

# How global labour arbitrage will shape the world economy

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After three unusually tough years, a US-centric global economy is awaiting sustained revival with bated breath. There are hopes that the great American job machine, central to any growth spark, is finally revving up. But these hopes are not likely to be realized – and the revival is unlikely to conform to the hiring-led upturns of the past.

A new global labour arbitrage – a by-product of IT-enabled globalization – is now acting as a powerful structural depressant on traditional sources of job creation in high-wage economies such as the United States. America's recovery without job creation could well be here to stay. That could also be the case in Europe, Japan and elsewhere in the developed world.

A unique and powerful confluence of three mega-trends is driving the global labour arbitrage. The first breakthrough is the maturation of offshore outsourcing platforms. China exemplifies the critical mass in new manufacturing outsourcing platforms. Built on a foundation of massive inflows of foreign direct investment and domestically funded infrastructure, the Chinese factory sector has become a key link in the global supply chain.

Fully 65% of the tripling of Chinese exports over the past decade – from \$121 billion in 1994 to \$365 billion in mid 2003 – is traceable to outsourcing by Chinese subsidiaries of multinational corporations and joint ventures.

And China is not alone. Similar offshoring patterns are evident elsewhere in Asia and in Mexico, Canada, South America, and eastern and central Europe. Outsourcing is hardly a new phenomenon, but today's offshore platforms offer low-cost, high-quality alternatives to goods production and employment on a scale and with scope never seen before.

## Outsourcing services

A comparable trend is now emerging in the once sacrosanct services sector. Dubbed “non-tradables”, services have long been perceived as having to be delivered in person, on site. That's no longer the case. Offshore outsourcing of services is now occurring up and down the value chain – from low-value-added transactions processing and call centres to activities with a high intellectual capital content, such as software programming, engineering, design, accounting, actuarial expertise, legal and medical advice, and a broad array of business consulting functions.

India exemplifies the critical mass in offshore services outsourcing. One study estimates that India's IT-enabled services exports will increase ten-fold over the next four years, from \$1.5 billion in 2001/2002 to \$17 billion by 2008, making it one of the fastest-growing major industries in the world (see *The IT Industry in India: Strategic Review 2002*, published by India's National Association of Software & Service Companies with McKinsey & Co). Nor is India alone: services outsourcing is increasingly prevalent in countries like China, Ireland and Australia.

E-based connectivity is the second new mega-trend behind the global labour arbitrage. This is the first business cycle since the advent of the internet. Whatever one thinks about the web, it has transformed the supply side of the global macro equation.

For manufacturing, it gives new meaning to the real-time monitoring of sales, inventory, production and delivery trends that drive the logistics of global supply chain management. And it provides new transparency to the price discovery of factor inputs and upstream materials and supplies.

For services, the internet enables a dramatic expansion of outsourcing options. The intellectual capital of research, analysis and consulting can now be transmitted anywhere with the click of a mouse. Today, a systems problem in New York, for example, can be quickly fixed by a software patch written in Bangalore.

Such connectivity creates a new pipeline for global information flows that drive the service-sector supply chain. The internet allows well-educated, hard-working and relatively low-wage offshore knowledge workers to be seamlessly integrated into global service businesses, once the exclusive domain of knowledge workers in the developed world.

The new imperatives of cost control are the third factor in this equation – in effect, the catalyst that brings the global labour arbitrage to life. In an era of excess supply, companies lack pricing leverage as never before. As such, businesses must be unrelenting in their search for new efficiencies.

Not surprisingly, the primary focus of such efforts is labour, representing the bulk of production costs in the developed world. In the United States, worker compensation still makes up more than 75% of total domestic corporate income. And that's precisely the point. Wage rates in China and India range from 10% to 25% of those for comparable-quality workers in the United States and the rest of the developed world. Consequently, offshore outsourcing that extracts product and/or services from relatively low-wage workers in the developing world has become an increasingly urgent survival tactic for companies in the developed economies. Mature outsourcing platforms, in conjunction with the internet, give new meaning to such tactics.

These mega-forces are largely irreversible – especially mature outsourcing platforms and the internet. The imperatives of cost-cutting could diminish, once global supply and demand are in better balance. But, in my view, that will not occur for some time.

Meanwhile, the footprints of accelerated outsourcing are unmistakable. It's not just the pitfalls of jobless recoveries. It also shows up in the form of an 11.4% surge in US real goods imports growth over the first six quarters of this recovery – far in excess of what might normally be expected in the context of an anaemic 4.2% increase in domestic demand over this period.

In the case of the United States, rising import propensities and the concomitant offshore outsourcing of jobs are the functional equivalent of imported productivity, as global labour arbitrage substitutes foreign labour content for domestic labour input. In my view, that could well go a long way in explaining the latest chapter of America's fabled productivity saga.

### **Asymmetry of globalization**

Halfway around the world, there are clear indications of complementary adjustments in Asia's huge reservoir of surplus labour. In China, foreign-funded subsidiaries now employ some 3.5 million workers, up more than 3.5 times over the past decade. Moreover, another 3.25 million Chinese workers are employed by subsidiaries funded in Hong Kong, Taiwan and Macao.

Similar trends are evident in services outsourcing. India currently employs about 650,000 professionals in IT services, a figure that is expected to more than triple over the next five years, according to the McKinsey study cited above.

Moreover, there is good reason to believe that increased staffing by Indian subsidiaries of multinational service providers will be matched by headcount reductions elsewhere in their global platforms. Evidence for this can be found in a table prepared by Morgan Stanley's own Mumbai-based research outsourcing centre (see table).

The global labour arbitrage underscores a profound asymmetry of globalization. Offshore outsourcing is an unmistakable first-round opportunity for low-cost developing nations to enter the supply side of global commerce.

But their demand response typically lags, often by a considerable interval. China is a classic example.

Its production-based growth is obvious, but its demand response, especially in terms of domestic private consumption, remains weak. That should not be surprising. Chinese reforms of state-owned enterprises are resulting in ongoing layoffs of 6 million to 8 million workers per year.

Moreover, without well-developed national social security and retirement schemes, China still lacks a viable safety net. In the absence of job and income security, the emergence of a consumer culture understandably lags. Today, China is about supply. Tomorrow, it will be about demand.

The global labour arbitrage raises the possibility that jobless recoveries could well remain the norm in high-cost developed economies for some time. That is especially true in the United States, where this jobless recovery is in a league of its own.

Fully 23 months after the economy purportedly bottomed in November 2001, private non-farm payrolls are down by nearly 1 million workers. Relative to the hiring that would have occurred in business-cycle upturns of the past, that translates into a cyclical shortfall of about 7 million jobs (see graph).

Concerns run deepest in the US manufacturing sector. In one respect, that is somewhat surprising, since manufacturing employment has been on a secular downward trend for most of the past 50 years and currently accounts for only about 13% of total private payrolls in the United States.

But this cycle has broken the mould. Normally, the secular decline in factory sector hiring gets interrupted in economic recoveries. In fact, in the first 23 months of the past six recoveries, manufacturing payrolls increased, on average, by 5.5%.

That is not the case in this era of global labour arbitrage. Manufacturing headcounts are, in fact, down fully 8% over the first 23 months of this recovery. That means today's depressed level of factory sector payrolls is fully 2 million workers below the path implied by historical cyclical norms. Little wonder the pressures currently bearing down on Smokestack America have received so much attention.

That is not to say that the white-collar services sector isn't suffering. Headcount in this vast area of the US economy is virtually unchanged over the past 23 months, in sharp contrast with the 5.5% average gains of the past six cycles. That puts the service sector about 5 million jobs down compared with the hiring that would have occurred in a normal business-cycle upturn.

In this context, America's jobless recovery appears to be on a collision course with the Bush administration's re-election hopes. With America's fiscal and monetary levers already fully engaged, I sense that the White House has now decided to take out more insurance against a pre-election economic down-draught in the event that the current growth spurt proves to be short-lived.

That gives the weaker dollar a new and prominent role in America's reflationary policy arsenal. Here, fundamental economics is on the administration's side, as America's massive current-account deficit cries out for a depreciation of the dollar.

The impacts of the global labour arbitrage are now sparking great debate in political circles. That's not surprising. In the end, threats to traditional sources of job creation strike at the heart of economic security. The resulting angst of disenfranchised workers almost always seems to drive the political agenda during election years. That is exactly the case today. There has already been a protectionist backlash in the US Congress, one that has now evolved into an especially lethal and ominous strain of China bashing. Therein lie the classic risks of unintended consequences. As high-cost supply models in the United States, Japan and Europe are marginalized by the rapid development of low-wage outsourcing platforms in the Chinas and Indias of the world, the modern-day global economy is facing unprecedented tensions.

The choices are stark. Either we fight the loss of traditional sources of job creation through politically motivated protectionism, or we turn the pressures to our advantage as a catalyst for uncovering new sources of economic growth.

Learning to live with globalization was never going to be easy. But coping with the global labour arbitrage is proving to be especially vexing for the body politic, to say nothing of the global economy and world financial markets.