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Future Bangalores? The increasing role of Central and Eastern Europe in the Global Services Offshoring Market: Evidence from Trade Statistics

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Many Central and Eastern European countries invigorated by EU enlargement became important locations for offshored service centres. Building on the region's nearshoring advantages such as geographical-cultural proximity and on its multilingual graduate supply, CEE is likely to utilise more value added and quality-driven services. Trade statistics support the assumption that an expanding export in other business and ICT services has been associated with offshoring services in the six NMS analysed in detail in the paper. The service export data adopted from the Balance of Payments statistics gives a good approximation to indentify those sections of service trade, which can be regarded as offshorable. The paper summarises the additional factors favouring nearshoring (as in CEE locations) over offshoring (e.g. India) and lists several factors besides size why CEE countries cannot outpace India's market potential.

Keywords: offshoring, nearshoring, service trade, balance of payments statistics, offshorable services, Central and Eastern Europe, new member states, India, offshoring advantages.

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„New contenders in Central and Eastern Europe outshine more established offshoring locations” (AT Kearney, 2007)

„What is unusual about Eastern and Central Europe is that their most advanced cities offer a potent mix of attributes that even Bangalore cannot rival: a highly educated, multilingual pool of talent in an increasingly affluent consumer market — all barely a stone’s throw from its prime clients” (The New York Times, 30 April 2007)

„Neither India nor Russia has 200 graduates in Economics with German fluency, are familiar with German GAAP, and are prepared to start a job within 2 weeks” Director of McKinsey BPO centre Warsaw, 2007.

1 INTRODUCTION

The rapid surge of globalisation, opening up of formerly isolated regions such as Eastern Europe, Russia and China to global trade, has substantially boosted task trade and service related cross-border investments. After and parallel to the outsourcing/offshoring from developed to low-cost developing countries of the low and medium skilled production processes in manufacturing, similar processes have emerged in services (Bryson, 2007). Central and Eastern Europe (CEE) have played a considerable part in both processes. Relocation of these activities have grown rapidly, particularly after 2000, especially in the new EU member states (NMS) of the region (Czech Republic, Hungary, Poland and Slovakia though “latecomers” such as Romania and Bulgaria have also begun to act as host for this type of investment) (Gál-Sass, 2009).

The question is whether these locations might stand as a challenge for the overwhelmingly dominant global position of India and the other East Asian countries or only offer a complementary offshoring base for the continental European companies preferring to relocate their services nearby. There is a large amount of anecdotal information underpinned by the recent estimates of consultancy reports, which views the CEE as an attractive region for offshoring even in a global context. Its leading hubs are now seen by some analysts as “future Bangalores” in terms of providing offshoring solutions.

In many cases offshoring is not simply a corporate management issue but attracted media and policy responses on far broader fronts, such as labour markets and education. The significance of offshoring is often overestimated and this is because still only a smaller proportion of services are transferred abroad (Amiti and Wei, 2004, 2005a-b). In fact, offshoring by no means generates as drastic effects as one might expect from the ongoing political debate on job losses (Mankiw and Swagel, 2006). The literature concentrates mainly on (developed) home country impacts, especially in terms of job losses, relative wage decreases for unskilled workers and welfare implications (Hansen et al., 2007). However, host

country impacts have hardly been researched even though these may be wide-ranging. Even research on the job-creating impact in home countries is missing (Jensen et al., 2006, Ekholm and Hakkala, 2006). Offshoring skill intensive activities to Central and Eastern Europe has contributed to relative wage decrease for skilled workers in some sender countries and increased the productivity in host countries¹ (Protsenko, 2003, Marin, 2010).

Service offshoring-related activities, such as outputs, value added, employment, foreign direct investments and exports in services have grown rapidly, particularly after 2000 in the NMS. Still most of the papers are concerning about the consequences of offshoring to low-wage countries for the labour markets in the West (Amiti and Wei, 2005a, Kirkegaard, 2005, Ekholm, 2006). Fragmentation and “trade in task” theorems developed by Jones & Kierzkowski (1990, 2005) and Grossman & Rossi-Hansberg (2006) examine the new role of services in international trade. Advances in this process have made it easier for companies to disaggregate their value chains around the globe, all the while maintaining management control over them, or to disperse service production among numerous supplier firms even in distant locations.

A bulk of research examines offshoring both as a part of worldwide structural shift towards service-based foreign direct investment and also as a new direction of managerial and localization strategy of corporations (Baldwin, 2006, Blinder, 2006, Bryson, 2007, Grote and Taube, 2006, 2007, Bevan and Estrin, 2004, Hardy 2007, Ptacek, 2009). However, current economic statistics do not provide reliable indicators of the scale and characteristics of offshoring therefore our knowledge of the developments in services outsourcing/offshoring is limited because of data and measurement problems. Due to the problems with collecting data on business service investment, statistics are supplemented with qualitative research in recent studies (Hardy 2006, Capik, 2008, Sass, 2009, Fifekova and Hardy, 2010).

This paper attempts to examine the scale and sectoral characteristics of services offshoring in NMS-6² by means of using trade data in order to partially overcome the scarcity of consistent empirical contributions in measuring the actual significance of NMS in offshoring services. Despite the deficiencies of reliable and consistent data sources balance of payments statistics including the exports of services are still the most closely related to offshoring/outsourcing. Balance of payments positions are often being used in the literature and particularly authors at the IMF and OECD are the keen users of this information to describe offshoring (Amiti and Wei, 2004, 2005a)

The paper is divided into four sections. Following the introduction, the first section gives an overview of services offshoring position of CEE and discusses the measurement problems of service offshoring. It examines the service trade trends in other business and ICT services,

and BoP trade data in order to find evidence of offshoring-related service intensity in the NMS. The second part explores the reasons of the comparative advantages and the growing popularity not only of the examined NMS but the whole CEE region as an offshoring hub, drawing on factors favouring nearshoring (as in CEE locations) over offshoring (e.g. India). The conclusion stresses the positive impact of service offshoring on corporate productivity and on the host countries' economic performance and discusses the sustainability of the region's attractiveness.

2 CENTRAL AND EASTERN EUROPE AS AN EMERGING OFFSHORING HUB – EVIDENCE FROM TRADE STATISTICS OF THE NMS

2.1 The increasing role of NMS in the global offshoring market

The tradability revolution in services has resulted in a rapid surge of locational transfers in service activities. Within Central and Eastern Europe the NMS of the EU have achieved the most enormous progress in modernizing their service industries and from the Millennium have witnessed a rapid shift towards services. Countries of the region are gaining importance as offshoring locations. This growth can be partly attributed to the establishment of new capacities, and also to relocation of existing functions from other, higher cost locations. Yet the extent of relocation is much smaller than is perceived on the basis of information from the media (Hunya & Sass, 2005). In 2003, CEE with its \$1 billion share in the global offshoring market (which is worth an estimated \$40 billion) lagged far behind the more prominent locations (McKinsey, 2005). The share of Visegrad countries in the global business services FDI was less than 1% in 2008. Nevertheless, the share of CEE is rapidly growing. In 2003, only 5% of service-related global FDI projects were realised there, while in 2006, 22% of related FDI projects went to regions in these countries. However, the number of current projects in Western Europe continues to exceed CEE projects – 1,600 and 220 respectively (Sass, 2008, Gál-Sass, 2009).

Central and Eastern Europe is still an attractive supplier for mainly continental European corporations as a growing number of outsourcing services seekers from Western Europe have found Bangalore in their own backyard. Major companies after targeting India and its Asian companions as the prime destinations for offshoring services sector jobs, are now looking towards Eastern Europe to meet their nearshoring requirements. During the first stage of

service offshoring, captives in the form of shared service centres were the main service providers, and recently independent global vendors are also opening their new offshore outsourcing centres in CEE to serve their European clients (Gál-Sass, 2009).

2.2. Measurement problems of offshoring services

The main driving forces of offshoring to CEE are closely related to the FDI inflows as the region became an increasingly popular destination for foreign investors seeking to expand their market and to gain access to cheap resources. The NMS particularly benefited from the worldwide structural shift towards service-based FDI. Fifekova and Hardy (2010) calculated that the share of service-based FDI that reached more than 60% of total FDI flew into the Visegrad 4³ countries between 2001 and 2008. This new wave of investment is characterized by not only the fragmentation of activities, where processes of service sector's value chain can be split up and relocated across different countries but also by the changing composition and shift within the service FDI from the traditional services towards business services.

Analysing the patterns of service sector investment and trade, indicators derived from FDI, trade and employment statistics would give an optimal base to measure the extent of service offshoring activities in CEE and the relative positions of the countries in this process. However, we are facing various measurement and data problems. It is mainly due to the definition problems of service sector in general, and the lack of generally accepted and standardized classification of services, which is particularly applies to the breakdown of subdivisions (e.g. classification of business services). Moreover various names are used for describing the same and similar subgroups (e.g. other business services, knowledge intensive business services, computer and business services etc.) that are affected by offshoring (Chakrabarty, 2006, Sass, 2009,).

FDI data in services can be also problematic and vary in large extent depending on the source of the statistics. FDI plays an important role in offshoring, although it is more difficult to quantify it, and services trade data provide a more reliable source of measurement. First of all, one has to make a distinction between FDI serving the foreign market, offshoring and offshore outsourcing. Offshoring is usually connected to FDI, though not all FDI is offshoring (Kirkegaard, 2005). Sass (2008) expresses that constraints of FDI data lie not only in their unreliability but also in their limited size in services compared to manufacturing investments. The invested amount of capital and the costs of setting up a service centres (renting office space, training and recruitment employees) are negligible to manufacturing investments,

therefore the volume of services FDI does not reflect the real extent of service sector investment. In sum, the offshore outsourcing is usually less connected to FDI than to trade.

Detailed data on employees involved in different types of service activities would provide a good proxy, although these are not available in most cases. Labour data can also be misleading due to the problem of differentiating among the relevant jobs according to the ownerships of companies involved (thus, the independent domestic providers are also included in the data) and between service and manufacturing activities. The employment figures of offshoring projects, if they were available, would allow international comparison (Sass, 2009).

Research on this topic is limited due to the lack of appropriate data while the available data can be used to define offshoring only with certain restrictions. Considering the shortcomings in different statistical sources, the indecisive evidence of the consultancy reports and the lack of a commonly accepted definition of offshoring, this paper uses trade data derived from the Balance of Payments statistics. This gives a good approximation to identify the trends in those sections of service trade, which can be regarded as offshorable and helps to identify the geographical direction of contemporary relocalization processes within the region, and it also highlights the shifts in county level performances in attracting offshored services. In case of vertical investment, where the motivation is primarily to take advantage of the local resources, not to serve the local market, the majority of the services produced are immediately exported. These service activities are highly export-oriented and their export intensity is very high (around 100%). That is why the trade data give the relatively most relevant proxy for calculating the extent of offshoring and outsourcing of these services. The growth of vertical investments in the service sector therefore results also in increased exports in services. The majority of exports from the NMS is directed towards the EU (the exports from V4 countries to EU reached 70%), which illustrates that service centres are providing services mainly for customers and subsidiaries within Europe (Fifekova and Hardy, 2010). Between 1992 and 2005 the increase in global imports of CIS (computer and information services) and OBS (other business services) by EU-15 accounted for 9.5% while their imports from CEE over the same period have increased by 13.5%. By comparison, the total services imports have risen just 6.7% (Meyer, 2006).

2.3 Services offshoring market in NMS – evidence from trade statistics

Nevertheless, services trade data due to their statistical shortcomings would be only indicative and gives us an indirect way of measuring the extent of offshoring and offshore

outsourcing. There are several constraints that underpin this argument. For example, not all the trade data registered for ITO (IT outsourcing) or BPO (business process outsourcing) are the result of offshoring. Some authors therefore use trade data as an upper limit for the actual volume (Meyer, 2006). However, reliable services trade data are still missing and available data are incomplete and insufficiently detailed. Sturgeon et al. (2006) argues that the non-physical nature of services and the increased tradability due to the use of communication technologies makes more difficult to measure service trade crossing the borders. In some cases, data are available on intra-firm trade, which could be used as a proxy for assessing the extent of offshoring as in the NMS still the majority of total services trade can be considered intrafirm (Marin, 2005, 2010, Sass, 2008, 2009).⁴ However, intra-firm trade covers mainly the captive cases, and transfer pricing, which is easy to perform in certain service sectors (ICT), distorts these data, too. Further, some trade in services is not reported at all, while others are double-reported because of re-export. Differences between reported and mirror trade statistics can be also significant making the measurement of the real extent of offshore outsourcing and offshoring more difficult. Sass (2009) found the biggest gap (in some cases more than 30%) between the two types of statistics in the cases of Hungarian and Polish exports and imports.

Following the international methodology (OECD, 2004; UNCTAD, 2005; Amiti and Wei 2005b; Ghibutiu and Poladian, 2008; Sass, 2009) two services categories are suitable to approximate the size of trade in offshorable services.⁵ Information and computer technology (ICT) services and other business services (OBS) are the most inclusive categories that can be regarded as potentially offshorable services.⁶ Eurostat data make international comparisons possible at a more detailed level.

The question is whether the data support the widely accepted view that the new member states (NMS) are increasingly affected by the relocation or outsourced provision of offshorable services. Export services data in the case of the six new EU member states (NMS-6) included in this study provide an approximate method to define the extent of offshoring services.⁷ Exports in services in NMS-6 have been expanding from a very low base amounting to 63 billion Euro by 2007, which is almost 3 times higher than that in 1996. The share of the NMS-6 in the global service exports is still modest (2.8 per cent) illustrating the still lower services export capabilities of the region although its growth rate is higher than the global or the EU-15 average. In absolute terms, shown in Fig. 1, Poland, the Czech Republic and Hungary are the leaders in this field.

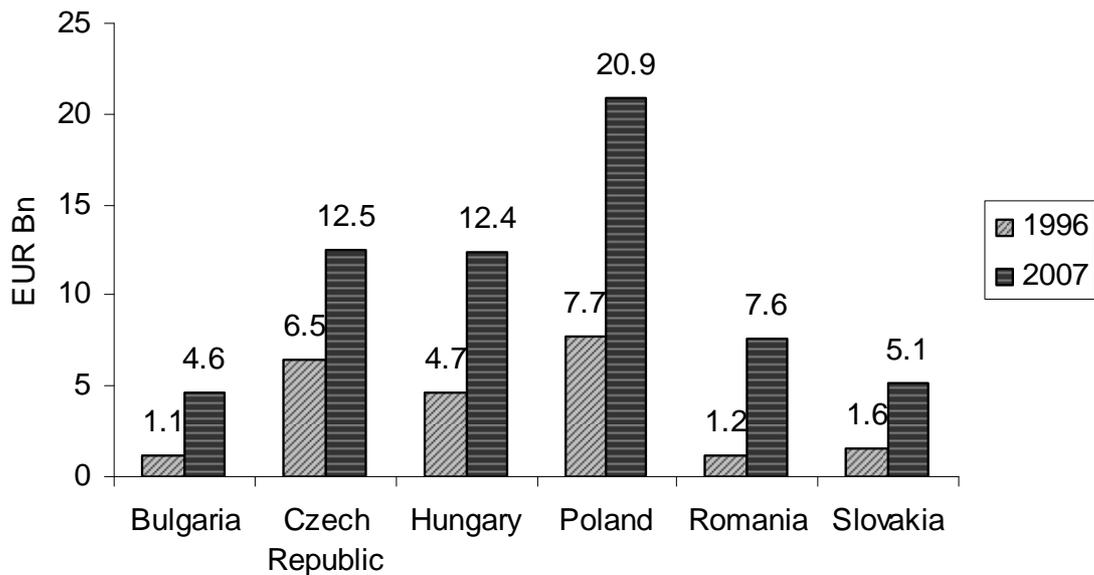


Fig. 1 Exports of services in the NMS-6 in 1996 and 2007 (EUR Bn)

Source: Author's calculation based on Eurostat and IMF BoP data

When looking at the sectoral composition of service exports in comparison with West European countries, the still lower share of other services (including offshoring-sensitive business services) is striking and this means that the higher share of traditional branches of services (travel, transport) reflects the patterns of economic transition.

It is widely accepted that offshoring services means the global sourcing of business and IT services from abroad, therefore to find further evidence of offshoring related service development, export data on the so called “offshorable services”, namely on the other business and ICT services, can be collected for NMS-6 using the Eurostat database. The increased tradability of these sub-categories is more visible in the patterns of services trade and their export/sales intensity is the largest among services (Sass, 2009). The share of offshorable services within total service exports steadily grew from 16 per cent to 24.2 per cent between 1997 and 2007⁸. The total value of offshorable services in the NMS-6 was equal to 15.3 billion Euro in 2007 and within this aggregate the overwhelming dominance of business services (85 per cent in average) is striking. In absolute terms, Poland and Hungary are the largest traders followed by the Czech Republic and Romania (Fig.2).

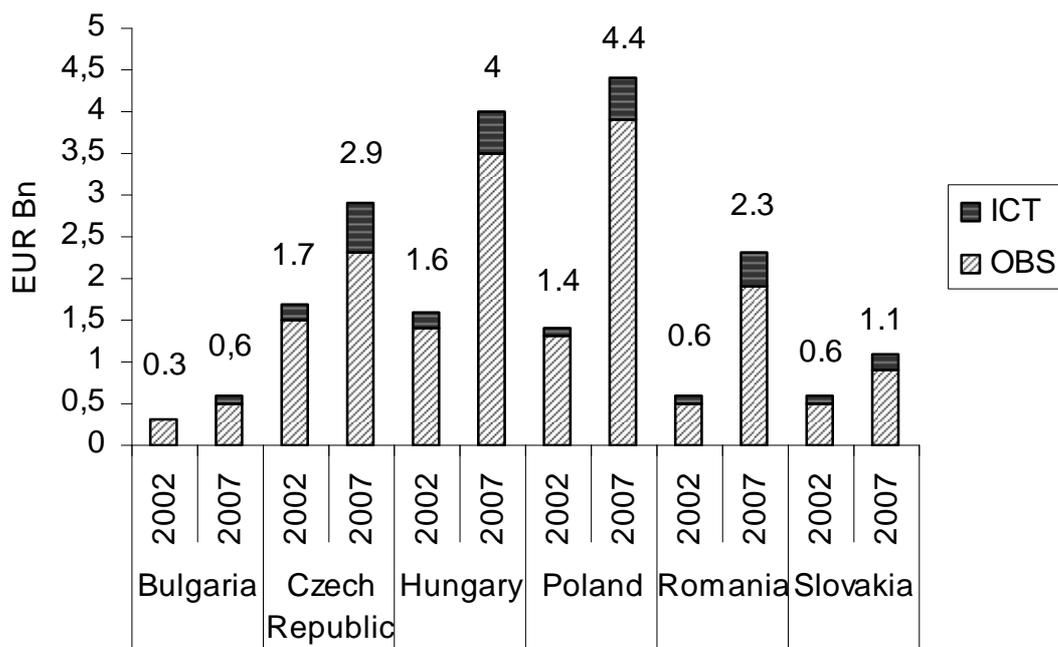


Fig.2 Exports of offshorable services and its sectoral composition in 2002 and 2007 (EUR Bn) ICT = Information and Communication Technology Services, OBS= Other Business Services

Source: Author's calculation based on Eurostat BoP data

The export of services has grown significantly in the region. In comparison to 1996 the level of services exports in 2007 tripled in the Visegrad countries. Within the service sector the growth rate of offshorable service export increased the most dynamically (by an average of 20 per cent) and Romania, Poland and Hungary experienced the highest growth between 2002 and 2007 (Fig. 3). This could be explained by the rapid growth of export oriented vertical investments in the forms of shared services centres. However, one has to be careful with these data because not all the export is provided by service centres and considered to be offshoring.

Due to the rapid growth of offshorable service exports over the period of 2002-2007, in combination with the slower expansion of imports the deficits decreased steadily and this resulted in the development of net trade gains amounting to 800 million Euros (2007) in NMS-6. Hungary reached its export surplus by 2004, earlier than other neighbouring countries. Poland reduced its trade deficits more rapidly, and turned it into small surplus, while Romania achieved the highest surplus by 2007 (800 million) within the shortest period (Fig. 4.).

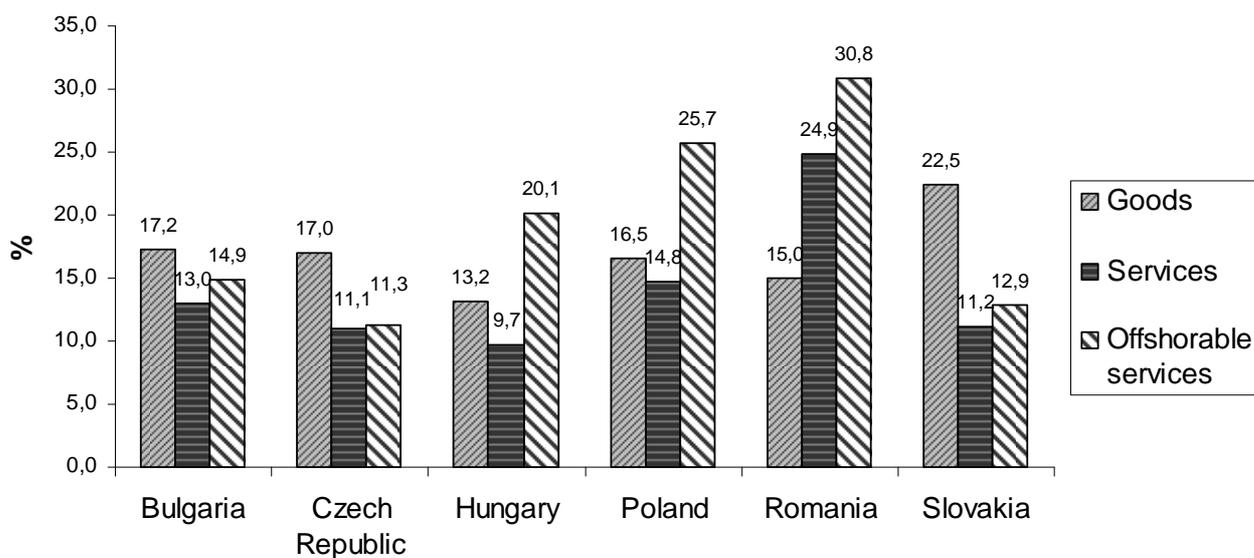


Fig. 3 Average annual growth rates of different export sectors in NMS-6, between 2002 and 2007 (%)

Source: Author's calculation based on Eurostat BoP data

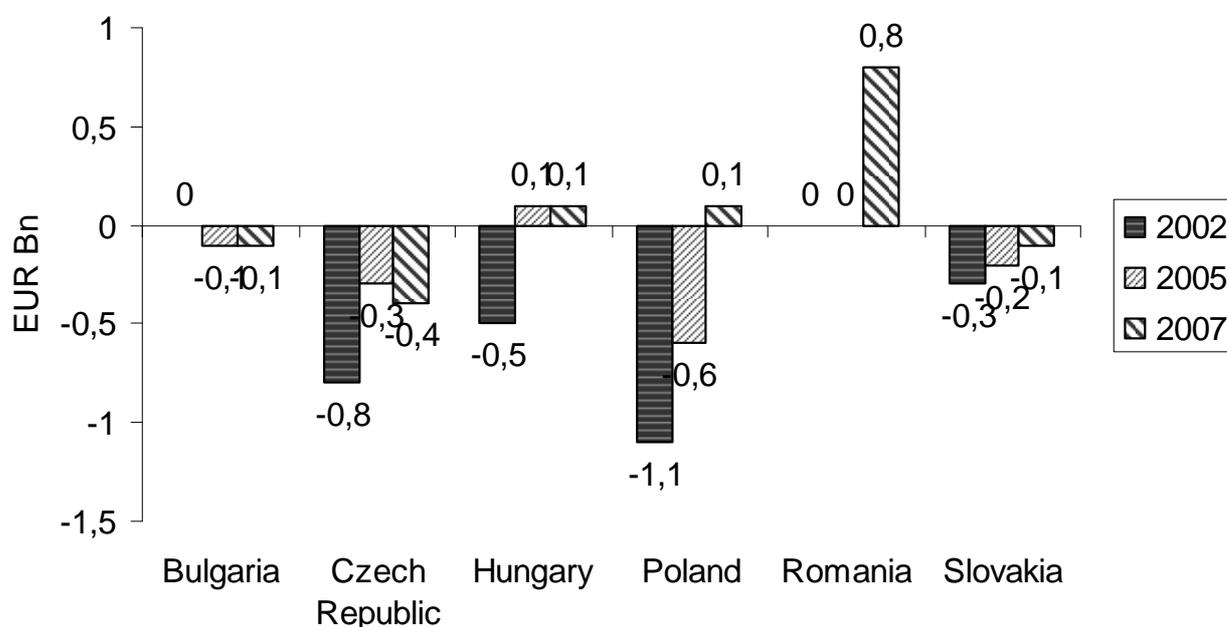


Fig. 4. Net trade in offshorable services in the NMS-6 in 2007 versus 2005 and 2002 (EUR Bn)

Source: Author's calculation based on Eurostat and IMF BoP data

Service trade statistics are supportive of the preliminary assumption that offshoring generated expanding exports in particular service categories and a large proportion of business export services in the NMS has been associated with offshoring. However, it is obvious that not all this kind of trade is provided by offshored services. These data do not show how much of the offshorable service exports are really provided by offshored service centres and do not distinguish between the different organisational forms of offshore outsourcing and captive offshoring at the same time.

3 FUTURE BANGALORES? – OFFSHORING ADVANTAGES AND DISADVANTAGES OF THE NMS

3.1 Comparative advantages of nearshoring services in CEECs

Due to the methodological constraints, quantitative data alone are not suitable to reveal the complexity of offshoring services. Besides findings based on statistical data there are qualitative approaches to identify the main motives of companies relocating business and ICT service activities in the NMS and to define the comparative advantages of regions which arise from the combination of geographical, organisational and cultural proximity to Western Europe.

On the demand side, growth and new business strategic directions are encouraging more and more European companies to establish service centres in locations with strategic geographical position in the CEE region. Strategic locations provide a good accessibility to potential customers (in some cases to domestic markets) and also indicate the geographical direction of future market expansion of companies. Another driver is the rise of the global service delivery model which creates a pool of global service centres around the world incorporating CEE as part of a global system (Gál, 2009).

These “closer to home or closer to expansion” strategies are applied when investors prefer the establishment of services-centres nearshore or close proximity to home country, other company centres and to international business centres. Nearshoring means relocating service activities to a foreign, lower-wage country that is relatively close in distance and within the same continent or time zone⁹ (Jahns et al., 2006, Bryson, 2007). Jensen et al. (2006) show that the importance of nearshoring in many cases overwrites cost considerations. Carmel and Abbott (2007) emphasize the importance of time zone and distance, which make the selection

of service centre locations a very important issue. The importance of time zone differences is a function of the level of communication required for the project. The distance just like different time zones will also increase the costs of face-to-face interactions (Rao, 2004). Nevertheless, bigger time differences could offer an attractive alternative for global round clock operations. The preference for nearshoring partly explains the growing particular attraction of the NMS in business services offshoring/outsourcing.

Another important, but less emphasized driver of the relocation of services to CEE is the lack of the sufficient number of qualified labour in home countries. Marin (2010) examines the concentration of skill intensive activities at the east European affiliates of German and Austrian companies in order to research the labour market impact of offshoring. She found that indeed, the high-skilled jobs are moving to the east due to the scarcity of human capital in the sender (home) countries.

On the supply side, locational advantages determine which countries are chosen as hosts for new or relocated service centres (Table 1). These advantages are similar to those of efficiency seeking investments. The most important of these is the availability of those factors (resources) of production that are used intensively in the production of the service in question at a lower cost. It also can be argued that the attractiveness of CEE is also based on talented, highly skilled labour and geography, rather than simply on low wages and a vast labour pool. Three groups of apparently important capabilities drive the nearshoring advantages of CEE.

First, these countries have close geographical, political and cultural ties with Western Europe. The advantages of EU membership not only diminished the external risks but dramatically simplified the administration cost, as well. CEE as a nearshoring location scores high marks because of its lower cost for communication between the customer and service provider. Nearshoring locations not only reduce costs and risks of working with distant foreign companies but also simplify personal contacts. The directness of communications and common cultural understandings have always been important cultural elements of successful interactions. Besides close proximity that may improve the efficiency of day-to-day information exchange to a service provider, nearshoring allows companies to facilitate control and smooth operation (Abott and Jones, 2002). Being in the same time zone is a huge advantage, especially, if projects require frequent travelling, and also CEE is particularly interesting for companies who require voice and customer-facing services in their mother languages¹⁰ (Meyer, 2006).

Second, the comparative advantages of CEE still to a large extent lie in the wage differences as cost savings are still one of the most important motives for offshoring. In CEE, labour costs are 40 to 60 percent lower than in Western Europe, although it varies largely

within the region. Hungary, the Czech Republic and Poland have the highest average salaries while, Romania and the Slovak Republic have relatively lower average salary levels (ECONOMIST, 2005). Comparative advantages in wages between countries and regions can change relatively fast, although CEE will remain relatively cheap for the near future. Ultimately, no low-cost country can remain low-cost forever. Most of the CEE countries are not among the cheapest locations and outpace those of the low-cost Asian countries. As costs in the most advanced CEE countries converge towards EU levels, companies are moving farther East in their search for high-skill and low-cost solutions (Russia, Ukraine, and Turkey). However, the recent depreciation of the local currencies as a consequence of financial crisis sustains the cost competitiveness of the region for a longer period. Other than labour costs are also relevant factors for the selection of service centres locations. Costs of infrastructure, operating costs and taxes were the most frequently mentioned factors by the interviewed companies (Fifekova and Hardy, 2010).

Third, much has been said about the quality of labour in the region, which consists of a highly educated, well-trained and motivated workforce, achieving a high degree of productivity and flexibility. Skilled labour, in many cases is coupled with the knowledge of certain foreign languages. However, the nature of the skill requirement of the activities has some subtle characteristics. CEE countries do not only have factor price advantages compared to more developed countries but they also have a 'knowledge advantage' in some submarkets compared to other lower priced countries in terms of the knowledge of 'smaller' languages and the supply of well-educated university graduates. In total, CEE produces a much lower number of university graduates than its large Asian counterparts. However, the CEE graduates turn out to be far more suitable to work for TNCs. According to the McKinsey survey, job candidates from CEE had higher suitability rate (around 50 per cent on average, whereas 80 per cent in developed countries) across all occupations than their Asian or Latin American counterparts (McKINSEY, 2005). While the technical universities have maintained their quality standard, the share of science and engineering graduates is lower than the Indian or West European averages, which, in turn, diminishes the region's capability to specialise in IT or sciences-based service provision.

Fourth, other non-cost related factors should also be considered when choosing offshore locations. Good quality telecommunication infrastructure is also an important locational factor and the quality of this infrastructure is now high and can be used at reasonable prices in these countries. This is also true for office space. In order to ensure smooth functioning of the service plant, certain other services (e.g. financial, other business services) must be available. Moreover, a good legal and regulatory environment with effective enforcement is important.

These conditions are now present in the required quality in those NMS countries where general levels of legal compliance are high. In some cases protection of intellectual property is indispensable which lends a competitive edge to these countries over China or Russia. European Union membership also encourages high 'trust' in business relationships (Gál-Sass, 2009).

3.2 Benchmarking offshoring locations: India versus Central and Eastern Europe

A few studies have tried to estimate the impact of Central and Eastern European nearshoring locations on the global market and on the largest global players, such as India (Meyer, 2006, 2007, Rajan, 2006). Many countries are attempting to imitate India's success by promoting themselves as offshoring and nearshoring locations. India emerged as the "destination of choice" for offshore delivery of almost all kinds of IT and business processes, and as a well-established leading destination in terms of market share, as well as the depth of services work, it cannot be easily challenged. India will remain the leader in global sourcing and CEE provides a much smaller scale of different factors facilitating service sourcing from there.

Table 1 also summarises the additional factors favouring nearshoring (as in CEE locations) over offshoring (e.g. India). The expansion of outsourcing of new types of higher value services may require more interactions that only nearshored locations can provide due to the need for a well-educated multilingual workforce, cultural understanding and service provision within working hours that requires location in the same time zone. In this regard, CEE regions possess five primary advantages over India: cultural and geographical proximity to Western Europe, relatively competitive wages, good educational standards reflected by the higher rate of graduates' suitability, low risk profile and reliable infrastructure.

There are several reasons, listed in Table 1, besides size why CEE countries cannot outpace India's potential. Firstly, companies from the US and UK are still the leading purchasers of offshoring services, while the continental countries of Europe generate a larger demand towards the CEE countries but are responsible only for 20 per cent of all European offshoring expenditures (Meyer, 2007). CEE may remain a preferred location for Western European companies or Europe-oriented multinationals from other regions, but cannot effectively challenge the position of India as a global location. There is another reason which has made India a favoured destination. India, contrary to CEE, is able to provide global round clock operation for Western European companies (in CEE it is true only for companies based in Americas).

However, compared with other trade flows, the quantitative significance of offshorable services and IT services in particular, is still lower than in India. In India 78 per cent of total export services are produced by ICT and other business services, while the corresponding figure for NMS-6 is 39 per cent. India has already developed a massive net surplus position since 1996, while only a few NMS have achieved net trade surplus in offshorable services. NMS-6 at aggregate level achieved positive trade balance in offshorable services only in 2006, which is led mainly by the export increase in other business services.

Table 1 Offshore environments: India versus Central and Eastern Europe

	Central & Eastern Europe	India
Advantages	Value player	Volume player
	Proximity to the European customers	Large global vendors
	Nearshoring location decreases the cost of distance & time zone differences	Round clock operation for western European companies (different time zone)
	Language skills in European languages	Proficiency in English, wide skills, experience
	Untapped locations choices	Large cities/talent pools
	Motivated, more suitable talent pool	Very low salaries
	Acceptance, common cultural understanding	Flexibility, determination
	CEE has a good potential for further growth	Strong IT specialisation
	Captive dominance	Strong third party vendors
	Specialisation in BPO and KPO (R&D)	Primary specialisation in IT
Disadvantages	Developing infrastructure	Poor infrastructure
	Higher labour cost	Wage escalation
	Government incentives	High attrition rate
	Innovativeness, flexibility	Languages, accent, cultural barriers
	Office availability	Office availability
	Smaller local vendors (with no global presence)	Far-shore, additional cost
	Bureaucratic environment	India is close to its peak saturation

Source: Gál (2009), Gál-Sass (2009), edited by the author

The average annual growth rate of offshorable export services in India between 2002-2007 amounted 29.6 per cent, while the corresponding rate was 19.3 per cent in the NMS-6. India's leading role especially in ICT service provision is unquestionable. In India 56 per cent of the

total offshorable export services are ICT services (77 per cent in 2002), while the corresponding figure in NMS-6 is 15 per cent showing no strong export specialisation in IT (IMF BoP statistics, 2006, 2007) (Fig. 5). Consequently, CEE plays a more important role in business service provision, though the Czech Republic and Romania show a relatively stronger specialization in IT services indicated by the above average share (21 per cent and 18 per cent, respectively) of ICT export within offshorable services trade.

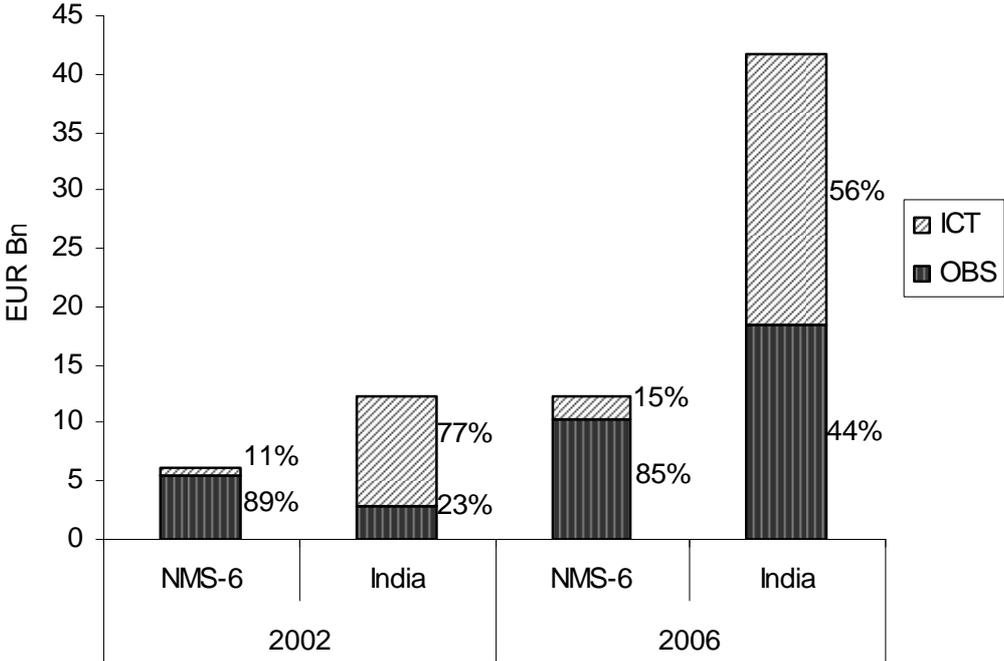


Fig. 5 Exports of ICT services and OBS: India versus NMS-6, 2002-2006 (EUR Bn, percentage)

Source: Author’s calculation based on Eurostat and IMF BoP data

There are several factors besides the large size of the Indian economy why CEE countries cannot equal India’s potential. Among others, CEE cannot match the vast supply of Indian university graduates. India’s 380 universities and 11,200 higher education institutions produce 2.1 million graduates each year of which 350,000 are accounted for by IT graduates alone. Labour supply for the professional occupational groups associated with outsourced business services is seven times larger in India compared to the Czech Republic, Poland, and Hungary together (Gál-Sass, 2009, McKINSEY, 2005).

Most CEE offshore units are relatively small compared to their Indian counterparts, but also service vendors are much less well-known in global markets compared to Indian-based companies. The low level of government incentives, the bureaucratic environment and the lower level of office availability are similarly disadvantageous factors for the position of Central Europe.

However, despite lagging behind in certain areas, CEE has comparative advantages in business offshoring services which enable it to attract new processes in front office services as well as core knowledge intensive business functions. These issues are enough reason to argue that the CEE location provides 'niche clusters' in business services while India acts as a 'volume cluster' with the highest value in IT services. In addition, CEE is a regional player while India operates on a global platform.

CONCLUSION

Offshoring has been a stimulus to develop CEE as an important destination for resources seeking services investment. New member states invigorated by EU enlargement became important locations for shared service centres. The growth of vertical investments in the service sector results in increased exports in services. Trade statistics support the assumption that an expanding export in other business and ICT services has been associated with offshoring services in the NMS. The service export data adopted from the Balance of Payments statistics give a good approximation to identify those sections of service trade that can be regarded as offshorable.

Notwithstanding the various data problems and statistical shortcomings, which hinder the measurement of the real extent of offshoring and offshore outsourcing processes in services, the calculations based on BoP trade data largely support the assumption that an expanding export in other business and ICT services has been associated with services offshoring processes in the new member states. The improving net trade position of NMS in offshorable services has moved from deficits to growing surpluses also illustrated the shift towards the higher value added KIBS. The paper also argues that due to the discussed measurement problems calculations based on BoP trade data are only indicative and an indirect way of measuring the accelerated pace of this process. Determining the actual extent and patterns of service sector investment requires a combination of quantitative and qualitative research. This

latter must be carried out in the forms of company level investigation, in-depth company interviews and questionnaires.

Offshoring services has not only generated trade in services but also impinge on the positive effects on the dynamic growth of higher value-added 'offshorable services'. However, the share of the region in the global service trade associated with offshoring is still lower than is hinted by the media and superficial consultancy estimates. Besides findings based on statistical data, there are qualitative approaches to identify the main motives of companies relocating business and ICT service activities in the NMS and to define the comparative advantages of the CEE region as a whole.

Building on the region's nearshoring advantages such as geographical-cultural proximity and on its multilingual graduate supply, CEE is likely to utilise more value added and quality-driven services. The paper summarises the additional factors favouring nearshoring (as in CEE locations) over offshoring (e.g. India) and listed several factors besides size why CEE countries cannot outpace India's potential and cannot compete with India in volumes and IT specialisation. CEE may remain a preferred location for Western European companies or Europe-oriented multinationals from other regions, but cannot effectively challenge the position of India as a global location.

Despite the fact that the service industry is the most promising opportunity for the CEE economies, there are few threats concerning the region's future prospects as a major offshoring hub. It is not just the steadily raising costs. The size of the talent pool is still limited in CEE and, compared to India, the majority of the workforce still consists of young and inexperienced graduates. Another aspect of the problem is based simply on size. The population of the six largest Central European metropolitan areas is only equal to the population of the single Indian city of Mumbai. On the corporate side, local providers in CEE failed to establish their global presence on the map, because of their smaller size and fragmentation, and they are more attached to the local market instead of seeking out the global market. Another problem is the bureaucratic environment and the lack of assessment of direct consequences of financial crisis. However, the pressure to stay competitive is forcing both the companies and the host countries to exploit the further advantages of services offshoring and outsourcing.

The steady growth of services exports during the last decade and the changing composition of service trade in favour of the higher value added activities have exerted a positive impact not only on companies' productivity but on the host countries' economic performance, which have its repercussions on the overall performance of the European economy. Services offshoring also generates increased pressures on the NMS to adjust their

economies and manage the challenges raised by the rapidly changing global offshoring landscape by continuous upgrading of their comparative advantages.

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¹ Protsenko (2003). finds that German vertical FDI in the Czech Republic has positive effects on the productivity of local firms, while horizontal FDI does not have such effects.

² Czech Republic, Hungary, Poland, Slovakia, Romania and Bulgaria

³ Czech Republic, Hungary, Poland, Slovakia

⁴ Marin (2005) examines the extent of offshoring and outsourcing by looking at the pattern of Austrian and German intrafirm trade both in manufacturing and services with Eastern Europe. She finds that more than half of German FDI and about 15 % of Austrian FDI realised in the Central and Eastern European countries was connected to offshoring.

⁵ SASS (2009) explores several methodological problems related to the exact quantification of offshoring services, and stresses the difficulties in grouping those particular service categories which are affected by offshoring, partially because the NACE classification packs together offshorable and non-offshorable service categories..

⁶ As GHIBUTIU and POLADIAN (2008) pointed out, it is difficult to distinguish between offshorable and offshored service parts because not all service trade is related to offshoring, nor it is possible distinguish between affiliated and unaffiliated trade, or differentiate between captive and independent providers respectively.

⁷ Bulgaria, Czech Republic, Hungary, Poland, Romania, Slovakia. The share of NMS-6 in the total service export of NMS-10 is accounted for 85%.

⁸ On country level some offshorable export shares increased even more between 2002 and 2007: Hungary from 20 per cent to 32 per cent, Romania from 24 per cent to 30 per cent and Poland from 13 per cent to 21 per cent.

⁹ Some companies have special operation requirement within a time zone to provide 24 hours services for other than EMEA region. (Fifekova and Hardy, 2010)

¹⁰ In Eastern Europe, the share of German speaking graduates can be as high as the number of English speaking ones. (Nearly 40 per cent of schoolchildren learn German while 70 per cent of them English). Romania is particularly interesting destination for French companies as 85 per cent of schoolchildren learn French there.