

# RESHORING IN MANUFACTURING AND SERVICES

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## Abstract

*The extent of offshoring and outsourcing recorded in manufacturing and services in the last two decades has gradually eroded the advantage of the global arbitrage of labor costs. Along with other factors, this process began to change the options of international relocation of some companies that initially had adopted such a strategy, generating a reverse trend for returning in the country of origin of manufacturing and other activities. This process, called "reshoring," has recently started to gain some consistency. The trend is most notable in the sphere of production. In terms of business and IT services we cannot yet speak of a tangible start of the reshoring phenomenon, as it does in the sphere of production. Nevertheless we can see a slowdown in the offshoring of services and the emergence of new strategies in the field.*

**Keywords:** *offshoring, outsourcing, reshoring, on-shore, TNCs.*

## Introduction

The phenomenon of offshoring and external outsourcing in the sphere of production and business services emerged in the '80s and quickly became, in the next two decades, a widespread phenomenon, and in fact a new component of what we call economic globalization.

Both external outsourcing and offshoring took place almost exclusively in the direction of developed countries - the least developed countries (mainly emerging), with important benefits for Western companies that have opted for this strategy as a result of a significant gap in labor cost (most noticeable factor of a wider set of factors that weighted in the geographic relocation decision), and also as a result of the indisputable advantages of the outsourcing of manufacturing and of other components of the value chain of a product in the context of the international functional specialization.

For the offshoring boom period remained emblematic the assertion of the Executive Director of the American giant General Electric, Jack Welch, who said that "the ideal strategy for a global company would be to put every factory it owned on a barge and float it around the world, taking advantage of short-term changes in economies and exchange rates".

The two manifestations of globalization, offshoring and external outsourcing, also produced advantages and disadvantages for the countries involved, namely multiple economic and social benefits to the countries to which production and services have been relocated, while for the Western countries most visible were the lower prices for a wide range of goods and the loss of jobs, initially more evident to those with lower skills, but increasing thereafter for the middle class also. This issue was raised in a survey conducted in 2010 by NBC News and the Wall Street Journal showing that 86 % of Americans indicated as the cause of economic difficulties the offshoring of jobs to low-wage countries.

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The scale of offshoring gradually eroded the advantage of the overall labor costs arbitration. Wages in China and India have grown by 10-20 % annually in the last decade, while payment per hour of work in industry, both in America and Europe, almost stalled. Along with other factors, this process began to change the options of international relocation of some companies that had adopted the offshoring strategy, generating a reverse trend of returning to the country of origin of manufacturing and other activities. This process, called "reshoring", has recently started to gain some consistency, which requires the analysis of the present and future favoring factors.

The trend is to be seen both in the production and in the business services areas.

### **Reshoring in manufacturing**

It must be emphasized first that reshoring is predominantly an American phenomenon. This follows from the following facts:

- European companies were much less involved in the offshoring strategy compared to the transnational American companies, so they have, from the start, less to relocate.

- Labor markets in European countries are still inflexible and expensive, so that a considerable advantage in labor cost arbitrage persists, even if wages in China and other countries increased meanwhile.

- Compared to the U.S., in Europe the share of family firms is high and they are prone to conduct business in their own country.

- European companies were to a greater extent relying on "near- shoring", meaning offshoring to East European countries, thus minimizing from the start the cultural and linguistic differences, but also transportation costs.

- However a differentiated approach to offshoring within the European countries can be also observed, most active being the companies of north European countries which, unlike companies in France, Italy and Spain, have not suffered the same social and political pressure to keep the jobs in the country.

Secondly the tendency to manufacturing reshoring results from the expressed intentions of the companies, as well as from the actual relocation of production capacities.

In this respect, from the two surveys conducted in collaboration by AlixPartners, McKinsey and Hackett on a global scale regarding the intentions of companies to relocate manufacturing, it resulted, for the period 2012-2014 compared with the period 2009-2011, on one hand a reduction of the offshoring volume (from 26 % to 23 % of production capacity) and on the other hand an increasing determination to relocate from the initial offshoring destinations (from 25 % to 43 % , including an increase in relocation to other low-cost countries from 16% to 24% of the capacity and an increase of reshoring intentions from 9 % to 19 % of capacity) .

Among companies that have already started reshoring operations worth mentioning are General Electric, Caterpillar, Ford Motor Company, Google, Apple and smaller firms such as IKEA, Emerson (electrical equipment), Desa (power tools), ET Water Systems. A year ago, the number of U.S. firms that have brought home the whole or a part of the manufacturing capacity already reached 100. The comparative figures the phenomenon is not yet of magnitude, but it is significant.

Transnational companies will become less overall as a result of this trend, but the geographic distribution of their activities will be more selective.

Among the factors that determine today and will influence in the following years the reshoring decisions of companies we should mention:

1. The narrowing wage gap between developed countries and "low-cost" countries. International Labor Organization has calculated that in Asian countries real wages increased

between 2000 and 2008 by 7.1-7.8 % per year, while in the developed economies, according to McKinsey Global Institute, wages rose in the same period only by 0.5-0.9 % per year. The gap appears even more striking compared to China where the aggregate of the salaries and benefits of an average worker increased between 2000 and 2005 by 10% per year and have accelerated between 2005 and 2010 to 19% a year, and the Chinese government has set the target to increase the minimum wage by 13% per year until 2015. Regarding the top management remuneration, according to a study conducted by the consulting company Hay Group, in some countries such as China, Turkey and Brazil it equaled or exceeded the levels recorded in America and Europe.

Other countries including Vietnam, Indonesia, Philippines, Cambodia, Myanmar offer lower wages than China, but still do not offer the same opportunities in respect of the long series of production, efficiency and supply chains. Not to mention other setbacks such as labor availability, productivity and skills.

In the context of the narrowing wage gap, already the well-known American company Manpower recommends to those Western companies that have in the overall cost structure of the product up to 15 % labor costs, to avoid the option for offshoring. This strategy will produce them losses due to the narrowing wage gap and its cancellation by transport costs.

It is expected however that in industries intensive in labor to observe a reverse in the current situation to the detriment of offshoring due to an impending revolution in robotics.

2. The impairment, by the interposing of a considerable distance between the functions of manufacturing and design, of innovation and quality. A solution would be the offshoring of research and development to the host countries of production offshoring. An example is the company Caterpillar which has recently decided to expand its R & D activities in China. However, because the protection of intellectual property rights in many developing countries cannot be fully guaranteed, most high technology companies prefer to conduct these activities in their home countries.

Impaired quality as a reason for reshoring is not new. A study by Deloitte Consulting in 2005 revealed that from 25 major companies who outsourced certain activities, a quarter insourced them back to achieve better quality and even lower costs.

3. Slower reaction to market demands when between this and the location of manufacturing is interposed a considerable distance. This factor increases in importance due to the fact that the proximity to customers and the quick respond to their demands became a major competitive advantage.

Increasingly the TNC's production relocation strategy is not so largely motivated by the arbitrage of production factors, as by the need to be close to customers. Some authors consider that in such cases we do not speak about offshoring in the sense that this term was used in the last three decades, but about "on-shore" in other countries. It is true that the term offshoring is often associated with the transfer of manufacturing to countries with low wages, but we must not forget that the transfer of manufacturing to other countries has been and still is the basic strategy of TNCs to conquer new markets. This aspect is to be found in TNC's strategy to go in various forms to China and other countries for their potential to grow as large markets. The carmakers case is relevant. But there are companies who initially moved manufacturing to China to take advantage of low cost of labor, but now remain and expand in China for the market itself (Bombardier, Siemens, etc.).

Closeness to the customer is a strategy that large companies from emerging countries have also started to implement through the offshoring of manufacturing to developed countries. For example, the Chinese giant Lenovo who bought a decade ago the manufacturing of PCs from IBM, decided in 2013 to transfer some production in the U.S. in order to meet customer demands and quickly customize the product without waiting six weeks until it would arrive by ship from China. Taiwanese giant Foxconn also announced

recently that it will increase activity in the U.S., motivated by the partial reshoring of Mac computers by Apple.

4. The appearance and decrease in the cost of implementation of new manufacturing technologies that will cut down the use of labor will gradually diminish the importance of a major reason for manufacturing offshoring. Perspectives closer than we can imagine will offer 3D printers and industrial robots. Already the average price of robots relative to labor cost decreased by 40-50% over the last 15 years with the increasing complexity of their operations and programming versatility.

5. Avoiding the problems of the supply chain management. Although logistics has improved, there are still plenty of factors that can jeopardize a complex chain of suppliers with high spatial dispersion. A recent resounding example was the less inspired product strategy of Boeing to manufacture a new and very sophisticated type of plane, the 787 Dreamliner, outsourcing 70 % of the development and manufacturing activities to about 50 suppliers who in turn have subcontracted to hundreds of other companies. As a result not only the deadlines have been exceeded, but some serious quality and reliability issues appeared. An example of a consistent strategy that relied on short chains and flexible suppliers is the Spanish company Inditex (with Zara as its main brand) that develops successfully by resisting the temptation to contract with suppliers from China and using the manufacturing capabilities of Spain, Portugal and Morocco.

### **Reshoring in services**

In terms of business and IT services we cannot yet speak of a tangible start of the reshoring phenomenon as it happens in the sphere of production. Transport costs do not play any role here. What we find is a slowdown in services offshoring and the emergence of new strategies in the field.

Regarding the first aspect, the slowdown in services offshoring, the main causes are:

a) The fact that most services readily transferable abroad have been already moved there, especially in the BRIC countries, with India as the main destination. In 2008 India was credited with 65% as a destination for IT services offshoring and 43% for business services. Thus, recent estimates show that European and American banks and financial services institutions have already transferred about 80 % of what can be transferred to India and other foreign locations.

b) The fact that many of the activities that could be outsourced are subject to further efficiency gains in developed countries and requiring a higher level of qualification, making them less outsourceable.

Hackett, an American outsourcing consultancy company estimates that during 2002-2016 offshoring will be responsible for the transfer of about 2.1 million jobs in the business and IT services, but this process will slow after 2014 and even stop complete to 2022.

The emergence of new strategies in the sphere of services offshoring and outsourcing can be observed and it is also expected that gradually more and more companies will reconsider their options in the near future. Some considerations can be the following:

1. Although during the crisis years of 2008-2009 the overseas transfer of jobs in the service sector accelerated, including also more complex and highly skilled activities, today, according to some specialists, more companies find that there are hidden costs of this strategy, first of all the loss of connection with some important functions of the company. Thus, if some activities were, until recently, regarded as not being important for the overall profitability of the company, such as information management, now they are reconsidered as essential and undesirable to be transferred to independent firms also located at considerable distances.

2. It is important to note that a strong signal about IT services reshoring was recently given by two American giants that were at the forefront of offshoring and outsourcing processes, namely General Electric and General Motors. The main motivation, but also favored by the reducing wage gap, is that returning at least a portion of IT services in the U.S. allows more flexibility, speed and innovation in relation to the local market, aspects suffering when they were performed by suppliers from India.

3. Decreased relative wage advantage is to be observed also in the sphere of services. In the case of IBM, for example, the cost of labor in India was in the beginning with 80 % less than in the U.S., but now the gap reduced to 30-40 % and decreases further.

From a survey conducted by Hfs Research from Boston in 2012 resulted that the most promising market for outsourcing IT and business services for at least the next two years was considered America, for the first outpacing India. One explanation comes from a study of McKinsey, a consultancy company, regarding the perspectives of jobs in U.S., showing that IT specialists in areas with lower wages in the U.S. can be hired cheaper than in Brazil or Eastern Europe, and being just 24% more expensive than those in India. In many developed countries there are wage regional differences, ranging up to 30 %, such as between Paris and northern France, or between western and eastern Germany.

4. Greater labor fluctuation in "low-cost" countries creates services quality issues. We can observe also that third companies cannot perform monotonous back-office tasks better, but on the contrary.

5. Cultural affinity also plays an increasingly important role in customers' mind, customers that are even willing to pay more for this convenience. This is more strongly observed in the case of financial services, and the result is the transfer of call center services from India to the Philippines, America or Europe.

6. A complementary to reshoring phenomenon is the transfer of services offered by big Indian companies from India to U.S.. For example, Infosys has opened in recent years a number of 18 new offices in the U.S., employing primarily Americans and being close to various U.S. companies.

### Conclusions

Can we say that the narrowing wage gap between developed countries and "low-cost" countries, along with other factors to which reference was made above, will increase in the near future the reshoring phenomenon, especially in the sphere of manufacturing and to a smaller scale in the business and IT services. As results from surveys conducted in the Western business environment, a number of factors such as the qualification of the workforce, labor legislation, the existence of appropriate infrastructure and industrial clusters, the stability and benefits of the tax system, get a growing importance in the companies decisions on international relocation. These issues have to be tackled with more consideration within government policies. Reshoring or quitting offshoring or outsourcing may be promising for Western economies, but they have to be stimulated by a greater flexibility of the labor market, by providing an increased number of specialists coming out the educational system, etc..

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