

# Business & Financial Services Offshoring in Central and Eastern Europe

Zoltán Gál

Research Centre for Economic and  
Regional Studies, Hungarian Academy of  
Sciences

- 1) Offshoring and its different dimensions?
- 2) How to measure services offshoring intensity in Central and Eastern Europe?
- 3) Emerging new locations and their impacts on CEE countries

# Models and approaches of offshoring

Offshoring = relocation of business activities (earlier in manufacturing, recently in KIBS) „Multi-faceted dimension of complicated geographies, governance & management practices.”

1. **Second global shift (Bryson, 2007):** relocation of services take advantages of tradability of services, quality labour and the geographical variation of service production costs
2. **A new form of trade:** separating tasks alongside the entire value chain in time & space; Productivity, labour supply and positive wage-effects (Grosman & Rossi-Hansberg, 2006)
3. **Fragmentation:** the dispersed global networks in services interpenetrate embedded value chains (Jones & Kierzkowski, 1990)
4. **GPN model:** discussing the governance and multi-actor characteristics of transnational production systems through intersecting notions of power, **intra- & inter-firm networks** and **embeddedness** with understandings of **sub-national regional development and clustering dynamics**.

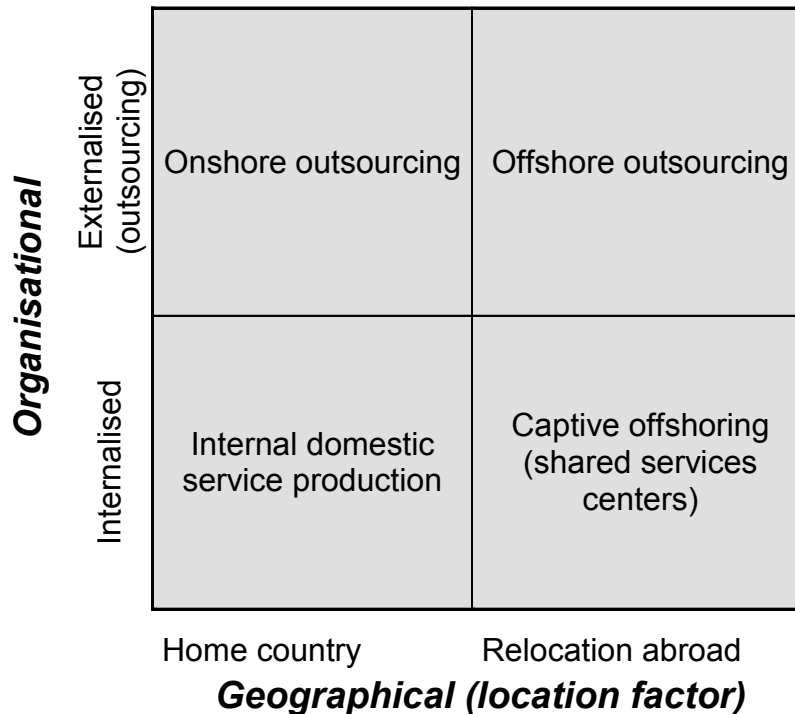
# Offshoring is not a new phenomenon: Second global shift

The new is its application to advanced business & professional services

<b>First global shift (relocation of manufacturing jobs)</b>	<b>Second global shift (relocation of service tasks)</b>
1980-90s first wave	Since the Millenium: new wave
Blue collar jobs	White-collar jobs (skill intensity)
Impacts by industry – manufacturing	Across sectors and across nations – service occupations
Transportation enabled	Internet enabled (tradeability revolution)
Driven by wages	Driven by wages, by new buseiness concept, language, technical training
High capital investment required	Lower capital requirement (proceed faster)
Limited to the particular manufacturing sector	Potentially affects firms in all sectors
Geographically more embedded: stronger links to local suppliers	Geographically more footlose

# Offshoring – Outsourcing


A mix of Organizational/Legal & Geographic dimensions



**Horizontal investments:** demand driven and market seeking operations (CEE: 1990s, financial subsidiaries); Relational value chains between buyer & sellers; requires proximity

**Vertical investments:** across national boundaries, supply & efficiency-driven, and low-cost seeking vertical disintegration of firms' operation among different global locations (SSC, BPOs); CEE from 2000 majority of FDI,

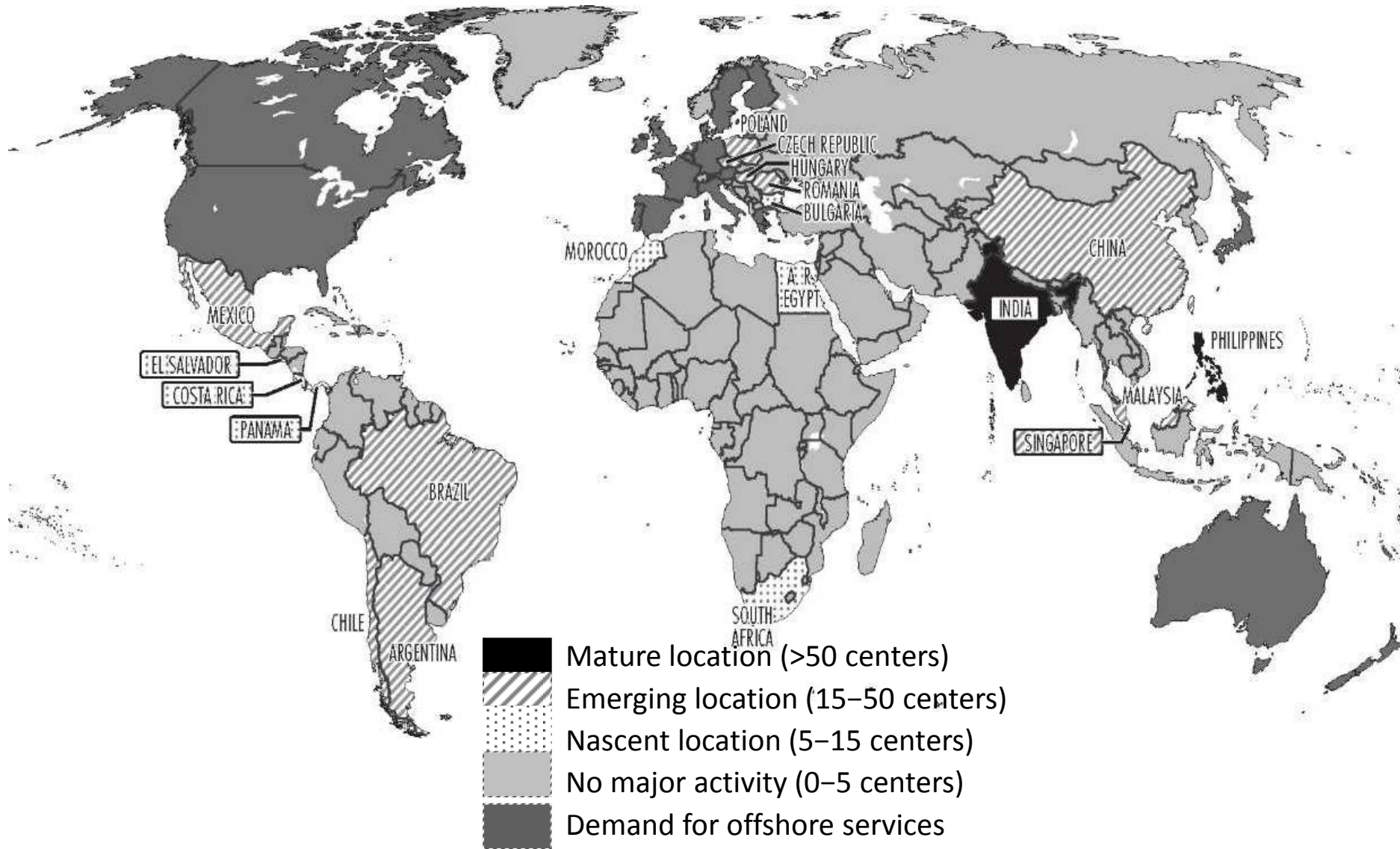
# Activities performed by services centres in CEECs

Back Office Functions	Customer Contact	Common Corporate Functions	Knowledge Services and Decision Analysis	Research and Development
				
<ul style="list-style-type: none"> <li>* Data entry</li> <li>* Data processing</li> <li>* Transaction and order processing</li> <li>* Document management</li> <li>* Inventory management</li> </ul>	<ul style="list-style-type: none"> <li>* Customer relationship management services</li> <li>* Call centre</li> <li>* IT support</li> <li>* Telemarketing</li> <li>* After sales services</li> </ul>	<ul style="list-style-type: none"> <li>* Accounting and financial services</li> <li>* Marketing and sales</li> <li>* IT helpdesk and call centre</li> <li>* Application and infrastructure outsourcing</li> <li>* HR management</li> <li>* Procurement and supply chain management</li> <li>* Audit and tax services</li> <li>* Quality management</li> <li>* Cost planning</li> </ul>	<ul style="list-style-type: none"> <li>* System integration</li> <li>* IT consulting</li> <li>* Business performance analysis</li> <li>* Risk assessment</li> <li>* Programme and project management</li> </ul>	<ul style="list-style-type: none"> <li>* Software development</li> <li>* Software customisation</li> <li>* Testing</li> <li>* Mathematical modelling</li> <li>* System design</li> </ul>

Source: Gál-Sass (2009)

# CEE on the global map

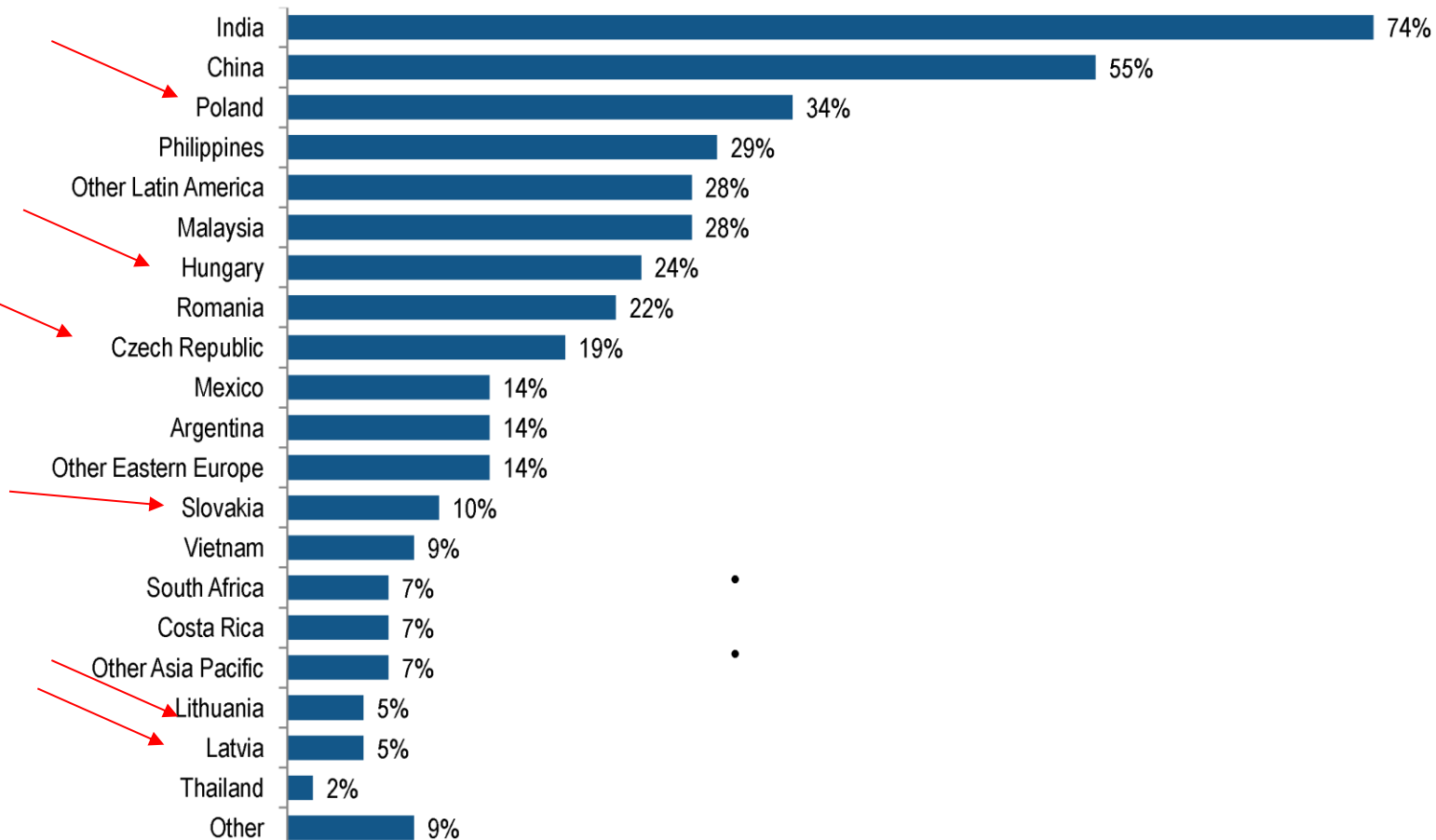
Global supply and demand for offshore services



# Low-cost destination countries on the short list for corporations (CEE is on the field), 2011

Global Service Location Index, 2007 (ranks)

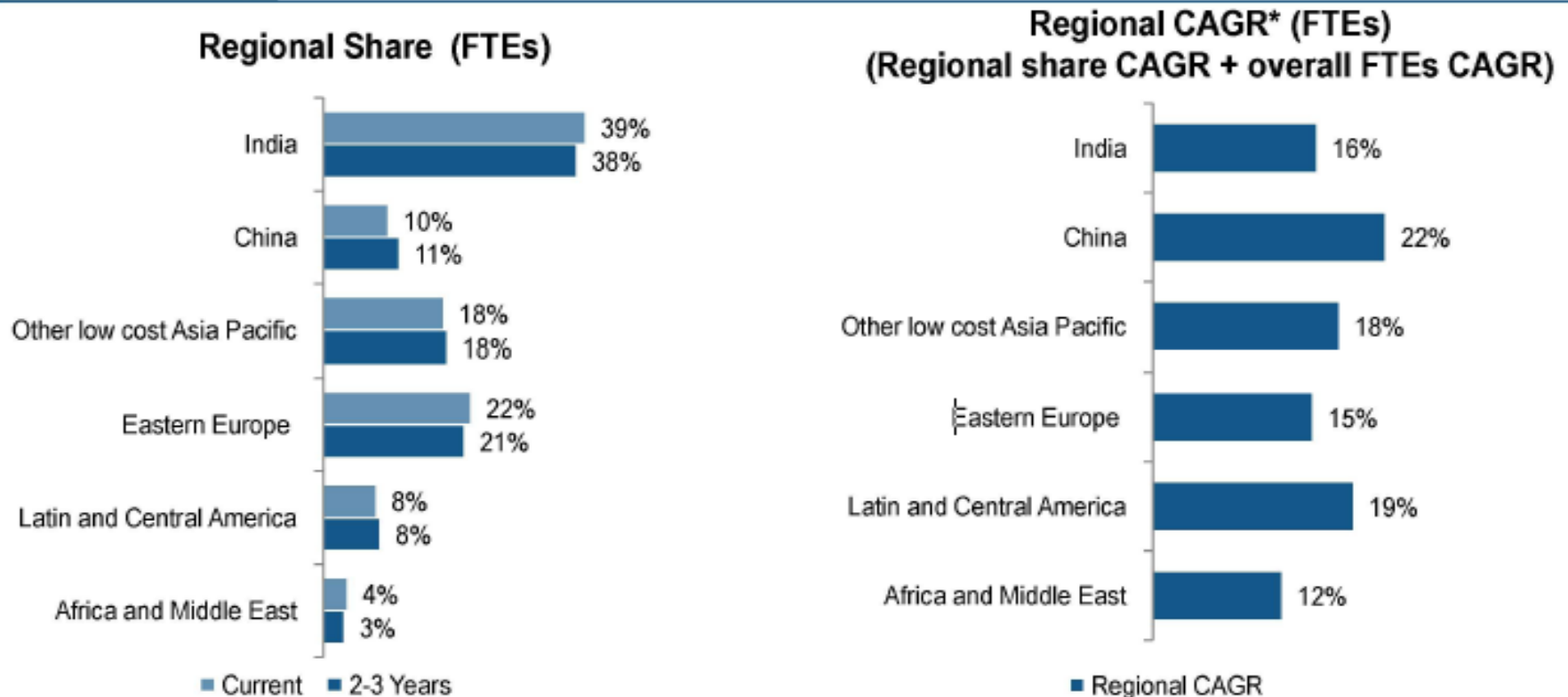
Percentage of companies citing as a potential destination on short list





# Position of Central & Eastern Europe

## Breakdown of globalised FTEs by destination geography and projected growth by region

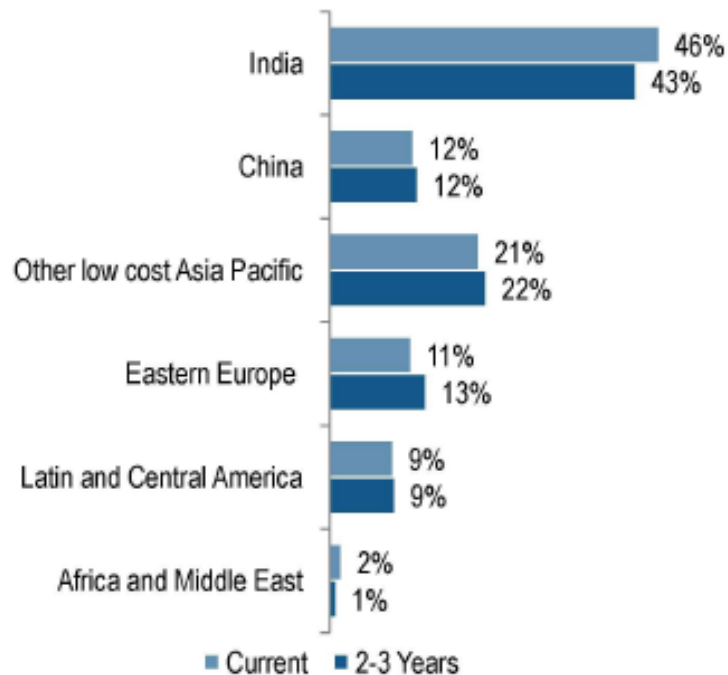


- India's market share as a globalised business services (GBS) destination geography will decline slightly, but it remains the overwhelming largest destination
- Because of overall volume growth of globalised resources, India will nonetheless experience substantial growth of 16%.
- China is the only destination anticipating growth in "share," which combined with overall volume growth results in 22% growth for the region.

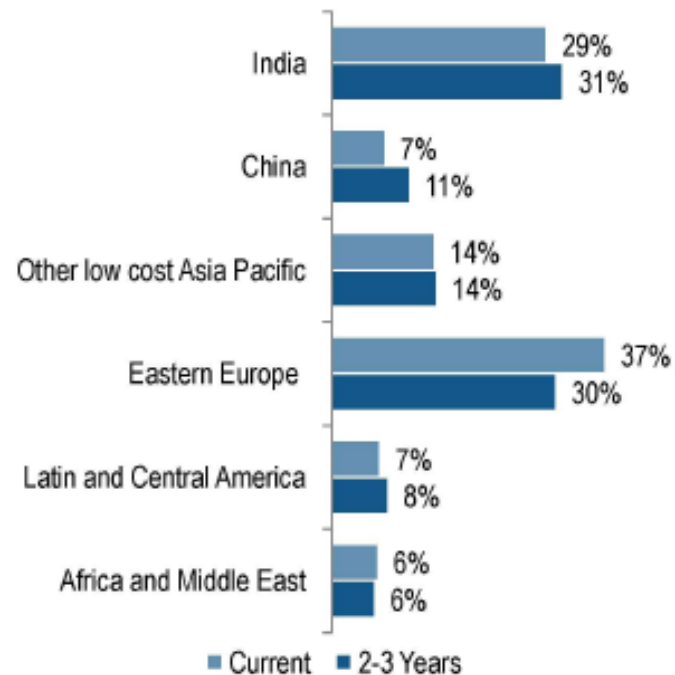
# Position of Central & Eastern Europe

## Breakdown of globalised FTEs by destination geography for US/Canadian and Western European companies

Regional Share (FTEs) – US / Canada HQ Companies



Regional Share (FTEs) – Western European HQ Companies



- Predictably, Europe-headquartered companies are the predominant source for Eastern European sourcing destinations, even exceeding India in absolute levels of globalised resources.

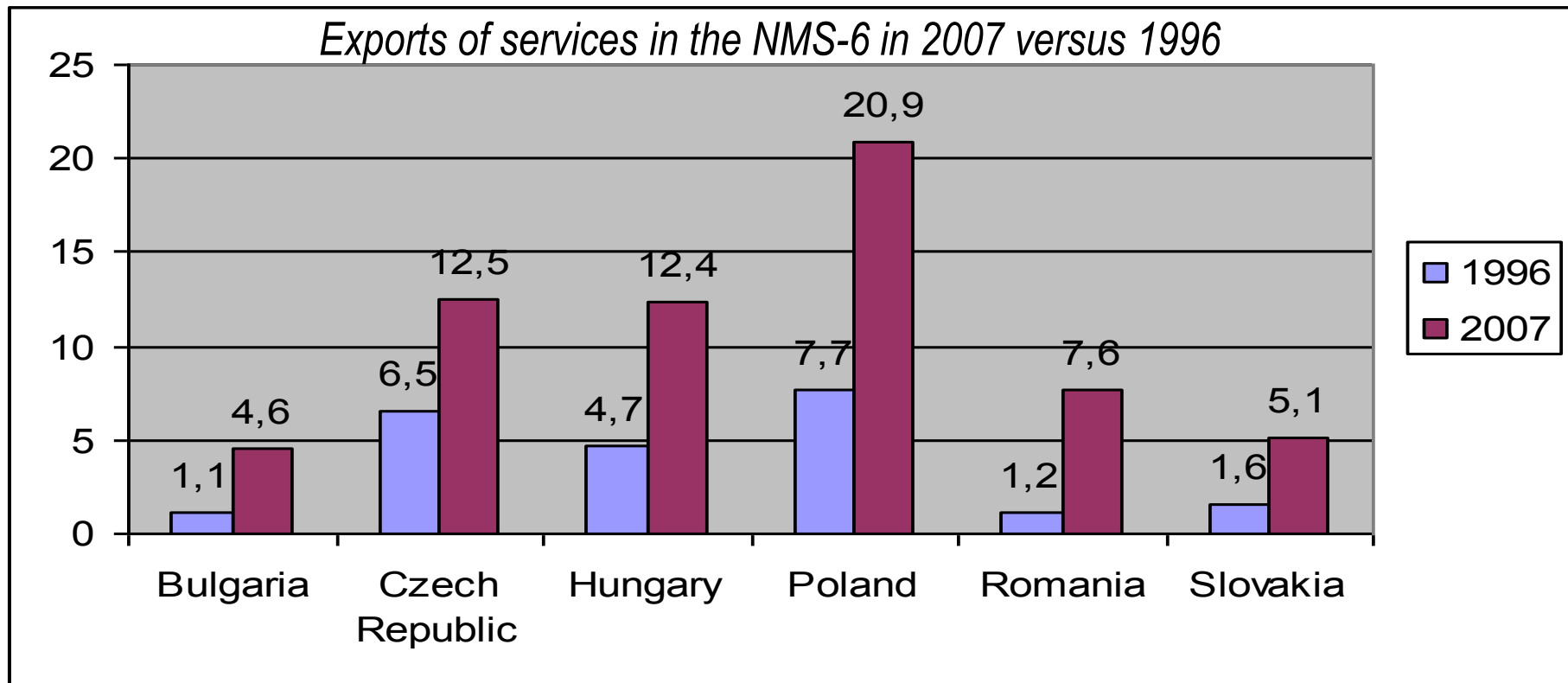
# Statistical problems

- No direct statistical data/measures available, proxies used
1. FDI – problems: not all related to it (offshore outsourcing less connected to FDI); high level of aggregation, general data problems; usually small/diverse amounts invested into services
  2. Number of projects: wide varieties in sizes (employment data better proxy (Hunya, Sass, 2005))
  3. Jobs – problems: not separated BPO and SSC-related, „trade in tasks” approach: real content
  4. Foreign trade data: in principle the best (traded services), general data problems, these lines in BOP used for other purposes, high level of aggregation (many problems of profit repatriation (reexport), many transactions may remain unnoticed, reporting, exchange rates, transfer pricing, statistical shortcomings etc.)

# How to measure offshoring?

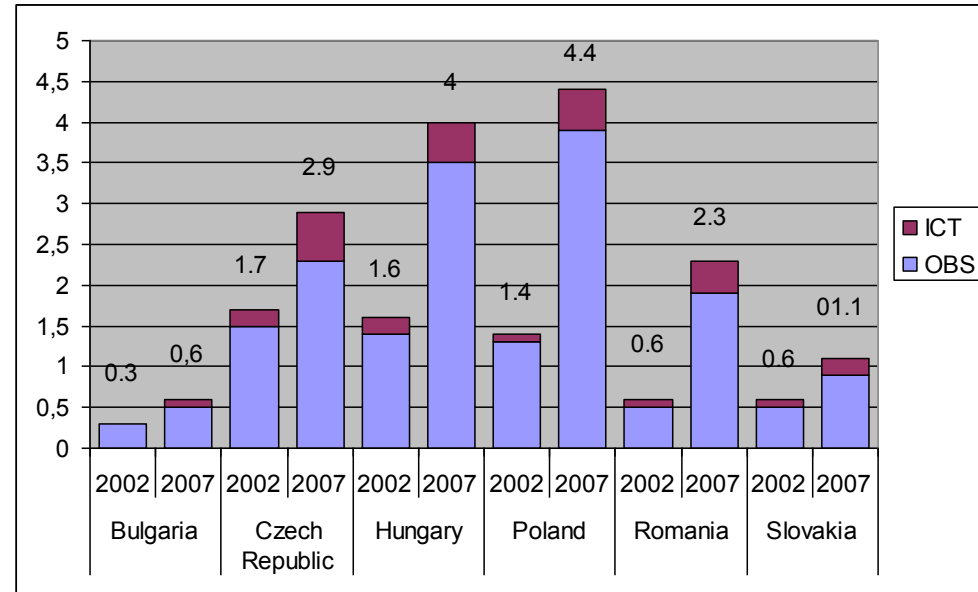
## Exports in services in the NMS-6

- Share of the region in global offshoring: 2.5% in 2003
- 5 % of service-related FDI projects invested in CEE
- High growth in services exports (63 Bn EUR, 2007)
  - 2.8% in global service export

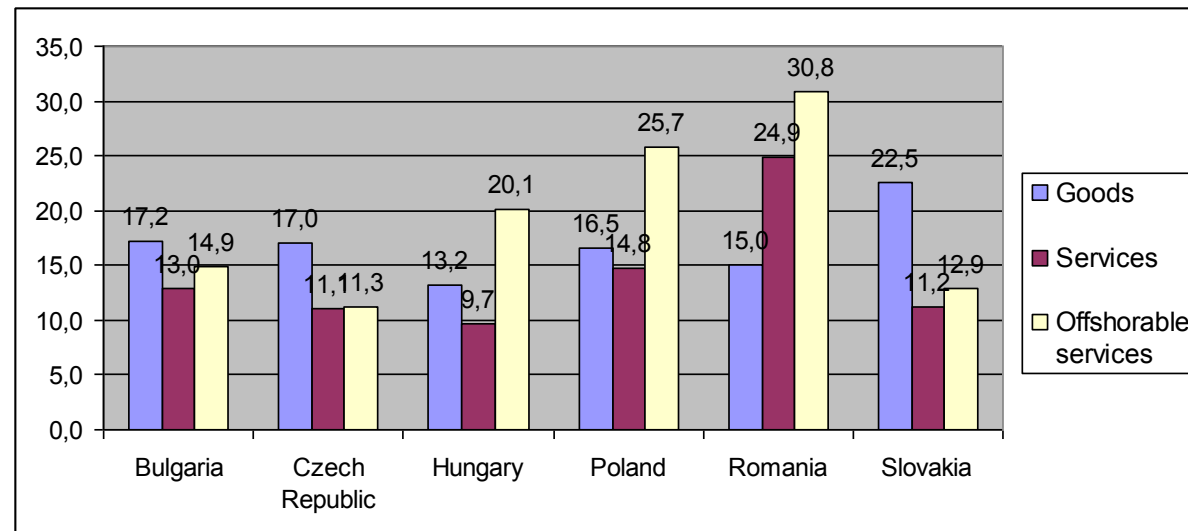


# Position of Central & Eastern Europe in services export

- 15 billion EUR (2007) 3 times higher than in 1996
- Overwhelming dominance of business services



- Share of offshorable services grew from 16 to 24% (2002-2007)



# Locational advantages



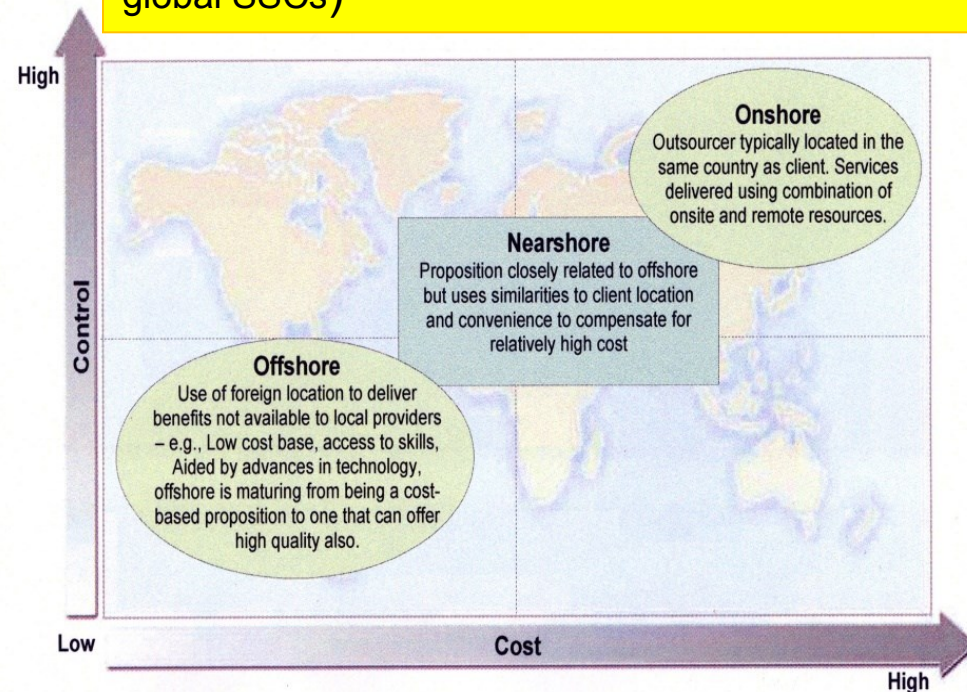
- Vertical type: the most important is the factor, which is used intensively: skilled labour at relatively low price (specificity: language knowledge)
- Vertical type: other factors related to the reduction of the costs of disintegration of production
- Geographical proximity/same/similar time zone in some cases (nearshoring),
- General: other factors generally influencing FDI (economic environment, etc.)

# New global hot spot in service trade: nearshoring advantages in Central and Eastern Europe

Nearshoring: relocation of services to a short distance (same continent)

1. New global service 'delivery models': demand for new locations
2. New higher value functions require more interactions (customer-facing)
3. Geographical, political & cultural ties: easing communication (Common cultural understanding)
4. High standard of education with certain constraints
5. Wage differences
6. Multi-lingual workforce

CEE region's share was 1% in 2004 (lagging behind Asia)  
Services related FDI 60%-of the total (70% in Czechia)  
In 2006 22% of services FDI projects went to the region  
CEE is emerging location: in Europe there are 1600 SSCs of which 444 is found in CEE (10.5% of global SSCs)



# Comparative advantage of CEE in labour cost

**Table 2.** Comparative labour costs in selected countries, 2003 and 2006

	Average hourly labour costs (€)		Average gross annual earnings (€)	
	2003	2006	2003	2006
EU27	19.7	19.8	30,347	31,302
United Kingdom	23.5	32.3	38,792	44,495
Germany	26.8	27.6	37,200	39,364
Spain	14.2	15.7	28,847	31,368
Portugal	9.6	10.9	13,349	14,892
Czech Republic	5.4	7.1	6,137	8,284
Slovakia	4.0	5.3	4,944	7,039
Hungary	5.1	6.3	6,447	7,865

Source: Eurostat.





# Location advantages 1

- **Strategic Locations:** determine which countries are chosen as hosts to new or relocated service centres (based on Dunning (1983) OLI-paradigm)
- **Knowledge advantage:** availability and cost of qualified labour efficiency seeking investments (costs and availability of appropriately trained or trainable skilled work in the required quantity); language knowledge (specific: other than English European languages, „small” European languages (including Turkish in Hungary))
- **Quality infrastructure:** specific: infrastructure (mainly telecom), office space;
- **Political & business environment:** availability of certain services (financial etc.), good regulatory and business environment, protection of IP,
- **Government incentives:** Very limited role of incentives (mainly for bigger projects)

# Location advantages 2 – inside the region

**Specific advantage:** knowledge of „smaller” languages, good geographical position

Poland stands out with its size (bigger projects), location (NE, Baltics)

Czech Republic: central location, best flight connections, specialisation on IT

Hungary: minor languages (minorities in neighbouring countries), good location (CEE, towards SEE)

Choosing among the three countries is based on:

- Earlier presence of the company;
- Previous good (or bad) experience with the country;
- Choice is influenced by the relative dynamism, success of local affiliates;
- Special language requirements;
- Active lobbying of the local affiliate;
- Quality of life, culture, English schooling etc. in the target city, especially in cases when expatriates are involved



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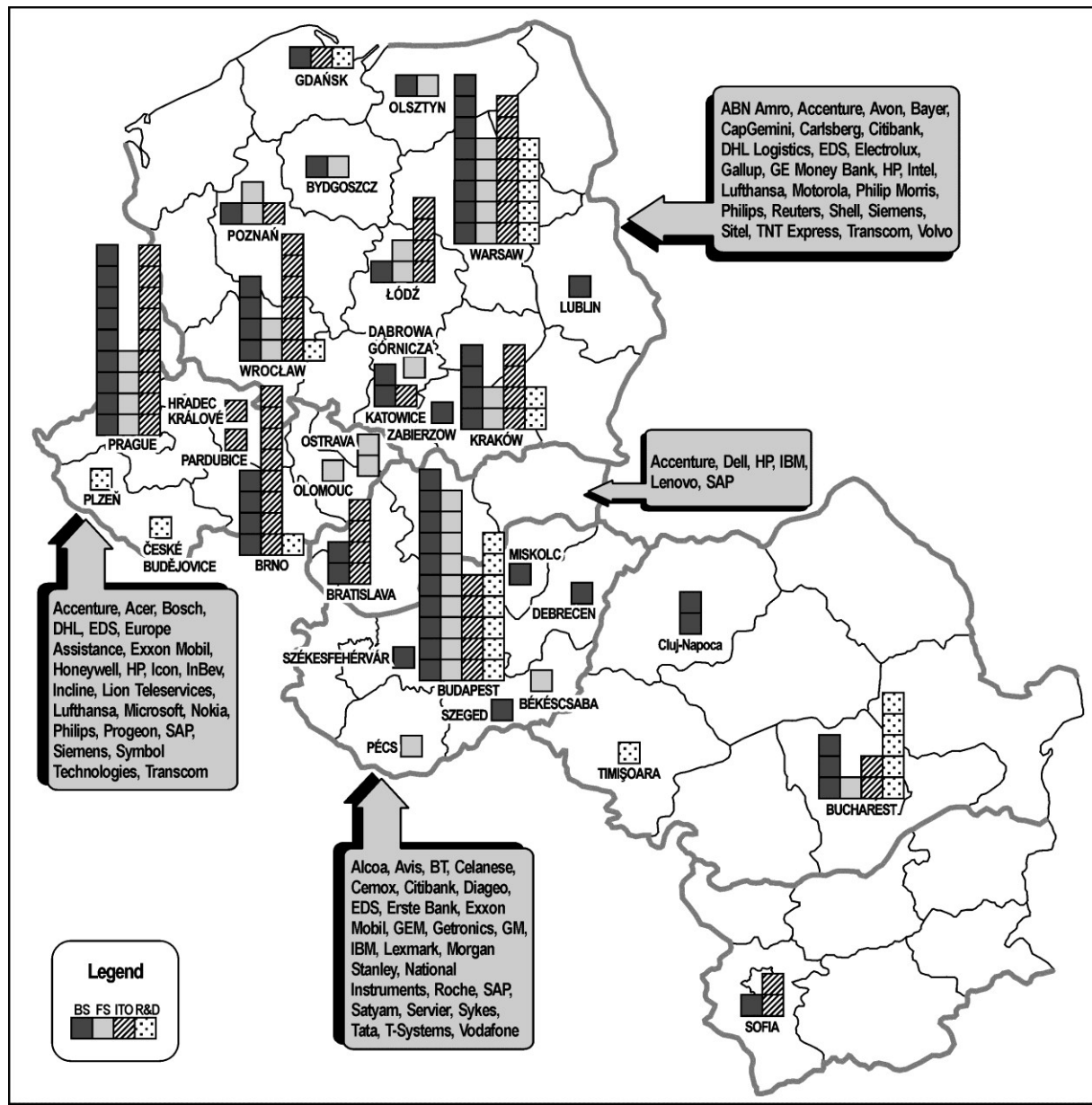
[www.polishinvestforum.pl](http://www.polishinvestforum.pl)



# Geographical clustering

- Capital cities are the main hosts to business services companies, vertical and horizontal types alike (the earliest investment hubs)
- Movement towards to 2nd tier locations with universities outside the capital cities The largest clusterization in Budapest
- The most successful decentralization in Poland
  - In CEE there are 40-50 undiscovered midsize locations with quality graduates supply which are characterized by lower cost, reliably infrastructure, less outmigration

# Offshore services location in CEE, 2008



# Impact on the local economy

1. Raising demand for skilled labour (job creation)
2. Linkages and other local contacts
3. Impact on the business environment
4. Impact on local infrastructure and services
5. Technology spillovers
6. Mobility of trained employees (spillovers)
7. Competition impact
8. Regional impact



SWS Poland, a newly opened service centre of the Irish outsourcing firm in Łódź (Poland)

# Impact on the host economy 1

## **Job creation**

- Significant impact: in Hungary approx. 20-22 thousand people working in BPO (incl. captive)
- Medium to high skilled jobs (very little unskilled) for young university graduates, usually with (multiple) language knowledge
- Activities carried out: table (overtrained...), though VA/output among the highest in services
- Shortage of properly trained employees in all 3 countries – wages growing very fast (high attrition rate)
- Spreading out to the countryside (from the beginning in Poland, now in the Czech Republic and Hungary)

## **Linkages and other local contacts**

- (Very) limited backward linkages (cleaning, security, cafeteria, etc., little substantial outsourcing)
- Forward linkages come as local companies become more „mature”, as competition is more intense (in Hungary seems to be more important compared to the other two countries)
- Contribution of linkages to raising the level of competitiveness/productivity of local companies: very limited

# Impact on the host economy

## **Impact on the business environment, infrastructure**

- Competition for appropriately trained employees is intense: companies are more active locally, than „ordinary” FIEs (participation in local business associations, links with universities)
- Intense use of local infrastructure: in some cases results in better services

## **Spillovers through trained employees**

- This seems to be one of the most important local impacts
- Trained employees in certain cases set up their own enterprises or go to work to domestic companies
- Not only skills, but business culture, business ethics are transferred through (former) workers



# Impact of the crisis



## Two counteracting forces:

- Demand effect: reducing offshoring/offshore outsourcing because of falling demand (in order to keep employment/sales at the parent company)
- Substitution effect: increasing offshoring/offshore outsourcing in order to reduce costs further because of increased competition
  - Until 2007, economic growth offset part of the jobs lost to productivity improvements and globalization, resulting in a relatively small number of net job losses.
  - Also, even as HR, IT, finance and procurement jobs disappeared, other sectors of the economy picked up the slack, largely driven by the real-estate boom and expanding financial services sector.
  - “Rationalization” of finance activities resulted in large improvements in productivity but also the acceleration of the movement of work offshore.
- Net outcome of the two?
- Question of sustainability and embeddedness
  - Danger of “backshoring”,



# Conclusion

CEEs/Visegrad countries increasingly involved in business services relocation/outsourcing (**Evidences of cluster formation**)

- Regional impact is limited: concentration of SCs still in few cities (e.g. Hungary, Slovakia)
- Strengthening regional /local embeddness: Poland (cluster formation),

From a competitiveness point of view business services related projects in CEE (*raising the competitiveness of overall EU-27*)

- Contribute to the formation of a better domestic business environment, in some cases availability of high quality services for domestic companies (forward linkages)
- Local contacts- backward linkages (suppliers): minimal, though, esp. forward linkages increasing over time
- Job creation for medium to high skilled, (though overtrained, partly due to the language knowledge requirement) spillovers through employees (skills, culture, ethics, own SMEs)
- Significant impact on the BOP, though due to methodological problems, it is difficult to quantify separately for these projects (FDI, FT-balance, profit repatriation etc.)

Offshoring somewhat a temporary phenomenon

- Requires strong policy responses
  - National and local policy incentives, special graduates programmes