Chapter 9
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"The Offshore Services Value Chain:
Developing Countries and the Crisis"

GLOBAL VALUE CHAINS IN A POSTCRISIS WORLD

A DEVELOPMENT PERSPECTIVE

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THE OFFSHORE SERVICES VALUE CHAIN: DEVELOPING COUNTRIES AND THE CRISIS

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Over the past decade, the offshore services industry has experienced tremendous growth, emerging as a dynamic global sector that involves both developed and developing nations. Structural changes in the global economy precipitated by the information and communication technology (ICT) revolution have allowed emerging nations for the first time to contribute significantly to the world's services industry. No longer relegated to manufacturing and natural resource-intensive industries, developing countries now have an important opportunity to advance both their economic and social conditions. The global economic crisis of 2008–09 highlighted an important characteristic of the offshore services industry for developing countries: the industry demonstrated significant resilience to downturns as a result of its principal *raison d'être*—to lower costs for all industries around the world, which leads to a constant search for lower-cost destinations. This dynamic thus opens up opportunities for new countries to enter this global value chain (GVC).

The offshore services industry, incorporating the trade of services conducted in one country and consumed in another, has transformed the way companies do business by allowing for the separation of the production and consumption of services. The scope of the industry has evolved over time, and increasingly sophisticated activities are being exported. What began with the outsourcing of basic information technology (IT) services to external firms now includes a wide array of activities known as business process outsourcing (BPO), knowledge process outsourcing

(KPO), and other advanced activities in the GVC such as research and development (R&D) that were previously considered core functions of the firm.

As a result of cost arbitrage advantages, developing nations are leaders in many of these offshore services, and the industry has become an important source of employment and economic growth around the globe. Early market entrants rapidly specialized in service areas in which they have a competitive advantage. As they upgraded to higher-value activities, new countries joined the industry at lower points in the value chain. This shift provides emerging economies with an opportunity to drive sustainable growth through the expansion of the knowledge economy and to reduce their traditional dependence on manufacturing and natural resource industries.

The recent economic crisis highlighted the weaknesses of economies based on commodities and sent an urgent call for structural changes in order to attain development (Bárcena 2009). Unlike many other industries, offshore services are typically business-to-business and based on multiyear contracts that buffer the sector to a certain extent from slumps in consumer demand and the accompanying negative macroeconomic factors. This delayed the impact of the economic crisis on offshore services, which first registered lower demand during the last quarter of 2008 and the first three quarters of 2009. This sustained growth is essential for developing economies to protect the development gains they have achieved.

The economic crisis had two key effects on the offshore services industry. First, during the recession, the “demand effect” resulted from a contraction of demand for services from existing customers as business slowed around the world. This effect led annual growth rates in offshore services to decrease significantly. Second, there was a simultaneous “substitution effect,” which involved the substitution of lower-price services (for example, those contracted in India) for the higher-price services originally carried out inside companies in developed economies. The “substitution effect” mitigated the negative impact of demand contraction as new clients began to adopt offshoring practices in order to lower costs and improve efficiencies. The response of the offshore service providers was to diversify both service center locations and client bases, improve cost structures, and provide innovative solutions. The net result was that while demand for offshore services dipped in response to the crisis, annual growth rates remained above 15 percent in large developing-nation providers such as India and the Philippines.

This chapter describes the development of the offshore services industry using the GVC framework to identify the opportunities for market entry for developing nations. It examines the structural changes that were taking place in business services prior to the crisis and provides an analysis of the effects of the crisis on the industry and on the various segments of the value chain.

The Offshore Services Industry: A GVC Approach

Having emerged rapidly in the past decade, offshore services now encompass an array of activities ranging from call centers to research and development services. The various segments and activities of the industry are identified and categorized here using a GVC framework. While the lack of official data makes it difficult to quantify the size of the industry, it has become clear that more companies are unbundling corporate activities, including services, using a variety of business models.

Key Concepts

The first stage in disaggregating the global services market is to categorize services based on the categories “outsourcing” and “offshoring.” These concepts distinguish the location of and control over the organizations contracted to perform the tasks. Outsourcing is the act of contracting a function or service from a legally separate unit outside the boundaries of the company, rather than using the company’s own internal resources and capabilities (in-house transactions). Offshoring is providing all or part of a function or service by entities outside national, rather than firm, boundaries. Offshoring is particularly important for policy makers and firms in developing countries.¹ Figure 9.1 shows different business models or trajectories that may develop in the outsourcing and offshore services industry (Sako 2005).

The first scenario (arrow 1) illustrates a firm’s decision to outsource services locally. Arrow 2 shows the decision to outsource to a foreign provider instead of a

Figure 9.1 Business Models in Outsourcing and Offshore Services

Source: Sako 2005.

domestic supplier (as in arrow 1). Arrow 3 shows the trajectory for a firm's decision to outsource services to a foreign supplier. Arrow 4 shows the firm's decision to move its service provision to a foreign affiliate or subsidiary. The final scenario (arrow 5), shows the shift from a foreign affiliate or subsidiary to provision of services by a foreign supplier (third-party providers). The most beneficial spillovers for host economies in terms of technology and higher-skilled jobs tend to occur in the process of changing from "captive offshoring" (upper right quadrant) to "third-party offshoring" or "offshore outsourcing" (lower right quadrant), as indicated by arrow 5 (Sako 2005).

The complex process of choosing an appropriate business model, that is, determining a firm's geographic location and level of control, depends on the nature of the service, size of investment required, entrepreneurship, local knowledge of the firm, and internal experience (BCG 2007). Governance patterns within this value chain² are beginning to emerge based on business models and supplier selection, and future research in this area will likely provide insight into the growing power of multinational offshore providers from developing countries like India.

Classification of the Offshore Services GVC

The services industry has evolved continuously since its inception, making efforts at categorization challenging. Despite these complexities, a fairly comprehensive, yet flexible, classification of the industry has emerged employing the global value chain (GVC) framework (Gereffi and Fernandez-Stark 2010). The GVC framework uses firm-level analysis to determine the different stages of production of a good or service and the value of each component (Gereffi et al. 2001). For manufacturing and extractive industries based on goods, value-added is determined by the difference between the cost of the inputs and outputs at each stage of the chain. In the case of the offshore services industry, measuring value is complicated by the lack of reliable company-level data and trade statistics for services (Sturgeon and Gereffi 2009). To partially address this problem, the value of different services can be related to employee education level and work experience (Gereffi and Fernandez-Stark 2010). By indicating the human capital required at different levels of the offshore services GVC, this classification system provides decision makers in developing countries with an instrument to determine where they may be best suited to enter the GVC in order to achieve their desired outcomes.

Figure 9.2 illustrates the GVC for the offshore services industry (Gereffi and Fernandez-Stark, 2010). This classification scheme makes it possible to identify the various types of offshore service activities, to show which firms participate in

Figure 9.2 The Offshore Services Global Value Chain

Source: Center on Globalization, Governance and Competitiveness (CGOC), Duke University, Durham, NC.

Note: DSP = digital signal processor; IP = intellectual property.

a. Industry-specific vertical activities: Each industry has its own GVC, within which associated services can be offshored.

b. This graphical depiction of vertical activities does not imply value levels. Each industry may include information technology outsourcing, knowledge process outsourcing, business process outsourcing, and other advanced activities.

which industry segments, and in turn, to locate the most important regions of the world in the industry's development.

The classification system works as follows. The first division is services that can be provided across all industries (horizontal activities), including information technology outsourcing (ITO), business process outsourcing (BPO), and knowledge process outsourcing (KPO). The second division refers to services that are industry specific (vertical activities). Firms operating in the horizontal services tend to be process experts, while those in the vertical chains must have industry-specific expertise and their services may have limited applicability in other industries. In horizontal services, all activities are related to supporting generic business functions, such as network management, application integration, payroll, call centers, accounting, and human resources. In addition, they include higher-value services, such as market intelligence, business analytics, and legal services (referred to as KPO in this chapter).

Within horizontal services, ITO contains a full spectrum of low-, middle- and high-value activities of the offshore services chain; BPO activities are in the low and middle segments, while KPO activities are in the highest-value segment of the chain. The value of each activity is correlated with human capital (education level), that is to say, lower value-added services are performed by people with fewer years of formal education. Call centers or routine BPO activities, for example, can be performed by employees with a high school diploma. Market research or business intelligence is typically carried out by employees with a minimum of a bachelor's degree, while the highest-level research and analysis is carried out by employees holding specialized masters degrees or PhDs.

This categorization can provide development agencies with an instrument for market entry based on the current educational level of their workforce. It also provides an initial blueprint for economic upgrading strategies within the industry. Developing countries that aim to provide services within certain segments of the GVC must evaluate their workforce development strategies and implement policies to build human capital for those segments, be it language skills for the call center market or promoting a doctoral program or advanced training for R&D activities in a specific industry.

Size of the Industry

The global offshore services industry is growing substantially, and no consensus has been reached on how to collect data that correspond to appropriate definitions of services. The rapid evolution of the industry has impeded attempts to categorize it, complicating the measurement of the offshore services themselves, and official statistics do not provide accurate quantitative assessment either (ECLAC

2009; UNCTAD 2009). Generally, countries do not collect data for these service exports, there is a relatively small number of trade classification codes to accurately identify service activities, and companies have little incentive to disclose this information (Sturgeon and Gereffi 2009). In addition to this dearth of available and reliable data, the different methodologies adopted to quantify the size of the offshore services industry have resulted in widely varying estimates from disparate sources.

Table 9.1 provides a list of estimates from private consulting firms, business associations, and international organizations. Two clarifications must be made at this stage:

1. *Outsourcing versus offshoring*: Some organizations, such as the global consulting firm Gartner, have measured the entire outsourcing industry, with respect to both domestic outsourcing and offshore outsourcing. These numbers for outsourcing are generally higher because they include both outsourcing and offshoring services. Another set of organizations, Organisation for Economic Co-operation and Development (OECD), Boston Consulting Group (BCG), and NASSCOM³-Everest, have measured only offshore services (their estimates range from US\$101 billion to \$157 billion for 2008).
2. *Activities included*: This chapter analyzes three industry segments: ITO, BPO, and KPO, along with more specialized, higher value-added service activities, such as engineering services and R&D. The size estimates in table 9.1 differ in the segments they include. Some provide estimates for just the ITO and BPO segments (for example, the McKinsey estimate), while others include higher value-added services in the BPO category (this is the case for the Gartner and BCG estimates). Generally, the high-value services segment is the most difficult to quantify; thus, it may be underrepresented here since some of the activities may not be included.

According to OECD (2008) estimates, the size of the offshore services market will reach \$252 billion in 2010. The OECD stresses, however, that growth rates will be different in each segment of the GVC (see figure 9.3). The OECD study, published before the economic crisis began in early 2008, projected that the global demand for BPO services, especially those related to call centers, along with those in the financial services industry, was expected to triple between 2005 and 2010, and IT services were expected to continue growing at a similar pace. The demand for other high-value service activities was expected to reach \$31 billion by 2010. This growth translates into a compound annual growth rate for the KPO segment of 58 percent between 2005 and 2010, much more than the expected growth rates for the demand of the BPO (25 percent) and ITO (26 percent) segments.

Table 9.1 Global Offshore Services-Market Size Estimates, 2005–10

Source	Market	Activity	Revenue (US\$, billions) Year					Comments
			2005	2006	2007	2008	2009	
OECD (2008)	Global offshore services		81.4	100.8	125.6	157.4	198.6	Includes ITO-BPO and other high-value service activities
NASSCOM (2009)	Global offshore services		44.25	59	78.3	101	117.5	Includes ITO-BPO and other high-value service activities. "Derived from a 40% share of market from India." ^a
BCG (2007) Based on IDC data	Global offshore services	ITO BPO Total	19.2 27.4 46.6	22.7 42.3 65.0	26.9 65.1 92.0	31.9 100.3 132.2	37.3 154.5 191.8	BPO includes other high-value service activities.
Gartner (2009b)	Global outsourcing and offshoring services	ITO BPO Total					268 156 424	BPO includes other high-value service activities.
NASSCOM & Everest (2008)	Global offshoring BPO	BPO					26–29	

McKinsey & Company (2006)

Global offshoring ITO-BPO

ITO
BPO
Total

16.7–19.6
9.8–12.3
26.5–31.9

McKinsey calculates the offshoring market potential with a range. They state that the market has captured only 10% of its full potential.

ITO: \$147 billion–\$178 billion (captured only 11%)

BPO: \$122 billion–\$154 billion (captured only 8%)

From these estimates we have calculated the real market size in 2005.

22% of the global BPO market is offshore.

A.T. Kearney (2009b)

Global offshoring BPO

30

Source: Center on Globalization, Governance and Competitiveness (CGGC), Duke University, Durham, NC; based on A.T. Kearney 2009; Chakrabarty, Ghandi, and Kaka 2006; Harris 2009; NASSCOM 2008, 2009; OECD 2008; BCG 2007; Young et al. 2008.

Note: BPO = business process outsourcing; ITO = information technology outsourcing; KPO = knowledge process outsourcing; OECD = Organisation for Economic Co-operation and Development.

a. Based on the reports from BCG (2007) and the NASSCOM-Everest study in 2008. BCG estimated that Indian market share was 46 percent in 2007, while the NASSCOM-Everest estimate lies between 41 and 46 percent (NASSCOM 2008).

Figure 9.3 Global Demand for Offshore Services, by Activity, 2005–10

Source: OECD 2008.

Note: BPO = business process outsourcing; CAGR = compound annual growth rate; IT = information technology; ITO = information technology outsourcing; KPO = knowledge process outsourcing; R&D = research and development.

At the country level, as can be seen in map 9.1, the most mature providers of offshore services are India and the Philippines, with more than 50 centers in each country, followed by emerging nations, including Chile, the Czech Republic, and Malaysia. In addition, new locations are beginning to compete in the industry, such as the Arab Republic of Egypt, Morocco, and South Africa.

The supply of global services is highly concentrated among a small group of firms from a handful of countries. As shown in table 9.2, 13 of these firms are headquartered in North America, 4 in India, and 3 in Europe. The large global service providers operating in the offshore industry—Accenture, Capgemini, Computer Sciences Corporation (CSC), EDS (HP Enterprise Services), and IBM—are principally dedicated to serving large multinational corporations and governments (Datamonitor 2009). All these firms have operations in developing countries that serve as platforms for services exports. In 2007, Accenture employed more people in India than anywhere else in the world.⁴ By 2006, IBM had 60,000 employees in India, and Capgemini employees there had reached 12,000 (Dossani and Kenney 2007).

The Offshore Services Industry's Potential for Developing Countries

The offshore services industry has emerged just within the past 20 years. The ICT revolution at the end of the 20th century allowed developing countries to enter this market with great success. India and the Philippines have already reached market maturity, while countries in Eastern Europe and South America are in the early to middle stages of development. In many of these nations, offshore services have been the fastest-growing industry in recent years. This has led to significant positive externalities for local economies, such as knowledge transfer, more and better jobs, access to new markets, and infrastructure improvements.

The offshore services industry provides opportunities for many developing countries that are striving to diversify and upgrade their economic activities. The global industry is still in its nascent stages, and the vast majority of its potential remains largely untapped. The McKinsey Global Institute's labor supply report in 2009 estimated that up to 161 million workers' jobs can be performed remotely. It states that "any task that requires no physical or complex interaction between an employee and customers or colleagues, and requires little or no local knowledge, could be performed anywhere in the world by a suitable qualified person" (McKinsey Global Institute 2009).

Figure 9.4 illustrates the significant growth potential of the offshore services industry. The shaded bars represent the adoption of offshore practices in the years 2003 (darker) and 2008 (lighter). In just five years (2003–08), this industry

Map 9.1 Global Supply and Demand for Offshore Services

Source: Center on Globalization, Governance and Competitiveness (CGGC), Duke University, Durham, NC; based on data from Everest 2009 and Datamonitor 2009.

Table 9.2 Top-20 Offshore Services Providers

Rank	Company/country	Total sales, 2008 (US\$, millions)	Total employees	Total services sales, 2008 (US\$, millions)	Main services activities
1	IBM—United States	103,630	398,455	58,892	Consulting, IT services, application, and outsourcing services
2	Accenture—United States	23,171	177,000	23,171	Consulting, IT, and outsourcing services
3	Electronic Data Systems Corporation (EDS), now HP Enterprise Services—United States	22,100	139,500	22,100	IT, applications, and BPO services
4	Computer Sciences Corporation (CSC)—United States	16,740	92,000	16,740	IT services (software management), BPO in customer relationship management (CRM), supply chain management, and KPO in legal matters
5	Capgemini—France	12,740	89,453	12,740	Consulting, IT, and outsourcing services
6	Automatic Data Processing (ADP)—United States	8,867	45,000	8,867	BPO (human resources, payroll, tax, and benefits outsourcing)
7	Affiliated Computer Services—United States	6,523	76,000	6,523	ITO and BPO in CRM and human resources management; also e-Government
8	Logica (formerly LogicaCMG)—United Kingdom	6,577	39,525	6,320	Business consulting, IT, and BPO services
9	Tata Consultancy Services—India	6,048	111,407	5,824	Consulting, IT, engineering, and BPO (includes KPO) services
10	Infosys Technologies—India	4,717	105,453	4,533	IT, engineering, consulting, and BPO services (knowledge and legal services)

(continued next page)

Table 9.2 continued

Rank	Company/country	Total sales, 2008 (US\$, millions)	Total employees	Total services sales, 2008 (US\$, millions)	Main services activities
11	Wipro Technologies—India	5,645	98,521	4,234	Consulting, IT, and BPO services
12	CGI Group—Canada	3,673	25,500	3,673	Consulting, IT, BPO, and systems integration services
13	Hewitt Associates—United States	3,228	23,000	3,228	Human resource consulting and outsourcing
14	Cognizant Technology Solutions—United States	2,816	68,000	2,816	Consulting, IT, and BPO services
15	Convergys Corporation—United States	2,786	75,000	2,786	BPO (customer care—call centers)
16	Perot Systems—United States	2,779	23,100	2,779	Consulting, IT, and BPO services
17	Teleperformance Group—France	2,605	102,186	2,605	BPO (customer care—call centers)
18	SITEL—United States	1,700	66,000	1,700	BPO (customer care—call centers)
19	Ceridian Corporation—United States	1,695	8,776	1,695	Payroll services and human resources management solutions
20	Genpact Ltd.—India	1,041	36,200	1,041	IT and BPO services
Total		240,210	1,815,519	192,267	

Source: Center on Globalization, Governance and Competitiveness (CGGC), Duke University, Durham, NC; based on OneSource, companies' Web sites and companies' annual reports.

Note: BPO = business process outsourcing; CRM = customer relationship management; HRM = human resources management; IT = information technology; ITO = information technology outsourcing; KPO = knowledge process outsourcing.

Figure 9.4 Actual and Potential Adoption of Offshore Practices

Source: McKinsey Global Institute 2009.

Note: Adoption of offshoring assesses the current and projected levels of offshoring to low-wage countries within a sector. Theoretical maximum global resourcing potential describes the percentage of a sector or function that may be performed remotely. Global employment is measured in thousands of jobs.

has demonstrated rapid growth. However, the dotted bar presents the vast opportunities that still exist to offshore activities across different industries. The graph also highlights the emergence of new segments in the GVC, including industry-specific offshoring in retail banking and the health care industry.

Nonetheless, global employment in offshore services had already reached 4.1 million by 2008 (McKinsey Global Institute 2009). This growth is being driven by an increasing number of business procurement services abroad to improve their efficiency levels in the global economy, enter new markets, and gain access to strategic assets in other countries (Lopez, Ramos, and Torre 2008). They are attracted to developing countries by competitive advantages, such as low human resource costs, technological skills, and language proficiency (AT Kearney 2007), as well as time zones and geographical and cultural proximity to major markets (ECLAC 2008).

Operating in the same time zone helps facilitate connections between companies, optimizing time and accelerating decision making. In addition, as more sophisticated jobs, such as new product development, R&D, and other knowledge-intensive activities, are performed abroad, the supply of scientific, engineering, and analytical talent offered by developing countries becomes more important (Duke Offshoring Research Network and Booz&Co. 2007).

Structural Changes Facilitating Offshore Services Growth

As the offshore services industry continues to expand—based to a large degree on low-cost yet educated labor forces around the world—developing nations have the opportunity to emerge as important players. Structural changes in the world economy during the past decade have facilitated this explosive growth and suggest that this shift of offshore service work to the developing world will be permanent. These changes are summarized as follows.

- Information technology (IT) now allows for quick and easy information transfer, eliminating the need for on-site operations. This has allowed many developing countries with basic IT infrastructure to enter the global economy and export services all over the world. India has updated its IT infrastructure and now is able to perform remotely almost every service requested.
- Companies looking to reduce costs have unbundled their corporate functions, such as human resources management, customer support, accounting and finance, and procurement operations, and have offshored these activities (Gospel and Sako 2008). This reduces the burden of support activities and allows firms to focus on their core business. These support activities are mainly IT and BPO activities; for example, many multinational corporation (MNC) customer support operations are being offshored to the Philippines.
- In recent years, core activities have also begun to move offshore. Many firms today look beyond low cost to talent in order to drive R&D activities. For example, many pharmaceutical contract research organizations from India and China are offering their services to giant pharmaceutical MNCs, such as GSK, Lilly, Merck, and Novo, among others (Gupta 2008; Wadhwa et al. 2008). This reflects the capabilities of developing countries entering the GVC, not only at the production level but also in creating the knowledge behind the products.

Developing countries have recognized this economic opportunity, and many are actively encouraging the development of the offshore services industry. Countries are offering different services according to their skill level. For example, Chile is working to position itself as an innovation center; already one-third of the country's offshore

services are in engineering services (IDC Latin America 2009). Other countries in Latin America, such as El Salvador and Honduras, focus on call centers.

Impact of the Economic Crisis on the Offshore Services Industry

The global economic crisis of 2008–09 has had a tremendous negative effect on almost every industry in the world. Its impact, however, has been less severe for the offshore services industry. Two opposing effects have been seen: some companies have frozen offshore contracts, while other companies have offshored additional services in order to remain competitive by lowering their costs. Perhaps most significantly, demand slowed from financial service institutions, the offshore industry's key client, requiring suppliers to lower costs and improve efficiency to bolster sales. These two conflicting effects are explained in the next section.

Further, the economic crisis has affected distinct segments of the GVC to different degrees. In horizontal activities, IT and BPO services have been affected more than KPO services. Vertical activities reflect the level of impact of the economic crisis in their respective industries. The impact of the economic crisis in the offshore services GVC is analyzed later in the chapter. The overall effect reveals an industry that is still growing, although at a slower pace than previously and showing signs of recovery.

A recent Forrester report explains that companies react differently in their IT plans during an economic slowdown, depending on the model adopted in each organization. Some companies will face more cost pressure; others will react according to their business or may encounter more pressure to innovate and be competitive in their industry. Figure 9.5 illustrates the different categories of firms and the strategies that companies can consider, depending on their business model⁵ (Andrews 2008).

According to Duke University's Offshoring Research Network (ORN) findings, companies are continuing to implement their plans to offshore some of their functions, despite the global economic crisis, and may even accelerate these strategies (Lewin et al. 2009). Figure 9.6 illustrates the changes identified by ORN in the key drivers of offshoring decisions as a result of the economic crisis. The results of the survey conducted in November 2008 show that the most significant driver in decision making about offshoring is "taking out costs," in other words, labor cost savings (see figure 9.6). Reducing labor cost in companies from developed countries directly boosts the competitiveness of developing countries in the offshore services industry.

The second most important change in offshoring services reported by ORN is the decision to offshore in order to enhance efficiency by redesigning business

Figure 9.5 How Firms Respond to the Economic Crisis

Source: Andrews 2008.

Note: ROI = return on investment.

Figure 9.6 Changes in Key Drivers of Offshoring Decisions, November 2008

Source: Center on Globalization, Governance and Competitiveness (CGGC), Duke University, Durham, NC; based on Lewin et al. 2009.

processes and to strengthen existing organizational capabilities for managing offshoring strategies. To achieve this goal, the ORN study suggests that companywide strategies should be developed to help increase organizational flexibility, service quality, and above all, to achieve further cost savings.

Although access to qualified personnel continues to be an important driver, during the crisis, this factor had lower relative effects compared to cost (Lewin et al. 2009). The economic crisis is temporarily offsetting the search for global talent as a major driver for offshore services. However, the ORN study also argues that the slowing demand for talent can be explained by increased unemployment fueled by the economic crisis, which has made such talent more available domestically.

On the supply side, the economic crisis has also forced service providers to reduce prices, which has decreased both annual hires and salaries. The recession has increased the motivation of providers to improve the efficiency and quality of their services. Some providers have found new opportunities as a result of the crisis by engaging in innovative solutions for their clients. Providers are reevaluating their value proposition to their customers, and they have been forced to develop out-of-the-box services (NASSCOM Newslines 2009).

Table 9.3 shows the revenue growth of offshore service providers both before and during the economic crisis. The largest decline in provider revenues was during the April–June 2009 trimester. Almost all companies show negative growth rates compared to the same period in 2008. Accenture's revenues dropped 16 percent in that period, while those of IBM declined by 13.3 percent. Providers from developed countries show a sharper decline than providers from India (Tata

Table 9.3 Offshore Services Revenues by Provider, July 2007 to September 2009 percent, year-to-year comparison

Provider	Economic crisis									
	Jul-Sep 07	Oct-Dec 07	Jan-Mar 08	Apr-Jun 08	Jul-Sep 08	Oct-Dec 08	Jan-Mar 09	Apr-Jun 09	Jul-Sep 09	
Accenture	27.0	18.1	17.2	18.9	17.7	6.0	-6.6	-16.0	-16.1	
IBM	6.6	9.9	11.2	12.8	4.9	-6.4	-11.4	-13.3	-6.9	
Computer Sciences Corporation	11.3	14.3	10.9	15.6	5.5	-5.0	-8.3	-12.1		
Automatic Data Processing	13.5	14.7	11.8	10.4	9.5	2.5	-2.2	-4.5	-3.6	
CapGemini		21.00		14.4		0.2		-12.7		
Logica		27.60		16.3		-1.0		-20.1		
Affiliated Computer Services	7.8	5.9	7.1	6.2	7.5	6.7	4.4	5.1	4.5	
Tata Consultancy Services	40.3	37.4	30.3	23.4	17.1	0.5	-5.3	-4.3	-3.2	
Wipro	55.6	54.7	45.8	41.3	22.3	0.2	-8.4	-10.5	-3.7	
Infosys Technologies	36.1	34.9	33.6	27.8	22.2	9.7	-0.9	-4.0	-6.7	
CGI Group	14.6	15.1	19.0	13.1	3.3	-9.6	-17.8	-13.6		
Hewlett Associates	5.6	9.8	7.6	7.0	7.3	-3.1	-3.5	-6.4		
HCL Infosystems	26.6	27.7	13.6	-5.5	-8.8	-21.9	-19.8	-9.5	-10.9	
Cognizant Technology Solutions	48.0	41.4	39.7	32.7	31.5	25.5	16.0	13.3	16.2	
Convergys Corporation	0.1	-0.9	-0.5	-2.5	-3.9	-1.4	-3.0	-1.0	13.2	

Source: Center on Globalization, Governance and Competitiveness (CGGC), Duke University, Durham, NC; based on OneSource, Hoovers, companies' Web sites and annual reports.

Consultancy Services, Wipro, Infosys Systems). The July–September 2009 trimester showed signs of recovery.

Many leading services providers from the developed world have more employees in emerging nations than in their own countries. This trend has accelerated during the recession. In order to mitigate the effects of the economic crisis, large providers have decided to expand their operations to developing countries and to reduce their personnel located in rich economies. These actions will help cut provider costs because salaries in emerging economies are just a fraction of those in developed countries. For example, IBM laid off more than 4,000 U.S. workers in January 2009 and moved these positions to developing economies, including Brazil, China, the Czech Republic, India, Mexico, the Russian Federation, and South Africa. To reduce negative social effects, the company created Project Match, in which laid-off U.S. workers with strong employment records could be relocated to the countries mentioned above, although with local salaries and employment conditions (McDougall 2009). Table 9.4 shows a select list of offshore services providers from the United States, Europe, and India that have reported layoff and hiring activities during the economic crisis.

The hiring and layoff activities reported in table 9.4 include changes implemented at the global level; however, hiring trends have been concentrated in the developing countries, with most retrenchments and layoffs occurring in developed economies. For example, Accenture announced they will hire 8,000 people in India during 2010, and Wipro added 3,500 workers in India and the Philippines between 2008 and 2009. Genpact hired almost 3,000 people in Guatemala, India, Morocco, the Philippines, Poland, Romania, and South Africa during 2009, and the company was planning to hire an additional 10,000 workers in early 2010. On the other hand, in November 2009, Logica, the British offshore services company, laid off 2,200 workers in the United Kingdom from their 40,000-worker labor force. Some of the growth effects noted for these leading companies reflect the acquisition of a large number of small companies, absorbing additional employees. This consolidation is one of the main effects of the economic crisis and was expected to continue in 2010.

The consolidation of this industry as a result of the economic crisis has also had an impact on the two most mature destinations: India and the Philippines. By the end of 2009, India controlled approximately 45 percent of the offshore services market, while the Philippines saw impressive growth in the five years leading up to the crisis. The section below highlights this impact on service supply in these developing nations, focusing in particular on the decline in attrition rates.

High employee attrition is one of the most pressing problems of the industry, specifically in India, and it is also affecting the market in the Philippines. In the Philippines, a survey carried out in mid-2009 revealed that 79 percent of the offshore

Table 9.4 Select Offshore Services Provider Hiring and Layoff Actions during the Economic Crisis, Late 2008 to Early 2010

Company	Date	Laid off	Hired	Action	Location
Accenture United States (Ranking: 2)	Mar 2009	500		Crisis effect	Manila, Philippines
	Aug 2009		100	Rehiring some of the people laid off	Philippines
	Aug 2009	300		Crisis effect and restructuring	Worldwide
	Oct 2009		NA	Acquisition to serve new sector	United States
	Feb 2010		NA	Acquisition	Rio de Janeiro, Brazil
CSC United States (Ranking: 4)	2010		8,000		Mostly in India
	Late 2008		20		India
	Nov 2008		5		Tianjin, China
	Early 2009	98		Acquisition to serve local customers	East Greenbush, NY, U.S.
	Aug 2009		550	Acquisition to serve local customers and strengthen existing sector	Brazil
Capgemini France (Ranking: 5)	Sept 2009		65	New center to offer shared services	Albany, NY, U.S.
	April 2009	56		Layoff of managers	Irving, CA, U.S.
	May 2009	100		Layoffs of middle management	Chennai, India
	Jun 2009		45	New center to perform IT help desk support and business continuity work	Iasi, Romania
	Nov 2009	85		Layoffs of middle management	Dallas, TX, U.S.
Logica United Kingdom (Ranking: 8)	Nov 2009		10	New center	Bangalore, India
	Jan 2010		200	New BPO to serve local customers	Katowice, Poland
Wipro India (Ranking: 11)	Apr 2009		NA	New International Utilities Competence Center	Portugal
	Oct 2009		NA	New center on IT-based solutions	Chennai, India
	Nov 2009	2,200		Laid off for restructuring	United Kingdom
	Sept 2008	1,000		Laid off for restructuring	India
	Dec 2008		2,500	Acquisition to follow customer	India
Genpact India (Ranking: 20)	2009		1,000	New center	Philippines
	Q3 2009	630			
	Nov 2009		100	New center, IT and BPO	Chengdu, China
	Jan 2010	85		Layoffs in telecom R&D sector	Finland
	2009		2,400	New center	Guatemala, South Africa, Philippines, Romania, Morocco, India
	Mar 2009		500	New center to serve customers in EU	Lublin, Poland
	Oct 2009		70	New remote operations center	Hyderabad, India
	2010		10,000		Worldwide
	Feb 2010		1,200	Acquisition	India and United States

Source: Center on Globalization, Governance and Competitiveness (CGGC), Duke University, Durham, NC; based on company Web sites, company press releases, news articles, and reports from consulting firms.

Note: Ranking refers to the top-20 offshore services companies (see table 9.2). BPO = business process outsourcing; EU = European Union; IT = information technology; R&D = research and development.

services providers had noted attrition rates as the “same,” “decreasing,” or “decreasing significantly” (Philippine Daily Inquirer 2009). During the crisis, India saw a reduction in the attrition rates, to levels similar to those of three years ago. According to a survey by IDC and Dataquest, India’s average IT sector attrition rate decreased from 18 percent to 15 percent in 2009 (Business Standard 2010). For the last quarter of 2008, the attrition rates for TCS, Wipro, and Infosys were 11.9 percent, 11.9 percent, and 11.8 percent, respectively. Just one year earlier, the rates were 11.5 percent, 20.1 percent, and 13.7 percent, respectively, for the three IT majors (AbhiSays.com 2009). There was general consensus among senior management from the Indian offshore services providers that the highlight of the difficult 2008 crisis year was the decline in attrition rates. Alok Aggarwal, chairman and cofounder of Evalueserve, a KPO firm, noted that “attrition in the offshore outsourcing industry came down significantly and Indian employees became more realistic about their expectations and about their careers. The current expectations will be able to provide a more sustainable, long term growth for the Indian offshore-outsourcing industry” (BPOWatch India 2008).

Overall, the economic crisis has had various effects on offshore services. Some clients have frozen contracts, while others have demanded additional services in order to reduce costs. Providers have responded to the changing demands by employing a number of different strategies to reduce their own costs, including lowering salaries, opening offices in cheaper locations, and finding innovative solutions to enhance efficiency. As a result, even more activities are being moved to developing countries, both from developed nations to India, and also from India to other developing countries, due to labor arbitrage (substituting cheaper workers for more expensive ones) and the search for talent. The structural changes that facilitated the initial development of the offshore services industry have accelerated during the economic crisis, and these changes will likely become entrenched in future years.

Substitution Effect Versus Demand Effect

During the recent global economic crisis, the offshore services industry suffered two conflicting effects.⁶ The first is the “substitution effect” whereby activities are relocated to cheaper locations, leading to the growth in offshoring. The “demand effect” is a decrease in demand from the industry’s clients that were affected by the recession and consequently reduced their offshoring services.

Substitution Effect

In a globally competitive environment, companies use different strategies to reduce costs. Unbundling activities and relocating them to countries that have

lower labor costs has gained popularity in the past 10 years. In other words, there has been a substitution effect, moving activities from high-cost locations to lower-cost locations. This phenomenon has continued during the economic crisis. Indeed, some countries have seen acceleration in the offshore services industry.

According to *The 2009 A.T. Kearney Global Services Location Index*, the economic slowdown may increase the number of clients that use offshoring in their search for cost reductions. The report also notes that new offshore operations tend to be more efficient because they are not constrained by the bureaucracy in place in onshore facilities (A.T. Kearney 2009b).

A recent study on human resources (HR) outsourcing (Hewitt Associates 2009) says that HR departments will maintain their strategies aimed at outsourcing HR services despite the economic crisis. One-third of the companies surveyed indicated that they were more inclined to outsource compared to two years ago because of the cost reductions and improved efficiencies. In 2006, the same survey showed that the most important activity for HR managers was to “attract, retain, and grow talent,” whereas the 2009 survey found that their number one impetus is to “reduce operating costs” (Hewitt Associates 2009). The U.S. consulting firm Deloitte, for example, is planning to hire 15,000 people in India over the next three years. The company’s global chief executive Jim Quigley explains: “The global economic crisis is also an opportunity to expand and acquire assets at attractive valuations” (Current IT Market 2009a).

A country case example of the substitution effect is the Philippines, which has seen accelerated growth in offshore services in the past three years, despite the global financial crisis. According to the Business Processing Association–Philippines (BPAP), the offshore services industry in 2006 generated approximately US\$3.3 billion in revenues and employed more than 235,000 people. Further, the association estimates that by the end of 2010, the industry will reach US\$13 billion and will employ close to 1 million people (BPAP 2007).⁷

A key factor explaining this sustained growth is that the services being carried out in the Philippines are considered “nondiscretionary spending,” that is, services essential to maintaining a company’s business operations.⁸ The country is now one of the leading destinations worldwide for call centers, as well as finance and accounting outsourcing. According to the Call Center Association of the Philippines, call centers generated US\$5 billion in revenues in 2009 and employed more than 275,000 people (Villafania 2009). The capital Manila has already become the world’s largest city destination for BPO activities (Vashistha and Nair 2010). Its large workforce, low costs, and significant English-speaking population make it a key destination for these services. A number of Indian providers have opened up call center operations in the Philippines during the past two years, to diversify their operations base and further lower costs.

The offshore services industry in the Philippines began less than 10 years ago and showed growth rates from 2004 to 2007 on the order of 50 percent annually (see table 9.5). During the crisis, the information technology–BPO services revenue growth rate declined to 24 percent in 2008 and 18 percent in 2009. However, comparing the same indicators in India (see table 9.6), the Philippines presents higher growth rates in both industry revenues and employment. In 2009, the growth rate for offshore services employment in the Philippines was 19 percent compared to India's 11 percent.

The past two years have confirmed the consistent rise of the Philippines as a leading BPO destination. In the opinion of some market experts, the crisis has accelerated the takeover of India's back office supremacy by the Philippines (SiliconIndia 2009). In 2007, India had more than 300,000 call agents, while the Philippines had just half of that. Today, India and the Philippines have equal strength with 350,000 employees each in call centers (Economic Times 2010).

According to a survey of BPO providers conducted by the Business Processing Association of the Philippines and Outsource2Philippines, 49 percent of executives said that in 2009–10 they would expand their headcount by at least 11 percent; 33 percent of the respondents confirmed that the crisis had accelerated their service

Table 9.5 Offshore Services Industry Indicators in the Philippines, 2004–09

Indicator	2004	2005	2006	2007	2008	2009
Philippines GDP (current US\$, billions)	84.6	98.4	117.6	144.1	167.5	160.8
GDP growth (percent)	6.1	5.0	5.3	7.1	3.8	0.9
Revenues of offshore services industry: Philippines (US\$, billions)	1.5	2.2	3.3	4.9	6.1	7.2
Growth rate of offshore services industry (percent)	46	47	50	48	24	18
Offshore services share of Philippines GDP (percent)	1.8	2.2	2.8	3.4	3.6	4.5
Offshore services employment	101,000	163,000	236,000	300,000	372,000	442,000
Growth rate of offshore services employment (percent)	61	61	45	27	24	19

Sources: National Statistical Coordination Board; Business Processing Association of the Philippines; Economist Intelligence Unit.

Note: Offshore services industry refers to information technology–business process outsourcing (IT-BPO).

Table 9.6 Offshore Services Industry Indicators in India, 2004–09

Indicator	2004	2005	2006	2007	2008	2009
India GDP (current US\$, billions)	700.9	810.2	914.9	1,176.9	1,217.5	1,182.2
GDP growth (percent)	6.9	9.3	9.4	9.6	5.1	7.7
Revenues of offshore services industry: India (US\$, billions)	12.9	17.7	23.6	31.3	40.4	47 ^a
Growth rate of offshore services industry (percent)	37	37	33	33	29	16
Offshore services share of India GDP (percent)	1.8	2.2	2.6	2.7	3.3	4.0
Offshore services employment	830,000	1,058,000	1,293,000	1,621,000	2,010,000	2,236,614 ^a
Growth rate of offshore services employment (percent)	27	27	22	25	24	11

Source: Center on Globalization, Governance and Competitiveness (CGGC), Duke University, Durham, NC; based on data from NASSCOM and the World Bank; Economist Intelligence Unit.

a. NASSCOM estimates.

expansion process; only 5 percent declared that the effect of the crisis was “very significant.” Finally, the poll showed that some innovative firms were identifying new opportunities as a result of the downturn (Philippine Daily Inquirer 2009; TeamAsia 2009). Overall, it is estimated that the BPO industry in the Philippines will create 90,000 new jobs during 2010 (ABS-CBNnews.com 2010).

Many of the leading companies in the BPO industry, such as Genpact, Wipro BPO, Intelnet, Aegis BPO, and Firstsource, are scaling up their investments in the Philippines. Wipro BPO, one of the largest Indian service companies that specializes in IT and BPO, set up a new BPO center in Cebu City, Philippines, that hired 1,000 workers (SiliconIndia 2009). Similarly, Convergys opened three new call centers in the Philippines employing 3,000 workers in April 2009 (TeamAsia 2009).

Chile has also seen an increase in its offshore services operations during the economic crisis. Prior to 2000, the offshore services industry in Chile was insignificant. Yet by 2008, the country registered close to US\$1 billion in service exports (IDC Latin America 2009). Today the Chilean offshore services industry includes companies in all areas of offshoring, ITO, BPO, and KPO, as well as

industry-specific services that cannot be easily applied in other industries (Gerffi and Fernandez-Stark 2010).⁹ ITO and BPO services have grown considerably, together accounting for over one-third of offshore exports and 12,300 jobs (IDC Latin America 2009).

The Chilean industry has not been severely affected by the economic crisis, and the sector continues to grow, with several new projects established in the country during 2009. Of particular importance was General Electric's announcement in September 2009 that it was opening a new IT center in Valparaíso, Chile, that would hire 1,000 workers (*El Mercurio* 2009). More offshore services providers are planning to set up new projects, including Tata Consulting Services, McAfee, UST Global, and Konecta.¹⁰

Demand Effect

A second, and in some ways contradictory, effect of the economic crisis is a general decline in the demand for offshore services by existing clients. This is the first time that the industry has faced a slowdown; however, it still presents positive growth rates. A key factor in the decline has been the slack demand from the financial services sector, which was severely affected by the economic crisis. The financial sector has consistently been the largest buyer of offshore services, representing 32 percent of demand in 2008 (Technology Partners International 2008). The slowdown in demand is the result of a number of factors, including frozen offshore service contracts, a reduction in the scope of the contracts, and pressure on pricing (NASSCOM Newline 2009). The immediate consequences for providers have been the need to lay off workers, reduce salaries, and freeze hiring.

One of the most affected countries in terms of decreasing demand is India. The national characteristics that are key for offshore industry growth—low costs, strong technical and language skills, vendor maturity, supportive government policies, and an effective industry association—have made India the global leader of offshore services, with approximately 45 percent market share (NASSCOM 2008). The industry has evolved steadily, upgrading its activities from lower value-added activities to more advanced activities such as R&D services. Table 9.6 shows continuous positive growth rates for Indian offshore services, which grew fourfold in five years; in 2004, revenues were US\$12.9 billion, while in 2009 revenues were estimated to reach US\$47 billion. By 2008, offshore services employed over 2 million people, with an indirect job creation of about 8 million (NASSCOM 2009).

The offshore services industry's growth rates slowed down from around 30 percent during 2004–08 to 16 percent in 2009. This decrease also affected the industry's employment. While aggregate employment reached 2.3 million in 2009 (NASSCOM 2009), employment growth rates slowed from an average of 25 percent

between 2004 and 2008 to 11 percent in 2009 (NASSCOM 2009). One of the groups in India most affected by this economic crisis is new IT graduates: more than half of the 300,000 graduates were left unemployed in 2009. The oversupply of workers has also affected entry-level salaries, which have declined up to 30 percent (Current IT Market 2009b).

During the crisis, Tata Consultancy Services, the largest Indian offshore services provider, announced 1,300 layoffs, approximately 1 percent of its total workforce. Additionally, the company increased working hours to 45 hours per week from 40 hours (Finance Trading Times 2009). Despite these effects, the company is already showing signs of recovery and is planning new hiring in 2010 (Current IT Market 2009b). This is also true for other Indian companies like Wipro and Cognizant, which have begun offering promotions and salary increases. Infosys is also experiencing a recovery, but its policy is to wait for greater stability before offering promotions and salary increases (Indiatimes Infotech 2009).

The Indian industry began to show signs of recovery in the last months of 2009. A recent report from NASSCOM (India's National Association of Software and Services Companies), the offshore services Indian association, explains that the first half of 2009 was extremely difficult, with business paralysis and clients requesting immediate cost reductions. In the second half of the year, clients appeared to be in a better situation. They were requesting longer-term cost reduction initiatives moving forward and demonstrating a willingness to analyze new projects and initiatives. The Indian offshore services industry is expecting this slowdown to end during 2010 (NASSCOM Newline 2009).

Since the economic downturn, the industry is still adjusting to the new business environment. The most important changes in India's offshore services as a result of the crisis (NASSCOM Newline 2009)⁸ are as follows:

- Greater services specialization, with companies covering niche needs
- Industry consolidation
- New demand from vertical services
- Expansion into new locations
- Payment based on performance.

The Differential Impact of the Economic Crisis across Segments of the Offshore Services GVC

The economic crisis has impacted all segments of the offshore services GVC, especially vertical offshore activities, in different ways.¹¹ Sectors negatively impacted by the global recession generally faced lower demand for offshore services. In other cases, clients in industries less affected by the recession show similar

demand patterns as before the financial downturn, and in some cases there is demand for even more services.

The impact of the crisis also depends on the maturity of the industry in different countries, making it difficult to generalize across the value chain. For example, India saw similar declines in both IT and BPO activities, while the Philippines IT services sector was more affected than the BPO segment in which the country has more experience. In this section, two case studies of India and the Philippines, the two leading countries in these segments, provide further analysis of the impact of the crisis on the value chain.

In general, KPO services have been more insulated from the economic downturn. Business intelligence and legal services continued to perform well during the crisis. According to Gartner's annual EXP Worldwide Survey 2009 (Gartner 2009), covering 1,500 chief information officers worldwide, the business intelligence sector was the top investment priority. It has been the top priority for four consecutive years, and companies in the sector continue to grow, taking advantage of new opportunities afforded by the crisis. For example, MAIA Intelligence, an Indian market intelligence provider, launched affordable reporting and analytics solutions for small and medium enterprises. In the past, this service had only been available for large enterprises, but MAIA Intelligence found this niche to be an opportunity to offer this innovative product (NASSCOM Newslines 2009).

Legal services, referred to as legal process outsourcing in the GVC, are still mostly limited to India. The annual growth rate slowed from 40 percent precrisis, still reached a promising growth of 28 percent in 2008, which in 2009 declined to 16 percent (India PRwire 2009). The two largest companies in the segment, Mindcrest and CPA, saw positive growth during the crisis, likely the result of early and rapid consolidation of the still infant industry segment, with 20 percent of the providers in India exiting the industry (BPOWatch India 2008). Leading companies expect the sector to expand significantly in 2010 as a result of the tremendous cost-saving opportunities afforded for law firms (Crain's Chicago Business 2010).

Impact of the Crisis on National Offshore Services GVCs

The Indian offshore services industry faced the crisis with an already mature industry that had strengths in several key areas: IT and BPO services, engineering services, R&D, and software products. Prior to the crisis, the industry presented a sound upgrading trajectory. The country entered the industry offering IT services, moving to BPO operations and later added KPO activities. Additionally, the Indian industry provides sophisticated services to vertical industry segments, including R&D services. India has offerings in the entire offshore services GVC shown in figure 9.2.

The IT sector accounts for 57 percent of the total services; BPO activities, 27 percent; and engineering services, R&D, and software products, 16 percent. These market shares have been constant since 2005, and the economic crisis did not impact the proportions (see table 9.7 and figure 9.7).

Figure 9.7 shows that almost every Indian segment of the offshore services industry saw a decline in demand in 2009. The IT services segment had growth rates equal to or higher than 30 percent during the period 2006–08, but during the economic downturn, the growth rate decreased to 16 percent. BPO activities followed a similar pattern, experiencing growth rates over 30 percent annually and decreasing to half of that rate in 2009. The third category, engineering services and R&D, and software products, based on discretionary spending projects, is subject to greater fluctuation in demand and saw its growth shrink slightly more than the other segments. This is a category that combines two completely different sets of activities, “engineering services and R&D” and “software products.” Offshoring of engineering and R&D services has shown strong growth in the past two years, leading to the assumption that the fluctuations represent changing demand for new software products.

Table 9.7 India's Revenues from the Offshore Services Industry, FY2005–FY2009

Fiscal year/ indicator	IT services	BPO	Engineering services and R&D, software products	Total
2005				
Revenue (US\$, billions)	10	4.6	3.1	17.7
Percentage of total revenue	56	26	18	100
2006				
Revenue (US\$, billions)	13.3	6.3	4	23.6
Percentage of total revenue	56	27	17	100
2007				
Revenue (US\$, billions)	17.8	8.4	4.9	31.1
Percentage of total revenue	57	27	16	100
2008				
Revenue (US\$, billions)	23.1	10.9	6.4	40.4
Percentage of total revenue	57	27	16	100
2009 (estimate)				
Revenue (US\$, billions)	26.9	12.8	7.3	47
Percentage of total revenue	57	27	16	100

Source: NASSCOM.

Note: BPO = business process outsourcing; IT = information technology; R&D = research and development.

Figure 9.7 India's Offshore Services Industry Growth Rate, 2006–09

Source: NASSCOM.

Note: BPO = business process outsourcing; E = estimate; IT = information technology.

In the Philippines, the offshore services industry is concentrated in BPO activities. In 2009, revenues in this segment increased by 22 percent over the previous year. The KPO segment increased by 35 percent, and similar trends were expected for 2010 (BusinessMirror 2010). According to the Business Processing Association of the Philippines (BPAP), 70,000 jobs were created in 2009 in the BPO sector alone. The IT sector, on the other hand, declined by 5.5 percent, while revenues for other activities such as engineering services outsourcing and transcription were unaffected by the crisis (BusinessMirror 2010).

Impact of the Crisis on Industry-Specific Vertical Services

As mentioned earlier, banking, financial services and insurance (BFSI) was the economic sector most affected by the global recession. It is also the industry that uses the highest percentage of offshore services. In 2008, BFSI represented 41 percent of the total Indian offshore services market (NASSCOM 2009). The downturn of the mortgage market and related financial markets hit firms in the sector hard, shrinking demand for their services; as a result, BPO revenue from these sectors became exposed and vulnerable (Gartner 2009). At the same time, on top of a

decline in demand for BPO services, these firms cut back on their IT spending. Financial institutions in Europe and the United States have reduced their outsourcing activities sharply in the wake of the financial crisis. By one account, they have cut the volume of newly awarded IT outsourcing contracts by nearly 30 percent in 2008 compared to the previous year, explained Deutsche Bank economist Thomas Meyer (Meyer 2009).

According to Gartner, the decrease in demand for offshore services in the BFSI sector is also the result of insourcing strategies. The consolidation of the banking industry as a consequence of the crisis has resulted in a negative impact on the offshore services sector. A number of financial services firms merged, with previously outsourced processing being absorbed by internal shared-service centers. This was an important strategy to employ existing internal human resources to avoid even more widespread layoffs (Gartner 2009).

Offshore services providers that serve the BFSI segment thus saw demand for their services decline, with clients asking to renegotiate contracts. In order to respond to client demand, providers reduced internal costs, reorganized production, and also cut wages. For example, TCS, India's largest exporter of financial services, reacted to the crisis by reducing salaries by 1.5 percent and cutting new hires from 35,000 to 30,000. Similarly, Infosys reduced hiring by 10,000, to just 25,000 new recruits, far below their precrisis hiring estimates (Business-In-Asia, 2008). However, this trend appears to be temporary; as soon as economic expectations improve, the companies are likely to increase salaries again. In early 2010, TCS, Infosys, and Wipro announced wage increases of 8 to 12 percent (Business Standard 2010).

A number of providers in the sector responded to the crisis with a different approach based on innovation and diversification of the product portfolio. FIS, for example, is one of the world's largest providers of banking and payments technology, with the U.S. banking industry accounting for 67 percent of its total client base (ABS-CBN news.com 2010). This American company consolidated its market position by acquiring a key competitor, Metavante, and diversifying its client base (CBR News 2009). It opened a facility in Manila with approximately 1,000 workers (ABS-CBN News 2010) and made new investments to provide innovative, high-quality services. One such innovation, HORIZON,¹² which was released during the crisis, was a best-seller in 2009, attracting many long-term contracts with large financial institutions (FIS Press Release 2010) and contributing to the flat growth of overall revenues for 2008 despite the crisis.

Other sectors have not been affected significantly by the crisis, and some are even demanding more services. For example, the global health care industry is demanding more IT services from India as a result of the global increased focus on public health and attempts to make health care and health insurances affordable and universal (NASSCOM 2009). Medical transcription services have also

expanded during the crisis period, especially in the Philippines. Myla Reyes, the president of the firm Total Transcription Services in the Philippines, explains that “as a cost-cutting measure, more clients tend to ‘shop around’ for medical transcript service providers outside the US. This gives us an advantage as one of the destinations of choice in providing this type of service” (TeamAsia 2009).

Conclusions

While the offshore services industry has grown tremendously over the past decade, it is still considered a nascent industry with vast potential remaining largely untapped. Companies looking to improve their competitiveness continue to externalize many of their activities, not only back-office operations, but their core activities like R&D as well. The recent demand for these higher value-added activities indicates that few services will be retained exclusively in the developed world and that the industry growth will continue to be strong in future years.

The 2008–09 economic crisis was the first event that has tested the industry, and it has demonstrated marked resilience. The recession forced providers to upgrade and improve their services, increasing both efficiency and competitiveness for clients. The economic downturn created only a small inflection in the industry. The two conflicting effects discussed in this chapter (the substitution effect and the demand effect) are finding a positive reconciliation in 2010. The demand for offshore services continues to increase and is soon expected to reach similar growth rates as in the years before the crisis. The substitution effect will be even stronger in the future, as new sources of demand emerge from industries with limited current participation in the sector and as suppliers gain a greater degree of specialization. Increased growth and industry consolidation will, in turn, drive expansion to new locations, creating further opportunities for developing countries.

Offshore services is one of the few global industries where some developing nations have a real competitive advantage over the developed world, owing to their low cost of service provision and their educated labor force. Developing countries with a strong educational infrastructure thus have an important opportunity to enhance their economic development with this industry. Looking ahead, there is still room for new economies to emerge as offshore destinations. More activities will be offshored and more talent will be sought. This presents a great opportunity for developing countries to continue upgrading their economies to offer higher value-added activities that in the past were reserved for developed nations.

Notes

1. While outsourcing contributes significantly to gross domestic product (GDP) in developed countries, it requires internal or domestic demand to drive it. Most developing countries do not have sufficient demand for these internal services for them to be major factors in economic development.
2. For a detailed description of governance of GVCs, see “Value Chain Governance” (Frederick and Gereffi 2009).
3. NASSCOM® is the chamber of commerce of the IT-BPO industries in India. NASSCOM is a global trade body with more than 1,200 members, which include both Indian and multinational companies that have a presence in India.
4. At the end of FY 2007, Capgemini’s Indian operations added at least 8,000 new employees, taking the figure from the current 27,000 to a new high of 35,000, surpassing for the first time the number of employees in the United States (Shah 2007).
5. According to the report, “Solid utilities provide available and cost-effective infrastructure, trusted suppliers add product delivery capabilities, and partner players are tightly aligned with the business” (Andrews 2008, 4).
6. As mentioned previously, the offshore services industry is a recent global phenomenon and has been evolving rapidly. There are no official data available at a global level. The economic crisis analysis in this section is based on country and company cases that support the main findings.
7. These estimates were prepared before the economic crisis.
8. Nair, Ed. 2010. “The Impact of the Economic Crisis in the Offshore Services Industry.” Personal communication with K. Fernandez-Stark. March 10.
9. For an in-depth description and analysis of the global offshore services value chain, as well as the evolution of each segment of the industry in Chile, see Gereffi and Fernandez-Stark (2010) and Fernandez-Stark, Bamber, and Gereffi (2010).
10. Castillo, Mario. 2010. “Offshore Services Industry—CORFO—Chile.” Personal communication with CGGC research team, February 18.
11. See figure 9.2 for a diagram of the offshore services value chain.
12. HORIZON is a core account processing, solution for financial institutions. It offers financial reporting capabilities, transaction processing, and relationship-management technology to help banks gain a more comprehensive view of their customers.

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