff for more than three months without offering them permanent positions.
- Quality of education (primary, secondary, and college level) must be enhanced further.
- Foreign Direct Investment (FDI) should be welcomed in labour-intensive and protected industries.
- Power, ports, and transport facilities, essential for international competitiveness, must be drastically improved.
- Trade liberalisation must be extended and domestic companies must be exposed to foreign competition.
- Corruption and bribery must be eliminated.
- Special export zones (SEZs) should be put in place to extend export-oriented manufacturing companies the fiscal and labour advantages that have been enjoyed by the country's ITes and BPO sectors.
- Tariffs should be cut quickly. India's average tariffs, at around 22%, are the second highest in the world after Nigeria's.
- Red tape must be slashed. Some experts estimate that transaction costs (a euphemism for the paper-shuffling

within India's bureaucracy) could amount to \$15bn a year in lost trade. A typical international trade deal from India involved up to 30 separate parties, 257 signatures and 118 copies of the same document. Imports on average sit in Bombay's port for up to three weeks compared with less than 24 hours in ports elsewhere in the world.

Without labour-demanding growth, India's current "cost advantage" over its rivals could have highly unpleasant consequences. Debt burdens continue to be a threat to medium-term economic performance in India. Emerging markets as a whole have ratios of total debt to GDP that are now higher than the industrial countries—and much higher as a percent of government revenues (see Figure 3).

Asia now has a debt to GDP ratio significantly larger than Latin America. In India, though, the high debt level is the result of fiscal deficits that have persisted over a long period^[1]. High public debt ratios are a drag on the Indian economy. They keep borrowing costs high, discourage private investment and constrain the flexibility of fiscal policy—often to the detriment of much needed social and infrastructure spending that can help tackle education among poor. They also make economies vulnerable to rising global interest rates.

India needs to use the present period of strong growth to reduce fiscal imbalances, and lower fiscal vulnerability – the days of lot of talk and very little or no action are over. In India, debt levels have not yet come down, even if modest progress has recently been made in reducing fiscal deficits. According to the Indian commerce department, the trade deficit for the first 10 months of the fiscal ending January 2005 was \$22.68bn. It is estimated that the deficit at the end of March 2005 could touch \$30bn compared to \$15 billion trade deficit in 2004. Effective fiscal reform—though never easy—need not be just a painful and unpopular exercise in austerity. The revenue deficit for 2004/2005 is 3.6% of GDP, which means the government will have to

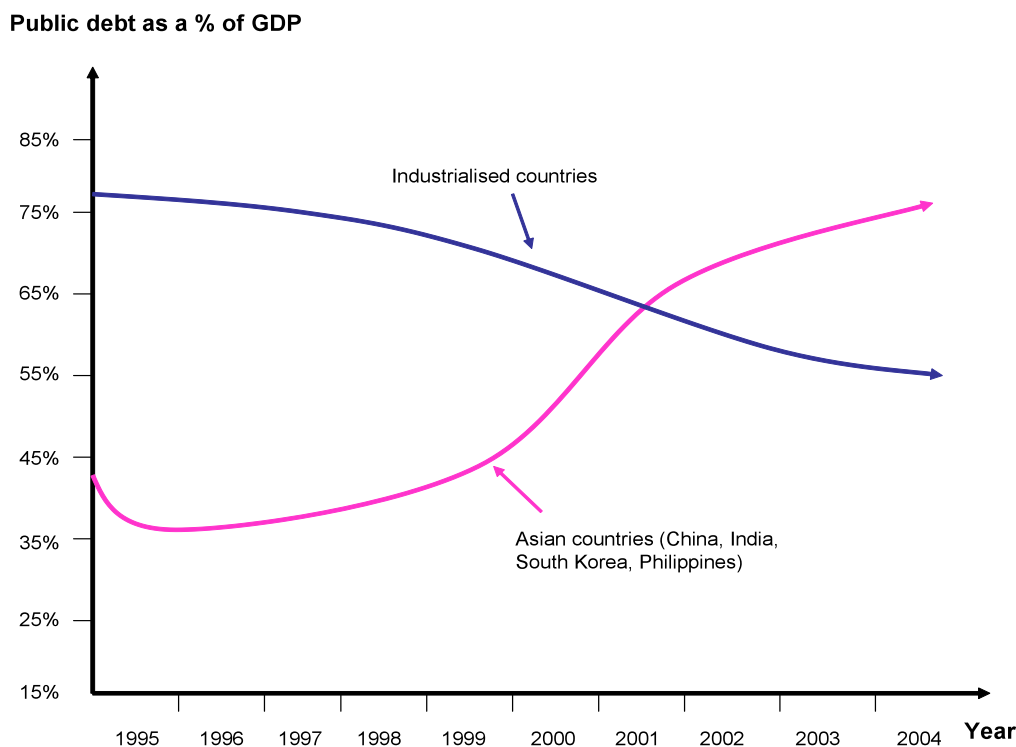


Figure 3: Public debt as a percentage of GDP [Source: IMF, October 2004 and Sirius & Co Analysis]

reduce it to 3.1% of GDP. Since the government's revenue receipts are currently running almost 40% below target, plugging that gap would be a challenge.

The experience of India during the 1990s—shows that fiscal adjustment can go hand in hand with faster growth if it is done right. Policies to put the public finances on a more solid footing and continue to safeguard price stability would provide the needed macroeconomic underpinnings.

Indian government must accelerate reforms in India's tax system both by reducing tax rates and by simplifying tax administration. Corruption is endemic within the public sector employees and must be eliminated. Next priority of the government is to boost investment in infrastructure. India's infrastructure is poor even by developing countries standard and in need of rapid modernisation. Building of airports, roads, power stations and irrigation systems are absolute necessity and all barriers should be lifted for liberal foreign investors. Indian government's plan to use foreign exchange reserves to finance infrastructure spending is of concern, because using reserves in this manner has the potential to compromise India's central bank independence and increase inflation. Reducing the borrowing needs of government would have the added benefit of freeing resources for private investment.

But to fully realise India's potential, more is required. India will need to generate more than 100 million jobs by 2015 to keep the unemployment rate from rising^[6]. Stepped-up reforms to remove structural impediments to growth (notably, reforms to increase the flexibility of labour market) will be needed to boost potential growth, strengthen resilience to shocks, and develop a poor performing manufacturing sector. Here, India is a bride's maid. The share of manufacturing industry in GDP, at 27%, lags by Asia standards; in China, for example, the figure is more than 50% (see Figure 4).

Without greater dynamism on the supply side, employment creation will have difficulty overcoming daunting demographics trends. In order to generate the large number of new jobs needed to meet the rising working age population, the policymakers should enhance the business climate, including by easing the burden of regulation, liberalise restrictive labour laws and increase competition by exposing inefficient domestic companies (such as in retail, agriculture, transport and aviation, and real estate sectors) to foreign competition and eliminate corruption.

Lowering barriers to trade, within a multilateral framework of reciprocity and rules, has been the foundation of the tremendous expansion in global prosperity over the last 50 years. For India, further progress with trade liberalisation

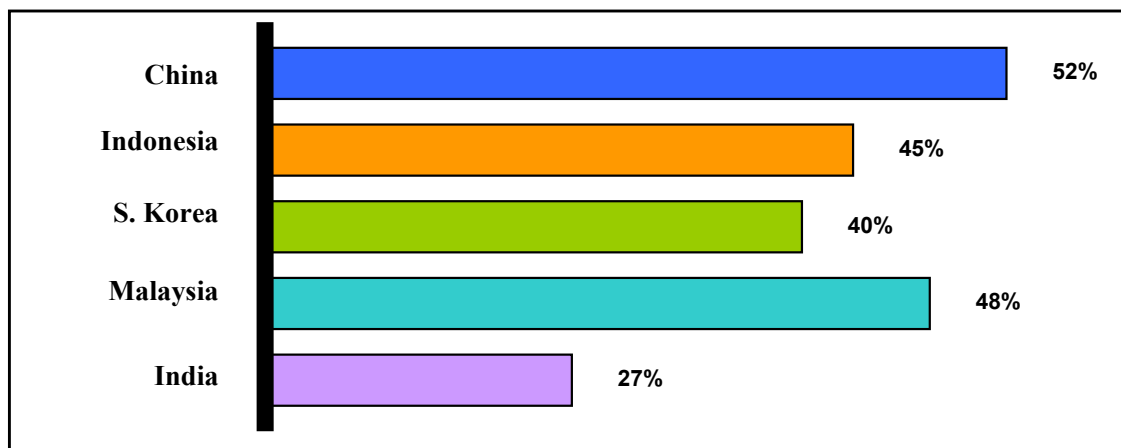


Figure 4: Manufacturing sector as a percentage of GDP 2002 (Source: IMF, October 2004 and Sirius & Co Analysis)

would allow the economy to benefit from the dynamism of emerging Asia, while integrating more fully into the global economy. India has a great deal to gain from continuing to tackle these common challenges with determination, and from assuming a larger economic role in the Asian and the global economy. One can be reasonably confident that these economic challenges are recognised at the highest level in the India government because of the appointment of the pro-business and an eminent economist as the prime minister of India in June 2004.

India's progress so far from the eyes of the Indian

In middle of 2005, the Indian prime minister gave his government six marks out of 10 for its performance during its first year in office; he was as fair as possible in his assessment considering the circumstances. Constrained by the leftwing allies Indian government failed to make the fundamental economic reforms that India requires, if it is to compete with China and accelerate the eradication of poverty. The government has watered down early promises of fiscal responsibility, and the combined deficit of the central and state governments is running at about 9% of GDP. Bureaucracy is as horrendous as ever. Limited progress has been made in investing the £82 billion needed for India's transport, energy and other infrastructure over the next decade. In September 2005, air traffic and financial services were affected across India as more than one million workers stayed home to protest against the Indian prime minister's economic reforms. Airlines cancelled services on main routes as workers challenged the planned privatisation of New Delhi and Bombay airports. There have been virtually no economic reforms in the last 18 months because the leftwing allies have an effective veto. Ministers seem more eager to

talk about privatisation than to privatise. Recent strike is an exercise in shadow boxing. The workers were protesting against privatisation when there hasn't actually been any.

As usual, Indian reforms have been one step forward and two steps backward. In August 2005, the Indian government formally scrapped the privatisation of 13 companies. This came after the leftwing allies blocked the sale of a stake in Bhel, the state-controlled electrical equipment group. Plans to open up the \$205 billion retail sector to foreign investment are next in line for derailment. The timing is unfortunate. India's stock market is at record highs. So too is foreign participation. That creates the perfect environment for the Indian government to start realising on some assets and money is desperately needed to help plug the budget deficit. Nor is India securing much FDI (India attracted only \$5.5bn in FDI in 2004-05, an increase of 18%, but less than a 10th of the inflows into China). Despite a deal from Posco, the South Korean steelmaker, there has been much backtracking on FDI. Promises of liberalisation have been clouded by delays and a lack of clarity, particularly in the airports and construction sectors. Even a much-heralded law to create SEZs had lost its main attraction for investors - a section allowing state governments to waive India's highly restrictive labour regulations - by the time it was presented to parliament.

The only real economic progress has been in areas where the Indian cabinet can implement its policies by executive order, for example, by allowing foreign investors to hold larger stakes than before in telecommunications ventures. India's private sector, led by computer software and pharmaceutical companies and providers of BPO services, goes from strength to strength. The economy is growing at a respectable rate. The Indian prime minister knows exactly what needs to be done. Yet he has avoided a direct confrontation with the leftwing allies that provide

Rank	2004	Rank	1997
1	USA	1	Singapore
2	Finland	2	USA
3	Singapore	3	Hong Kong
4	Denmark	4	Canada
5	Sweden	5	Switzerland
6	Iceland	6	Norway
7	Taiwan	7	Netherlands
8	Australia	8	New Zealand
9	Canada	9	UK
10	Switzerland	10	Luxemburg
11	Norway	11	Finland
12	Hong Kong	12	Japan
13	Netherlands	13	Malaysia
14	Austria	14	Denmark
15	Japan	15	Ireland
16	Germany	16	Taiwan
17	UK	17	Australia
18	Luxemburg	18	Chile
19	New Zealand	19	Sweden
20	Ireland	20	Germany

Figure 5: Global competitiveness rankings (Source: Robert Higgins Associates)

essential, if unconstructive, support to the coalition. The Indian government showed little sense of urgency in the honeymoon period of its first year, when it had the best chance of getting difficult legislation endorsed by members of parliament. While socialist China is rattling out privatisations – over \$8.5bn worth by middle of 2005 – ostensibly capitalist India continues to dither.

What it means for European business leaders?

The competitiveness of some of the economies in Europe, such as the UK, has declined sharply since late 1990s, due to poor productivity and lack of market reform (see Figure 5). For example, the UK has slipped from being the 9th most competitive country in the world in 1997 to 17th in 2004. A more worrying long-term issue, is the UK government's reliance on the public sector for jobs growth (public sector grew by 1.4m employees from 1997 to 2004 but the number of private sector jobs increased by mere 481,000), whereas the most competitive countries were fuelled by private sector growth and development. Such growth in the public sector will become unsustainable unless there is a greater generation of private sector employment and entrepreneurship. Unless this imbalance is rectified, the UK will fall further down the global competitiveness league in coming years. To capture value from offshore outsourcing, policymakers within the EU countries must improve national productivity rate and reform regulations that stifle competition and innovation, and

stimulate growth in the private sector (see *Offshoring: Saviour or Value Destroyer* by Pal).

The UK's economy grew at its slowest annual rate for 12 years in the second quarter of 2005, according to official figures from the Office for National Statistics (ONS). People are facing increase pressure on their disposable incomes and they are reluctant to spend because of higher fuel bills, the slowing housing market, and a reluctance to take on more debt. The ONS revised down its annual growth rate for the second quarter of 2005 from 1.8% to 1.5%, because of downgrades to back data for several sectors. It was the weakest rate of annual expansion since the first quarter of 1993. The official figures also showed that the savings ratio - the amount of disposable income people saved - rose to 5% in the second quarter of 2005, from 4.5% in the previous quarter. What happens to the savings ratio is the most important factor determining the course of the UK economy in the near future. If the ratio continues to rise, growth will struggle to exceed 2% in the next couple of years.

Location, location, location

The criteria for an offshore location are the caliber and cost of labour; productivity of labour force, multi-language skills; telecom bandwidth - cost and reliability; political stability; labour regulation; political influence on the legal system; enforceability of contracts; the general maturity of the business environment including macroeconomic stability;

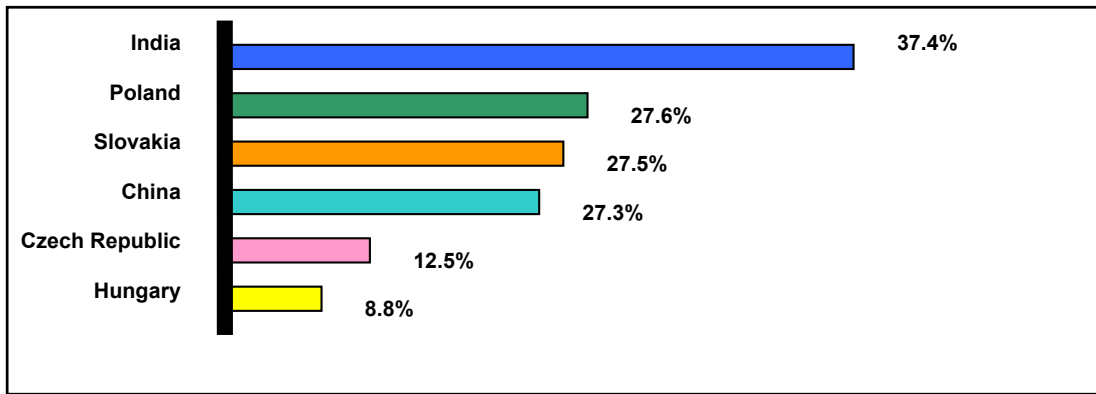


Figure 6: Corruption is a major constraints of doing business

(Source: Sirius & Company Analysis)

tax regime; corruption level; security and operational risk including level of data protection; quality of infrastructure; and senior management’s comfort operating in different locations.

Companies invest in foreign locations to reduced cost and improve profit. Profitability is influenced by three major factors: costs, risks, and barriers to competition. Each factor matters independently, and all three are interrelated. Some risks can be mitigated by incurring greater costs. High costs and risks are barriers to competition. Barriers to competition deny opportunities and increase costs for companies. One of the main factors that have a direct impact on cost is corruption, which is the exploitation of public office for personal gain. When it infects the highest levels of government, it can destroy the credibility of government and attractiveness of the location. Corruption levels within a select group of eastern and central European countries, who are competing for offshore businesses with India and China, are shown in Figure 6.

It shows the corruption constrains, which measure the share of senior managers that ranked corruption as a major or a very severe constraints of doing business in that location [8]. Here, India tops the table.

India’s top trading partner is the European Union, and not the USA, as many people tend to assume (see Figure 7). In 2004, India exported goods and services worth \$7.3 billion to the EU countries compared to \$6.4 billion to the USA.

Currently, for the offshore location, the global leaders are India and China. However, having entered the market about a decade after India, central Europe is catching up (see Figure 8). Out of 10 new EU members, 4 EU members stand out – the Czech Republic, Hungry, Poland and Slovakia. For example, foreign investment has made an impressive contribution to the Czech economy in the last 2-3 years. Among central European countries, the Czech Republic has attracted the largest amount of FDI on a per capita

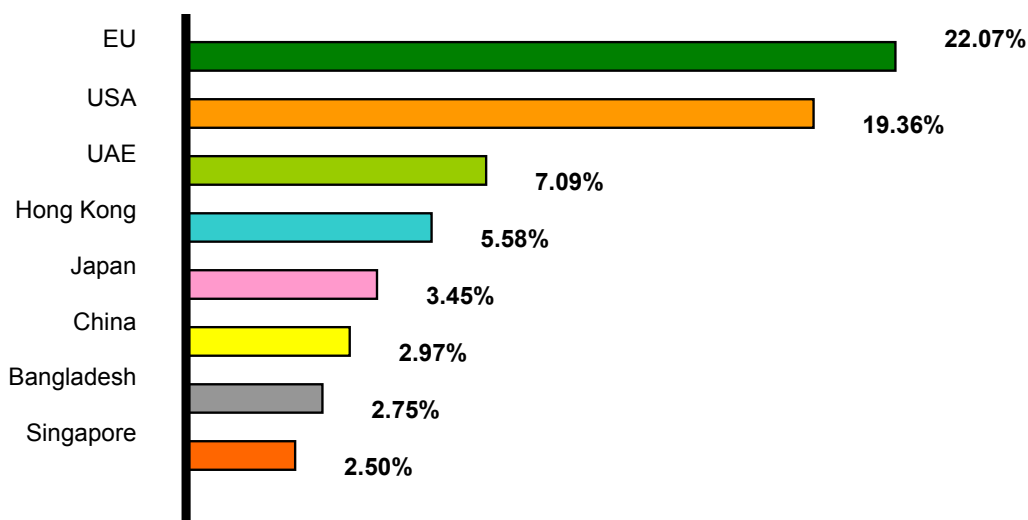


Figure 7: India’s global trading partners in 2004 [Source: Sirius & Co Analysis]

Country	Population (million)	GDP per capita at PPP, 2003	FDI per capita, 1989- 2002	Government budget balance (% of GDP)	GDP real annual growth, 2003 (%)	GDP growth forecast, 2004 (%)
Armenia	3.1	\$2,663	\$275	-1.2%	13.9%	7%
Azerbaijan	8.3	\$3,491	\$873	-2.3%	11.2%	8.5%
Belarus	9.9	\$6,432	\$203	-1.6%	6.8%	4.5%
Bulgaria	8.0	\$7,274	\$775	0.0%	4.5%	4.8%
Czech Republic (1)	10.3	\$15,669	\$3,709	-5.8%	2.9%	4.0%
Estonia	1.4	\$12,190	\$2,362	0.5%	4.7%	5.5%
Georgia	4.6	\$2,384	\$251	-2.9%	7.0%	5.0%
Hungary (3)	10.0	\$14,574	\$2,089	-5.6%	2.9%	4.0%
Kazakhstan	14.4	\$6,583	\$1,110	-0.9%	9.2%	7.0%
Kyrgyzstan	4.8	\$1,741	\$89	-5.1%	6.7%	4.1%
Latvia	2.3	\$9,683	\$1,435	-2.0%	7.5%	6.0%
Lithuania	3.4	\$11,036	\$1,163	-1.9%	8.9%	6.9%
Moldova	4.3	\$1,906	\$210	0.2%	6.3%	5.5%
Poland (2)	38.3	\$10,854	\$1,105	-6.9%	3.7%	4.5%
Romania	21.7	\$6,974	\$486	-2.4%	4.9%	5.0%
Russia	144.9	\$9,001	\$50	1.0%	7.3%	5.5%
Slovakia (4)	5.4	\$13,363	\$1,873	-3.6%	4.2%	4.4%
Slovenia	2.0	\$19,618	\$1,646	-1.4%	2.3%	3.1%
Tajikistan	6.5	\$996	\$32	0.9%	10.2%	6.0%
Turkmenistan	6.0	\$5,836	\$236	-1.5%	11.4%	9.1%
Ukraine	48.4	\$5,312	\$122	-0.2%	9.3%	6.0%
Uzbekistan	26.0	\$1,645	\$39	-0.4%	1.0%	2.5%

Figure 8: Vital statistics of central and eastern European countries (Source: Sirius & Co Analysis)

basis. Some 20% of the FDI stock represented privatisation (mostly of banks and network utilities). Foreign-owned firms account for more than one-third of industrial employment, nearly half of industrial output and value added, and over 70% of industrial exports.

Hungary's entry into the EU comes on the heels of impressive accomplishments. The country's success has been driven by structural reforms and privatisation during the 1990s, which also facilitated Hungary's outward orientation, FDI inflows, strong export performance, flexible labour and product markets and sound banking system. The success is also rooted in maintaining an adequate level of international competitiveness. Continued productivity growth and wage moderation would support further competitiveness gains, thus helping Hungary to capture a share of the global BPO outsourcing market.

Poland's economy is in a strong position. The prospects for rapid real GDP growth in the near term are good - underlying GDP growth in 2004 was 5.5%. Inflation, despite its recent spike, should not be a threat to economic stability. And the external position is strong. Fiscal reforms and privatisation plans are progressing. Although weaknesses remain (such as, high unemployment, a large fiscal deficit), underlying trends appear to be improving. The favourable economic environment offers Poland an excellent opportunity to move ahead at full speed with

the privatisation program and take a large share of the global BPO market, especially businesses from major EU countries, like Germany, France, and the UK.

Over the last couple of years in Slovakia, output has expanded and inflation has declined, while fiscal and external imbalances have narrowed substantially. Although unemployment remains high, Slovakia's growth record compares favourably with those of other countries - the GDP growth has been around 5% in 2004. The overall output seems recently to have accelerated, supported by an expansion in capacity. These accomplishments reflect, in no small measure, sound macroeconomic management and an improved business climate, achieved through privatising public enterprises, restructuring banks, simplifying procedures for establishing companies, and deregulating the labour market.

So, location is not so "one way" race - especially for companies in Germany, France, Spain, and Nordic countries (see Figure 9) - a significant part of Europe (see *Offshoring practices in European financial services companies* by Pal).

The EU continues to embrace economic reform but still a great deal to do. Most member states prefer growth of productivity to protectionism, prosperity to poverty, freedom to serfdom. A compelling indication of this truth comes from the 2005 Index of Economic Freedom^[7], produced by the Heritage foundation and The Wall Street Journal.

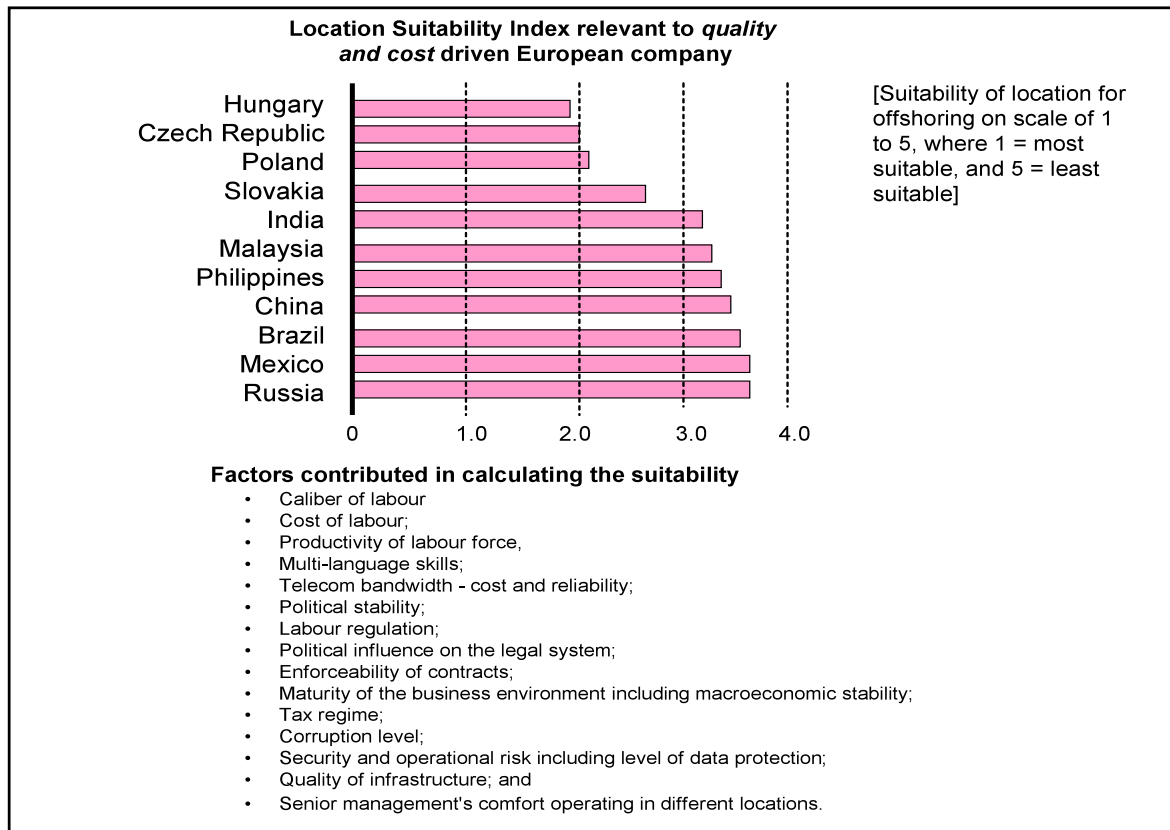


Figure 9: Location is not a one-way traffic for quality and value centric European companies

(Source: Sirius & Co Analysis)

No fewer than 10 of its 20 countries are EU members. Luxembourg, Estonia, Ireland, the UK, and Denmark are all ranked over the US. China is ranked 112th, while India is ranked 118th of the world's freest countries (see Figure 10, where EU members are shown in colour).

The labour costs in the new members of the European Union are on average less than a quarter of the level of the other member states. Employment costs in the EU as a whole are about 15% less than in the US. With the strength of the pound and euro against the dollar, it makes sense for US and western European companies to consider eastern and central European countries as viable offshore destinations. The continued and unprecedented level of salary rise and abnormally high level of attrition rate among Indian ITeS and BPO companies started to bring their labour cost closer to central European business service workers – an important factor in a sector where labour is often a big share of the total costs. In India, average incomes have already soared by 100% over the past decade and they are expected to grow further. But, labour cost is just one variable in a complex cost-reduction equation. Productivity matters, and productivity of BPO and ITeS workers in Europe is higher than in India or China. For many European companies, knowledge of languages other than English - including French, German

and Spanish - is a key consideration in any decision to transfer services offshore. And such skills in these languages are much easier to find in central and eastern Europe than in India or China. Cultural affinity also matters, especially where the service centre staffs are required to deal with customers. Geographic proximity is also important for European companies, especially those that require frequent contacts between the service workers and their customers in the west.

To ensure European countries benefit from offshore outsourcing, policymakers within the EU countries must make labour markets more flexible, improve national productivity rate and reform regulations that stifle competition and innovation.

Improving productivity is not a luxury

Improving productivity is fundamental of a modern economy and vibrant business environment. The current cyclical recovery in the EU is weak; underlying productivity performance is disappointing; and divergences among the EU economies are growing large. The output per hour has grown more slowly in the 15 members of the pre-enlargement EU than in the US since 1995 (see Figure 11). Some of this poor performance may be cyclical, but not all.

RANK	COUNTRY	RANK	COUNTRY
1	Hong Kong	11	Chile
2	Singapore	12=	Switzerland
3	Luxembourg	12=	USA
4	Estonia	14	Sweden
5	Ireland	15	Finland
6	New Zealand	16	Canada
7	United Kingdom	17	Netherlands
8	Denmark	18	Germany
9	Iceland	19	Austria
10	Australia	20	Bahrain

Figure 10: The world's freest countries (Source: The Heritage Foundation; The Conference Board; Goldman Sachs; and Sirius & Co Analysis)

Also, some economies within the EU are floundering.

The worst performing significant economies during the recovery have been the Netherlands, whose quarterly growth averaged 0.3%, and Italy and Germany, whose quarterly growth averaged only 0.2%. The Netherlands had strong growth before the most recent downturn. Germany and Italy did not. In the first quarter of 2005, Germany surprised on the upside, with quarterly growth of 1%, driven by strong exports. But Italy confirmed its role as laggard: gross GDP shrank by 0.5% after a decline of 0.4% in the last quarter of 2004. Italy is also close to the bottom on productivity (though Spain's performance is even worse). Between 1995 and 2004, its output per hour grew at 0.5% a year. This was much worse than the EU-15 average of 1.5%, which was itself far behind the 2.5% of the US. Over the same period, Germany managed 1.8% a year, France 2.1% and the UK 2%. Italy's challenges are far greater. The poor performance of Italy's exports is a function not only of weak productivity performance but also of an unfavourable specialisation of relatively low technology products, furniture, tiles, textiles and shoes, all of which are vulnerable to competition from low-wage countries, such as China and India.

Our analysis suggests that Italy's unfavourable specialisation reflects inadequate internal competition, shown in a weak service sector and undeveloped capital markets, a relatively poor quality of education and a lack of attraction for inward foreign direct investment. The ratio of the stock of inward FDI to GDP is about half that in Germany or France. There has

been no obvious improvement in productivity since 1997 in the UK. People in the UK, for example, produce 10% less than those in France and 25% less than those in the US, but a little more than those in Germany (see Figure 11).

The technology gap that European economies and companies assumed would protect them is not as wide as once thought, and in many cases does not exist at all. The perception that the UK has a knowledge-based economy is misleading. In the 1960s and 1970s, Japanese car and electrical equipment manufacturers, having started from scratch, quickly overhauled their US rivals, who had assumed their technology base made them unassailable. They took what the US was doing and did it better in just a few years. What we are seeing today, in India's ITes and BPO sectors are not too different. In 2005, for the first time, the eurozone will breach the Maastricht fiscal criteria. Budget deficits in Germany, France and Italy have been over 3% of GDP since 2003. It is estimated that the combined budget deficit of all the EMU countries to be 3.1% in 2005. The key to long term reduction of budget deficit is reform.

Reform of Europe is a necessity

What does all this mean? Making the EU business environment work better is not a luxury but a must. If the UK, for example, cannot hold on to a Marconi, then what jobs will be on offer to future generations? Future jobs can only be safeguarded by Europe's continued pre-eminence in

science, technology, and innovations to maintain a lead over China and India. There are excellent scientists and excellent infrastructure in Europe. However, it is a real worry when one considers the long-term impact of Europe's closures of university chemistry and physical sciences departments. Continued investment in primary and secondary education is vitally important. Global competition had put a huge premium on Europe's knowledge base. The key drivers of Europe's competitiveness are science, technology, entrepreneurship, finance, logistics and infrastructure, and education. The UK and the rest of Europe must continue to reinvent itself all the time in terms of technology, to stay ahead. Europe's comparative advantage lie in high value knowledge-intensive services, rather than low cost, labour intensive call centre operations.

In the future, Europe's workforce will need to live on its wits and intellectual capital either finding the kinds of technology to stay ahead of competitors, or providing creative, high end knowledge-intensive services valued by others. The key to Europe's success lies in R&D and innovation. However, European companies record of investing in R&D is poor - R&D spending has increased by just 2% in year 2004-05, while their counterparts in the US and Asia achieved 7% increase (see Figure 12). Sustained investment in human capital and research and development (R&D) are, therefore, absolutely vital.

Currently, EU lags far behind the US and Japan in the number of researchers, in R&D budgets and in investment in higher education. EU business leaders need to create a

framework for academic research and their companies need to work more closely together. They also need to promote cross-boarder cooperation. Rigid labour laws, the rising tide of protectionisms, and outdated EU regulations are all hindering the further development of competitiveness in EU. EU will fail to set up the investment priorities needed to encourage innovation, competitiveness and investment, as long as its members allow narrow and selfish domestic interests to dominate their decision makings (see Figure 13).

Responsibilities on European policymakers are enormous, especially:-

- First, aggregate demand needs to grow faster. Between the last quarter of 2000 and the last quarter of 2004, nominal demand grew at only 3.7% a year, which is too slow. The European Central Bank should pursue a more aggressive monetary policy.
- Second, all economies, but particularly the bigger ones with the EU, need to push through the reforms that will make their economies more flexible, efficient and productive.
- Third, it is the weakest economies that must do most.
- Fourth, EU needs a commitment to sustained structural reform. Employment rates have remained low for the last thirty years. Almost one in ten people in the labour force cannot find a job. Among the young, the ratio is twice as high. Unemployment is leading many people to question the benefits of a more integrated world economy. Central

**Growth of labour productivity per hour
Year 1995-2004 (%)**

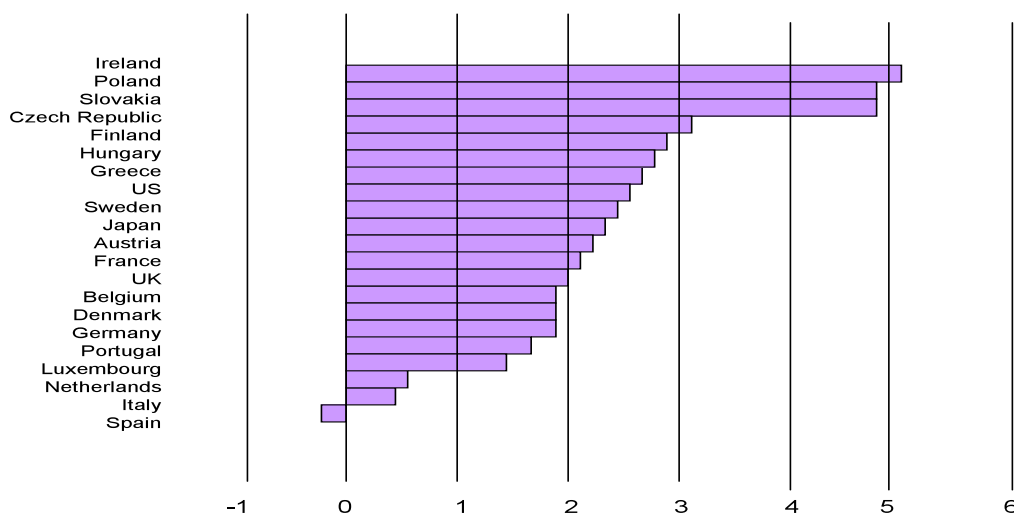


Figure 11: Underlying labour productivity in the EU is disappointing

(Source: WTO, Conference Board, and Sirius & Company Analysis)

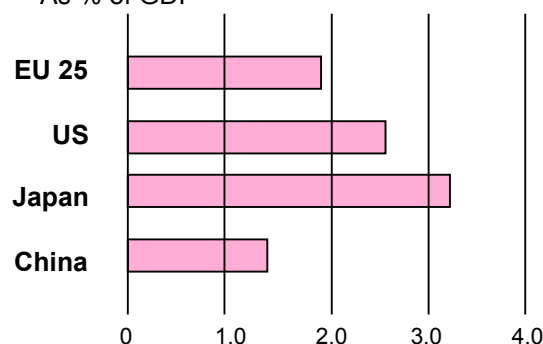
Top 8 R&D countries in 2004

No. of companies with R&D over \$370 million

Country	Changes in 2004 R&D over 2003(%)	Increasing R&D	Decreasing R&D
US (11.2%)*	7	5	17
Japan (6.3%)	4	30	16
Germany (6.2%)	1	11	7
France (8.9%)	3	10	7
UK (9.5%)	1	5	4
Switzerland (13.5%)	10	6	0
Netherlands (7.3%)	3	4	2
South Korea (12.7%)	40	5	0

Total R&D expenditure in 2004

As % of GDP



* = Operating profit as % sales

Figure 12: EU's R&D spending falls further (Source: 2005 R&D Scoreboard: European Commission)

to the issue is the aging of EU's population, which is poised to accelerate over the next four decades. Benefit payments will increase just as the workforce that pays for them starts to shrink. There is great uncertainty about what governments intend to do about these problems, as they have not, for the most part, yet mapped out in any convincing fashion how they intend to address them.

- Fifth, EU governments must strengthen and sustain welfare reform, and raise labor utilisation and productivity. This will require different measures across countries.
 - First, in many of them, pension reform is key. Raising statutory retirement ages by linking them to life expectancy is one crucial step.
 - Second, while governments should continue to support the jobless, they must also strengthen incentives for people to work. In addition, the unemployed need to be supported in their search for new jobs with both better placement services and training.
- Sixth, EU governments also need to reduce the costs

of job creation. Governments could better help people maintain adequate living standards by subsidising work through earned income tax credits. Administrative burdens on companies need to be lowered, particularly with respect to employment contracts.

- Seventh, achieving a better integration of Europe's product and services markets is an essential avenue toward higher growth. More financial integration will enhance competition and efficiency, lower the cost of capital, and improve monetary transmission.
- Eighth, individual countries within the EU need to focus on national solutions. And, policymakers must not lose sight of the considerable added value that comes from acting together^[14].

The EU is a collective endeavour that requires collective responsibility. The time for excuses is over. The world needs a more dynamic EU. But so do the people of the EU itself. Policymakers, who indulge in populist rhetoric instead, are betraying their responsibility to their people, their partners and the world.

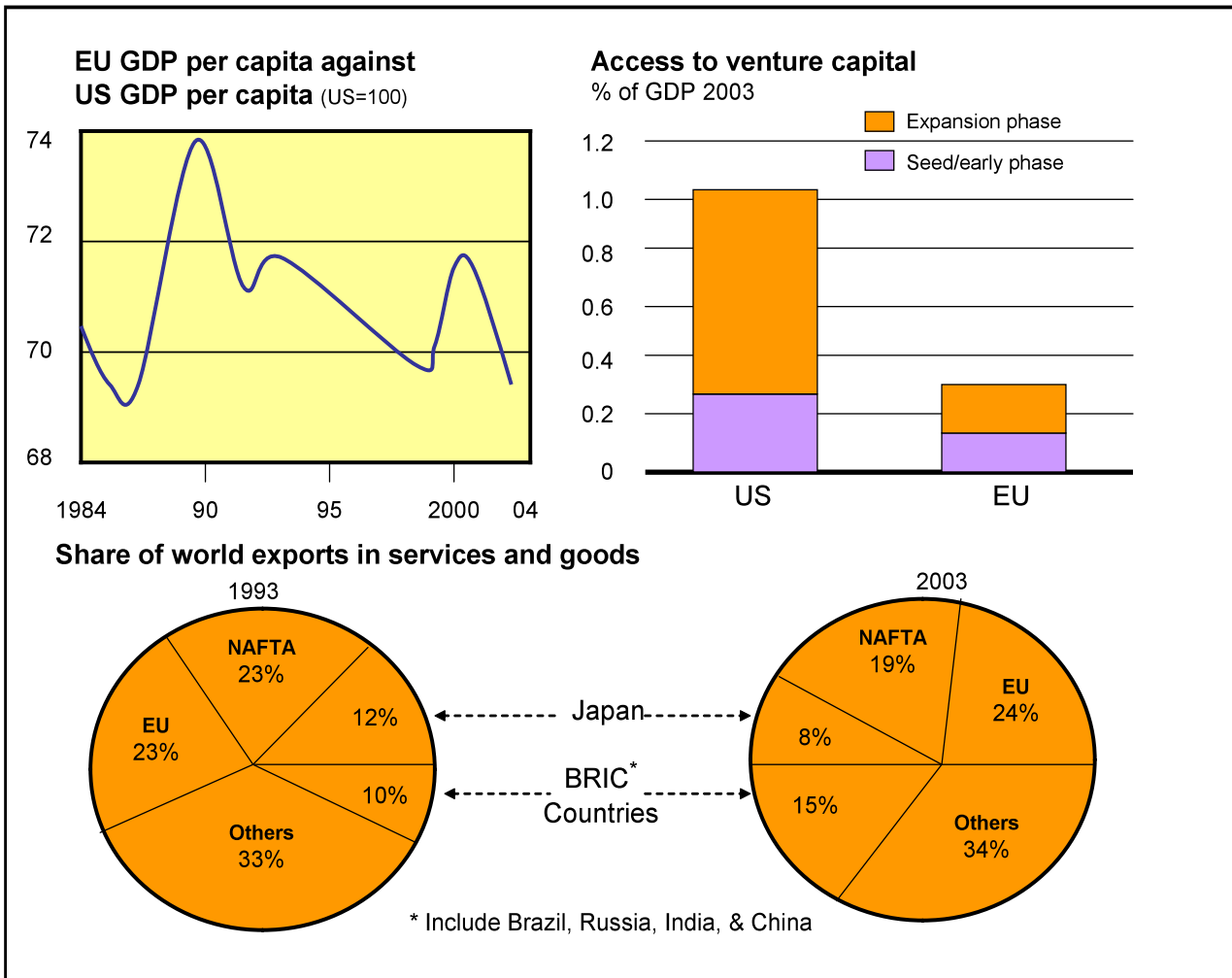


Figure 13: Protectionism and red tape slow European companies progress (Source: UNICE and Sirius & Company Analysis)

Responsibilities on European business leaders are significant, especially:-

- They must drastically improve their working practices in offshore outsourcing initiatives (e.g., sourcing decision making, supplier partnership management, economic value assessment of outsourcing and offshoring, etc.);
- Re-skill their workforce;
- Focus intensely on customer preference, quality, and value instead of just price;
- Skeptical of well known technology research companies and large-scale outsource service providers who have suddenly become “expert” on outsource offshoring matters.

In a highly customer-centric age, which industrialisation of services has brought - value is to price what accounting is to arithmetic. European business leaders will need to revamp their operating and sourcing strategies. Instead of

following the “me too” approach to offshore outsourcing, they must find:-

- New value from existing and unfamiliar sources;
- Unbundling and then radically re-bundling or innovating operational processes and linking them into a seamless service chain (see [Why integrate, when you can aggregate](#) by Pal); and
- Restructuring the organisation to accommodate new kinds of work and skills (see [Don't Re-engineer - Reinvention?](#) by Pal).

People in Europe expect higher salaries and standards of living. To fulfil these expectations, European companies will need to push higher up the value chain, adding more creativity and sophistication to their products and services.

NOTES

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About the author

Sukhendu Pal is the CEO and Managing Partner of Sirius & Company.