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# The Globalisation of Business



## Introduction

In this part of the White Paper, we summarise the changing patterns of international trade and investment, and the benefits they offer, drawing particularly on the example of the European Union.

We look at the history of international trade and investment, take a snapshot of the current state of play and a first look at the benefits that trade and investment can bring.

We consider how fast-growing new economies – particularly China and India – are changing the world economy, and look at why other countries – particularly in Africa – have been locked out of trade, investment and growing prosperity.

We recognise that trade liberalisation is not just about ensuring economic growth, but must also take into account important considerations of sustainable development and poverty reduction. We also explore this argument further in Part 3 of the White Paper.

We then look in more detail at why fewer goods and services are now made in just one country, and give examples of how UK businesses are contributing to – and benefiting from – this internationalisation of production. The ‘offshoring’ of call centre and other back office jobs is considered as a particular example of the challenges and opportunities the UK and other developed countries face.

## Chapter 1

# International trade and investment: a snapshot

The history of international trade goes back to the beginnings of human civilisation. Historically, periods of greater openness to trade have been characterised by stronger global growth. The concept of globalisation – a broader concept relating to the integration of economies and societies – dates back to the 19<sup>th</sup> century. The graph below separates trends in globalisation into three phases.

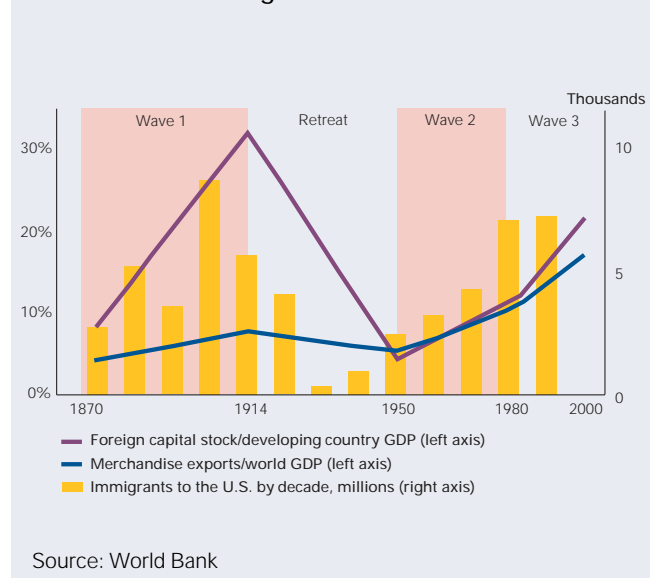
Most authors on globalisation speak of a first phase which began around 1870, driven by the industrialisation initially of the UK and subsequently of the US and Germany.

This first phase was marked by three main factors. There was a large increase in the importance of trade to the world economy (measured in terms of the ratio of trade to GDP); there was a sharp increase in the importance of foreign capital to the economy of poorer countries; and there were mass migrations, outstripping anything that we see today. The pattern of trade was much simpler than it is now. Broadly speaking, the colonial empires imported commodities, turned them into manufactured goods and shipped them back to their overseas possessions.

This phase came to an end with the First World War. The aftermath of the war saw large increases in barriers to trade as governments sought to protect domestic production from imports, culminating in the US “Smoot-Hawley” tariff increases of 1930, to which the US’s trading partners responded in kind. There followed a sharp dip in the contribution of trade to the world economy – the ratio of trade to GDP fell from 22% in 1913 to 9% during the 1930s. The world economy stagnated, with annual growth less than 1%. Looking back on this period in 1942, a League of Nations report described inter-war trade policy as “a vast game of beggar-my-neighbour”.

This led to an international consensus after the Second World War that a different kind of approach was required. A failed attempt by developed countries to found an International Trade Organisation left us with the General Agreement on Tariffs and Trade

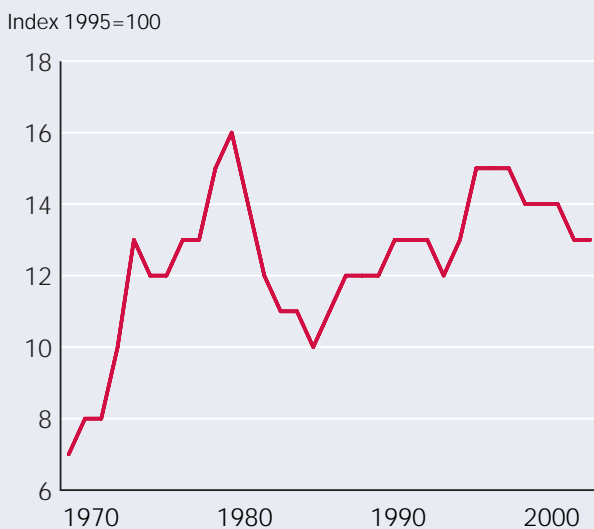
1.1: Three waves of globalisation



(GATT) which provided a framework for a series of “Rounds” of negotiations, by which tariffs were frozen and then cut. At the same time, some individual governments cut their tariffs over and above what was negotiated in the GATT. Eventually GATT was replaced by the World Trade Organisation (WTO), established in 1995 and now with 147 Member States. At its heart are the WTO Agreements, negotiated and signed by all the Members and including agreements for each of the three broad areas of trade covered by the WTO (goods, services and intellectual property), rules for dispute settlement and rules for reviews of Members’ trade policies.

Over the post-war period trade grew again, both in volume terms and in terms of its importance to the world economy (graph 1.2 shows this trend from 1970).

1.2: Ratio of world merchandise exports to world GDP (at PPP exchange rates)



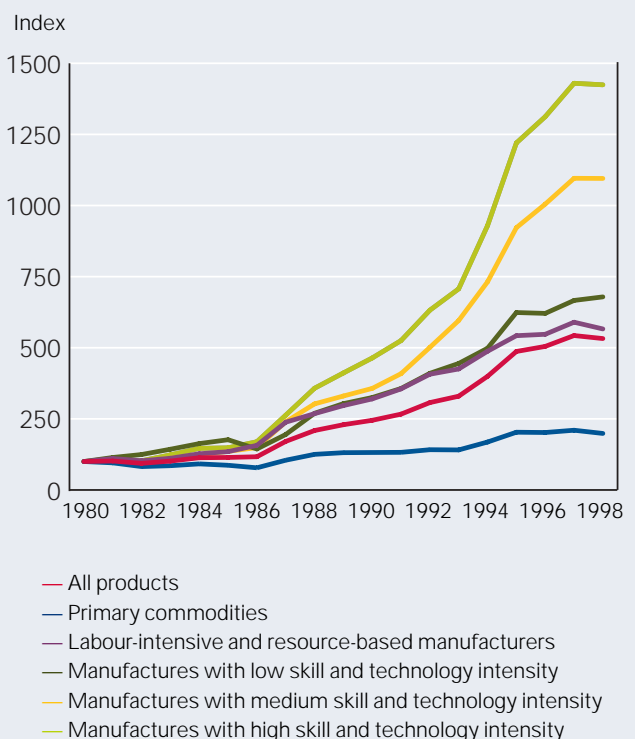
Source: WTO & IMF

Compared with the pre-1914 globalisation this increase in trade has different characteristics. Developing countries as a whole export a much

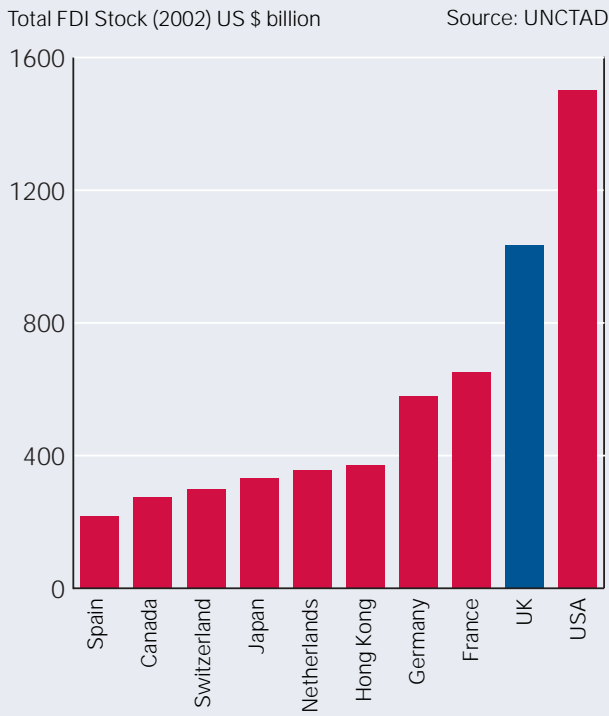
wider range of products than in the years when they were essentially suppliers of commodities. As graph 1.3 shows, exports of high-skill, high-technology manufactures by developing countries have grown considerably since 1980 and include over half of their 20 fastest growing export categories. For example, exports of computers grew by an annual 15% between 1980 and 1998, with developing countries quadrupling their share of world exports. For many developing countries manufactured goods and services have replaced agriculture as their main exports. Overall, manufactured goods now account for 65% of the value of developing country exports compared with a mere 10% for agriculture and food exports.

But behind the wider figures, many developing countries still rely on primary commodities for most of their export income. Agricultural subsidies and

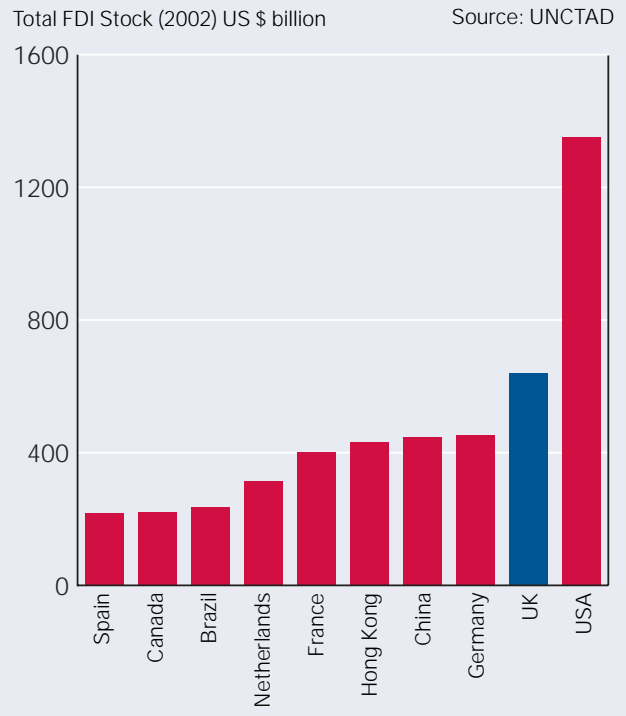
1.3: Growth of exports of different classes of goods from developing countries (by value) 1980–1998<sup>13</sup>



1.4: Largest providers of outward FDI



1.5: Largest recipients of Foreign Direct Investment



trade barriers have depressed prices and restricted markets for these products, preventing many poorer countries from securing the full potential from their natural resources and from climbing the value-added ladder out of poverty.

Instead of individual countries at similar stages of development specialising clearly in particular things, we are seeing two-way trade flows in very similar goods – for example cars moving across a national border in both directions.

Large factories do not necessarily make a good from start to finish: production can now be broken down across national borders, with different countries specialising in the production of different components. The old idea that products originate from only one country can also hamper well intentioned efforts to help particular developing countries (the rules of origin phenomenon is described in more detail later in Part 1; policy prescriptions are discussed in Chapter 6 of Part 3). Advances in telecommunications have made it possible for services also to be supplied a long way away from the customer; this is discussed in more detail later in this chapter.

Despite this, however, much international trade is transacted with neighbouring countries or within major geographical regions. Inter-regional trade

accounted for 40% of North American trade in 2002 and 67% of Western Europe's trade<sup>14</sup>. This is in part due to the continued importance of transportation costs. These "limits of globalisation" are discussed in more detail in Chapter 1 of the *DTI Economics Paper 10*, which accompanies this White Paper.

## Investment

Foreign Direct Investment (FDI) flows have increased dramatically over the past quarter of a century, with especially rapid growth in the 1990s. The world stock of outward investment is more than 12 times as large as two decades ago, growing from \$564 billion in 1980 to \$6,867 billion in 2002<sup>15</sup>. Although recent years have seen a slowdown in flows of FDI, as the world economy picks up FDI flows are expected to follow suit.

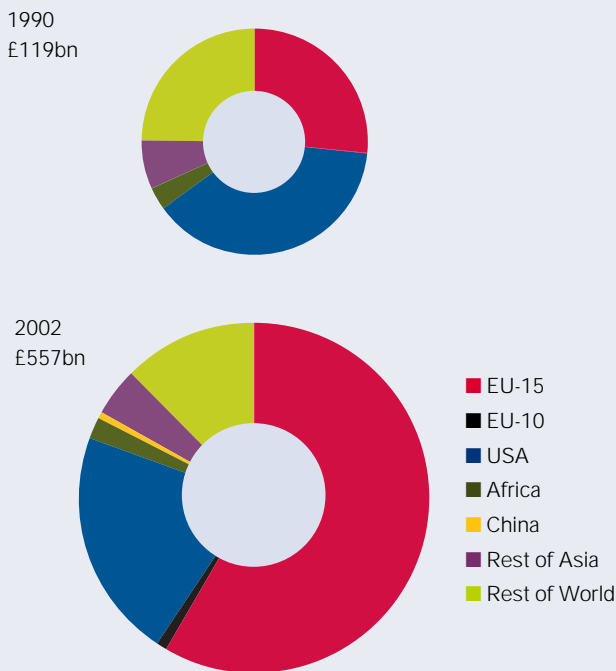
FDI remains highly concentrated. Developed countries are still the predominant providers and recipients of FDI, providing 87% and receiving 65% of all FDI in 2002. Graphs 1.4 and 1.5 show the largest overseas investors and recipients of this investment. Although emerging markets are now receiving a higher proportion of all FDI flows than they were in 1980 this investment has also been highly concentrated, with the few leading destinations – China/Hong Kong, Brazil, Mexico and Singapore – receiving over half of all FDI in the developing world.

<sup>14</sup> Source: WTO International Trade Statistics, 2003.

<sup>15</sup> Source: UN World Investment Report, 2003.

1.6: Where the UK's FDI goes

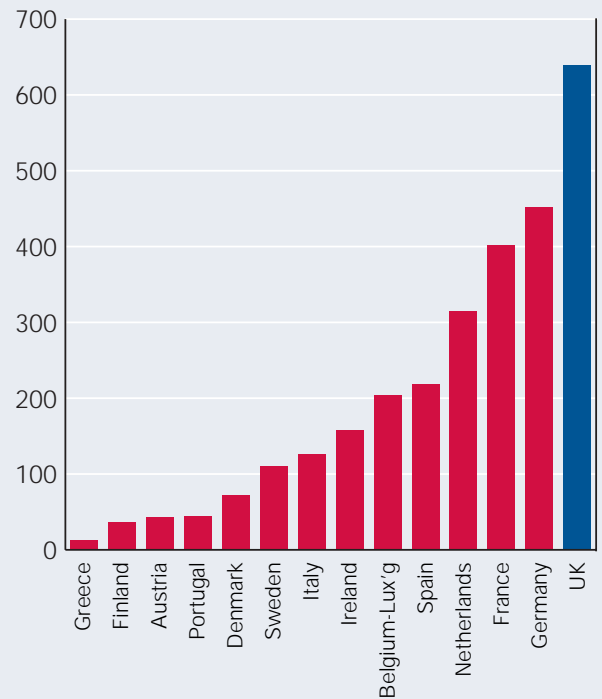
Source: ONS



1.7: 2002 Inward FDI Stock of the EU-15

US\$ billion

Source: UNCTAD



The UK is the world's second biggest outward investor. This contributes to UK prosperity, not least because pension funds are able to identify opportunities and spread risks as they invest in good prospects in a huge range of markets. Investment in overseas securities accounted for a quarter of UK pension funds assets under management in 2002<sup>16</sup>, whilst UK investment income earnings (credits) to the UK totalled £125 billion in 2002<sup>17</sup>. Graph 1.6 illustrates the way in which the destinations for UK FDI have changed since 1990.

The UK is also a major recipient of inward FDI, with more investment than any other EU Member State. Graph 1.7 illustrates this.

### International trade and investment: the benefits

The basic economic argument for international trade remains that of "comparative advantage": more trade leads to a better use of the world's resources, as countries produce more of those things that, in relative terms, they are better at producing.

It is important to stress that the benefits come from all trade flows – not just exports and inward investment but imports and outward investment as

well. Openness to trade boosts productivity, by enabling a more efficient allocation of resources; by providing greater opportunities to exploit economies of scale; by exposing the domestic economy to greater competitive pressures; by rewarding innovation and providing access to new technologies; and by increasing incentives for investment. Indeed, contrary to earlier policy thinking, which emphasised export growth and import substitution, the evidence suggests that the main way in which a country gains from trade is by opening its own markets<sup>18</sup>.

Many of the gains from imports also flow from inward investment which can raise the overall level of investment and productivity in an economy and play a major role in transferring technology and know-how. Inward investors often work in partnership with local business which can stimulate ripple through effects improving knowledge transfer and working practices in the domestic market. This is discussed in more detail in Chapter 3 of Part 2.

Individual companies also benefit from expanding into world markets. Where the domestic market is limited in size, a company can grow and become more

16 Source: International Financial Markets in the UK 2004

17 Source: ONS UK Balance of Payments 2002

18 "Trade and the Global Economy: the role of international trade in productivity, economic reform and growth" (DTI/HM Treasury, 2004).

efficient through exporting. As greater competition drives companies to innovate, the opportunity to sell on world markets can at the same time make that innovation profitable, creating a virtuous circle of investment, innovation and expansion.

Our view is that the benefits of international trade and investment should lead governments to work to remove their own trade barriers and those of other countries. But while removing trade barriers is *necessary* to let trade flow, it is not always *sufficient*. In general terms, countries with open markets seem to grow faster, but the extent to which this growth is driven by trade liberalisation varies from country to country. Some countries which have opened their economies to trade and investment have for other reasons, not seen an increase in trade, growth and prosperity. Many developing countries face much more pressing constraints in being able to capture the benefits of freer trade:

- the skills and health of their citizens need strengthening – not just for international trade, but to improve productivity across the economy;
- they need improved trade-related capacity, such as efficient customs, trade infrastructure, including roads and ports, to enable them to bring goods to market competitively;
- they need the capacity to cope with economic change, such as opportunities to re-skill, and a flexible dynamic economy that continually creates new jobs; and
- institutions need to be put in place to safeguard people through change.

These and other problems mean that, whatever is done on reducing trade barriers, the poorest African nations – 34 countries with 410 million people – would not see much benefit. For example, although sub-Saharan Africa has implemented significant trade reform, particularly since the 1990s, its share of world merchandise exports has halved, from 2.7% in 1980-84 to 1.3% in 1995-2002.

If, on the other hand, removing trade barriers does lead to an increase in trade and therefore drives change, there will be both winners and losers in the transitional period.

So trade liberalisation has to be properly sequenced with a range of other government policies aimed at harnessing the benefits but also dealing with more harmful consequences by tackling the serious supply side issues developing countries face. For poorer countries with less economic and regulatory capacity in particular, trade liberalisation has to fit within a broader approach to economic development and poverty reduction strategies. We discuss what this means in practice in more detail in Part 3.

## Chapter 2

# Trade and investment liberalisation in practice: the story of the EU

The benefits of trade and investment liberalisation are nowhere more apparent than in the EU. Since joining the EU (then EEC) in 1973, the UK has experienced an impressive increase in trade with other EU Member States, both in absolute terms and relative to our trade with other countries. In 2003, 56% of the UK's trade in goods was with our EU partners, up from around 35% in 1973. One seventh of UK income and production depends to some extent on our trade with the EU. Furthermore, around 3 million jobs<sup>19</sup> are linked, directly or indirectly, to our exports to the EU. The dismantling of internal barriers through the Single Market has boosted growth and productivity in the EU.

Successive rounds of EU enlargement have increased the size of the EU and the number of people who benefit from a reduction in barriers to trade between EU Member States. With the recent accession of 10 more countries on 1 May 2004, the European Single Market with 455 million consumers, now accounts for 40 per cent of world trade<sup>20</sup>.

By removing tariffs and creating a level playing field of regulations and standards, the European Single Market gives EU firms access to the largest 'domestic' market in the world, allowing them to specialise and exploit economies of scale. More trade and competition lead to more efficient production and encourages innovation. Consumers also benefit from lower prices, more choice and better quality. For example telecoms liberalisation within the EU has helped slash the cost of long distance calls across Europe by almost half since

1998. And the cost of flying to EU countries has halved over the last 10 years because of EU rules encouraging greater competition in the air travel market.

According to a report published in 2003<sup>21</sup>, EU GDP in 2002 was 1.8% higher (£110 billion) than it would have been without the Single Market. Over the last 10 years the Single Market has boosted EU GDP by approximately £588 billion – equivalent to £3,800 for every household in the EU.

In Part 2 of this White Paper, we set out in more detail how Europe should respond to the twin challenges it faces: how to continue improving living standards, particularly through strengthening the Single Market, and how to become more open to the global economy, as a natural extension of the Single Market.

19 Source: UK jobs dependent on the EU, Ardy, Begg and Hodsen, European Institute, South Bank University, April 2000.

20 Includes both intra- and extra- EU trade.

21 "The International Market – Ten Years Without Frontiers," European Commission, 2003.

## Chapter 3

# The experience of developing countries

Today developed countries still hold the lion's share of world trade. In terms of value the EU and the US together account for 51% of international trade, 79% of outward investment and 62% of inward investment (FDI)<sup>22</sup>.

The most recent phase of globalisation has seen other players arrive on the scene, including China, Brazil and India. But there are wide variations in the trade performance of developing countries. While some 24 developing countries – with 3 billion people – have doubled their ratio of trade to income over the past two decades and experienced GDP per capita growth of around 4%, the rest of the developing world – with about 2 billion people – has become relatively poorer. Countries in sub-Saharan Africa in particular have faced difficulties in diversifying their economies and export structure in response to freer trade.

## China

China has enjoyed average annual growth of almost 9% for the last 25 years. The world has never seen growth on this scale before. If China keeps up this performance, it will become the world's largest exporter by 2010, and could be the world's second largest economy by 2020. World Bank figures show that the proportion of people living in poverty in China has decreased by  $\frac{2}{3}$  since 1981, from 63.8% to 16.6% in 2001, representing over 400 million people.

This growth dates from a change in Chinese policy in 1979 to one of openness to foreign investment. From cautious beginnings, this policy gained momentum in the 1990s and has now accelerated again in the wake of China's WTO accession. The results have been hugely impressive. With a plentiful supply of labour and the attraction of a massive and growing domestic market, China had attracted over \$500 billion in FDI by the end of 2003, and reports a total of 465,277 foreign funded enterprises.

As international trade liberalises further – especially, now, as a member of the WTO – China has the potential to take advantage. In particular, China stands to benefit when quotas restricting trade in textiles and clothing (the "Multifibre Arrangement") are phased out in accordance with the outcome of the GATT Uruguay Round at the end of 2004.

But China's participation in international trade is about more than cheap "commoditised" manufactured goods. China has also been investing heavily in

<sup>22</sup> Figures are for FDI flows, source: UNCTAD World Investment Report, 2003.



### **Strix and Midea: a virtuous circle of investment, manufacturing and sales in the UK and China**

Strix was established in the Isle of Man in 1951. The company manufactures thermostats for kettles, with most of its research, development and manufacturing in the UK, though it also has offices in China, North America, South Africa, India, Russia and Australia. It enjoys 70% of world market share for its products with annual sales of over \$150 million. Its products are used one billion times per day by one in five of the world's population. Strix has invested £15 million in a plant in Guangzhou in China and supplies a number of Chinese manufacturers, including Midea.

Midea is the leading manufacturer of home appliances in China, with sales in 2001 of \$1.7 billion, including \$200 million from exports.

In October 2003 Midea announced its intention to set up its first overseas product design centre in London, following contacts between the company and UK Trade & Investment<sup>23</sup>. The UK subsidiary will also serve as Midea's European HQ for Small Home Appliance Products. As part of the circle of investment, manufacturing, assembly and sales, UK Trade & Investment introduced Midea to Kingfisher a few years ago, leading to the recent signing of a \$75 million "Strategic Purchase Frame Agreement" between Midea and Kingfisher Group/B&Q China. Part of the agreement covers kitchen appliances, which will include Midea's kettles, for which Strix supplies the thermostats, thus completing an international circle of investment, manufacturing, assembly and sales.

<sup>23</sup> UK Trade & Investment is the Government's lead provider of international trade and investment support to business. Their role is discussed in more detail in Part 2. See also [www.uktradeinvest.gov.uk](http://www.uktradeinvest.gov.uk).



### **Beijing Airport Terminal 3 – a concrete example of opportunities in China**

In 2003 a UK consortium, consisting of construction engineers Ove Arup and architects Foster, won the £25 million contract to design Beijing Airport Terminal 3.

This is one of the largest airport developments in the world over the next five years, comparable in size to Heathrow's Terminal 5. The new terminal must be in place for the 2008 Olympic Games.

Although the design contract itself is a major one for the consortium, an even greater gain for the UK is likely to be from the supply chain. UK Trade & Investment is putting in place an information relay system, headed up by a Chinese national. It is also using the Airports Intelligence Centre database website to disseminate information to UK companies. There are plans for inward and outward missions to ensure that UK companies are well positioned to compete effectively for the supply chain opportunities.

higher education and science and now has many world-class science facilities.

The growth of China is creating opportunities for its trading partners. Chinese imports are growing faster than exports; official Chinese figures in February 2004 showed an overall trade deficit for the previous year (largely accounted for by individual trade deficits with a number of other Asian countries). Chinese companies, increasingly, are investing overseas and engaging in joint ventures with foreign partners.

The UK Government has recognised the importance of strategic co-operation with China. In 2003, we established a China Task Force headed by the Deputy Prime Minister, with a view to boosting UK-Chinese co-operation across a range of areas including trade and investment. The Task Force reported in May 2004, with a range of recommendations which are now being taken forward.

## India

In the 30 years following independence, Indian governments followed protectionist economic policies. Since the mid 1980s, however, successive governments have recognised the need to liberalise the economy in order to meet their desired goals of economic development and poverty reduction. As the country has undertaken successive reforms, economic growth has accelerated, millions of people have been lifted out of poverty and a new middle class created. But the 70% of the population engaged in agriculture have seen much less of the increased prosperity.

India's education system has been highly successful in producing well-qualified people. Graduations are currently running in excess of 2 million a year including around 100,000 in IT related subjects. This feeds into a thriving services sector which is geared to international trade. India has also begun to specialise

in particular strands of research and development, for instance in the pharmaceutical industry.

Economic growth, particularly in China and India, is lifting millions out of poverty. But many poorer countries face considerable challenges to increasing their prosperity through trade (see Part 3 of this White Paper for more on this issue).

## Sub-Saharan Africa is a particular challenge

The problem is particularly acute in the case of sub-Saharan Africa. As we saw earlier the benefits accruing to the 34 poorest African countries would be severely constrained, whatever is done on trade barriers and subsidies, because they simply do not have the capacity to compete. The constraints on maximising the benefits of trade for development are developed further in Part 3, Chapter 6. The principal reasons why these countries have been unable to capture the benefits from freer trade relate to greater problems on the 'supply' side and lack of capacity to respond to market signals:

- education is essential for economic growth as well as social development. Many countries in sub-Saharan Africa are unlikely to achieve the second Millennium Development Goal of universal primary education by 2015. This means that the education and skills base of the workforce will continue to decline and sub-Saharan countries, unable to compete globally with knowledge-based economies, will remain trapped in an economic downward spiral;
- the HIV/AIDS epidemic is now recognised as having an impact on national economies through the loss of key workers to illness and death and the human capital costs of training replacements. Additional costs to firms, government and households include increased spending on medical care, funerals and insurance, alongside lower efficiency associated with absenteeism,

low morale, posts left unfilled and time off to attend funerals;

- non-economic factors including conflict, disputed borders, weak governance, and corruption undermine economic growth and trade;
- low levels of FDI and domestic investment, together with a major problem of capital flight, contribute to prevailing low productivity and make it difficult for these countries to diversify an export base away from primary products;
- poor and inefficient transport systems, high communication costs and burdensome procedures for traders which affect land-locked countries particularly badly. The impact of tariff barriers to trade is often dwarfed by other trade costs; and
- an economic environment in which entrepreneurs are unable to access market information, technical guidance and financial services, and, in many countries, are faced with restrictions on the development of the private sector.

In addition to all of these problems, countries in sub-Saharan Africa continue to face specific trade-related barriers. Africa is more integrated into global markets than is commonly thought, with imports and exports making up around half of Africa's GDP in 2001. Yet its share of world trade continues to decline. In 2002 it produced only 2% of global exports compared with 6% in 1980.

Part of the problem is that Africa remains heavily dependent on primary commodities and is therefore vulnerable to depressed and volatile prices. Agricultural products account for around 50% of export earnings. Several countries depend on just one commodity for over 30% of their foreign exchange earnings, for example Ghana (cocoa), Kenya (tea), Burkina Faso (cotton) and Mozambique (fish). Commodity prices are notoriously volatile, and

have fallen heavily over the past 20-30 years. If these countries could process their basic commodities themselves, they would generate value and reduce the dependency on primary commodity trade.

At present there are a number of barriers preventing developing countries from moving away from dependency on primary commodities. One of these is tariff escalation where value-added products derived from commodities attract a higher tariff than the primary commodity itself. For example cocoa beans can be imported from developing countries on a zero tariff but chocolate milk crumb has a tariff of 10.7%. However tariffs are not the only barrier – indeed, most African goods can be imported into the EU at reduced rates of tariff. There are a range of other problems, including:

- **subsidies:** high levels of agricultural support in the EU and US have reduced Africa's share of global markets for products where it has a comparative advantage, such as cotton, sugar and beef;
- **standards:** Western consumers, even more than in the past, are increasingly demanding that imported food can be shown to be safe. Food authorities, in response, set high standards and impose rigorous approval processes which small African producers find very difficult to satisfy. The standards imposed by major purchasers such as supermarkets can pose similar problems; and
- **rules of origin:** These rules, which specify when a product can be regarded as "produced in" a particular country, exist in order to make sure that the goods imported under a bilateral trade agreement were genuinely produced in the country in question. However when rules of origin are too restrictive, they can unfairly hamper trade. Current rules of origin prevent African countries from taking full advantage of the EU's preferential lower tariffs. As the internationalisation of production increases, so does the significance of



## UK-India: the Pharmaceutical Industry



### AstraZeneca

In June 2003, the Anglo-Swedish pharmaceutical company, AstraZeneca (AZ), opened a multi-million dollar research facility in Bangalore, with a focus on new treatments for tuberculosis (TB). The company has committed \$40 million over five years to the project. With more than 100 scientists AstraZeneca Discovery Bangalore works closely with other AZ R&D centres, particularly those in Boston, USA and Cheshire, UK.

Each year, more than two million people in India are diagnosed with TB, over eight million throughout the world. The challenge facing AstraZeneca Discovery Bangalore is to find the world's first new TB drug since 1964. AZ scientists are now able to initiate novel approaches to treatment, thanks to developments in molecular science that have revolutionised the search for

anti-infective drugs. Specific selective therapies, which may combat the threat of a TB epidemic in this century, are now in prospect. Though the aim is ambitious, AZ is optimistic of finding a drug candidate for TB by 2006, with the drug ready by 2010.

AZ has promised to make any potential TB medicines it discovers available for clinical development. It will also supply them to the world's poorest countries at low prices, in partnerships with governments, healthcare systems, international agencies and others.

AZ CEO, Sir Tom McKillop, explained that the decision to conduct the R&D in India was '... because of the quality of Indian scientists. You need scientists who are creative, who are able to solve problems.'

rules of origin. The UK will press for a review of all rules of origin to ensure that they are suited to the realities of trade in the 21st century and do not act as a barrier to trade, particularly for developing countries.

There is an increasing recognition that concerted effort is needed to address the decline of the sub-Saharan economies. The Commission for Africa<sup>24</sup> is seeking to work in partnership with the international community and African countries to meet the economic and human resource challenges.



#### **GlaxoSmithKline and Ranbaxy**

In October 2003, UK-headquartered pharmaceutical company,

GlaxoSmithKline (GSK), and India's largest pharmaceutical company, Ranbaxy Laboratories, announced a drug discovery and clinical development collaboration in a wide range of therapeutic areas, including urology, anti-fungal, anti-bacterial and metabolic disorders.

Under the agreement, the two companies divide the research and development work between them. Ranbaxy is also conducting early clinical work for a proportion of the selected candidates, with, in most instances, GSK completing development. GSK has exclusive commercialisation responsibilities worldwide, while Ranbaxy takes the lead in the huge Indian market and, with GSK's consent, may co-promote in both the US and EU.

Collaboration with GSK allows Ranbaxy to strengthen its performance in particular types of R&D and to gain access to cutting-edge technologies. For GSK, the move represents a further step in its strategy of building strong collaborations in drug discovery at the same time as accelerating its internal drug discovery programmes.

<sup>24</sup> The Commission for Africa was launched by the Prime Minister on 26 Feb 2004. The Commission will take a fresh look at the challenges Africa faces in the 21st Century, assess policy on Africa and make recommendations for what more can be done. It will report in Spring 2005.



### **Cotton: a clear-cut case of trade and development linkages**

**Cotton is a vital product for some of the poorest countries in Africa, accounting for 5-10% of GDP in Benin, Burkina Faso, Chad, Mali and Togo.**

Over 10 million people in the region depend directly on cotton production. In contrast, cotton production accounts for a tiny fraction of EU GDP while in the US 25,000 cotton farmers receive more in subsidies – some \$3 billion – than the entire economic output of Burkina Faso, where two million people depend on cotton. Further, US subsidies are concentrated on just 10% of its cotton farmers. Thus, the payments to about 2,500 relatively well-off American farmers have the unintended but nevertheless real effect of impoverishing some 10 million rural poor people in West and Central Africa, with African cotton producers unable to export to the US or compete against US cotton in other markets.

Four West and Central African countries (Benin, Burkina Faso, Chad and Mali) have submitted a proposal to the WTO calling for an end to unfair subsidies granted by developed countries to their cotton producers. As an interim measure, they have also proposed that least-developed countries be granted financial compensation for lost export revenues due to those subsidies.

The WTO panel ruling on US support for cotton, if upheld, will give added impetus to measures to reduce trade-distorting subsidies as a crucial part of the WTO's Doha Development Agenda talks on agriculture. Recent EU cotton reforms are a step in the right direction, 'de-linking' 65% of subsidies from production. However, more will need to be done in future, particularly in the US but also in the EU, to enable African producers to exploit the comparative advantages they have in cotton production and translate those gains into poverty reduction.

### How EU rules of origin fail African and other developing countries

**The EU's rules of origin under the Generalised System of Preferences require that a product be completely produced within that country.**

So, to take a concrete example, tinned vegetables from Tanzania would not benefit from the EU Everything But Arms scheme if the tin cans came from a neighbouring country.

The case of clothing from Lesotho provides another clear-cut example. The Lesotho clothing industry fits into a global supply chain in which massive orders from US brands, importers and retailers are awarded

to multinational companies, often with their head offices in Asia. These companies break down the orders, sub-contracting to their affiliates around the world to take advantage of their relative areas of competitiveness, but using the same designs, material and trimmings.

Some clothing was exported to the EU during the 1980s and 1990s under an exemption from the rules of origin. In 1996, however, the exemption was not renewed and exports to the EU slumped. By contrast, Lesotho's exports to the US under the more relaxed rules of the US Africa Growth and Opportunity Act (AGOA) have increased.

## Chapter 4

# How businesses are globalising: the international integration of production

For most of the 20<sup>th</sup> century – and despite the periods of growth in international trade and investment that we noted earlier – production remained largely national. British cars were made in Britain, German cars in Germany, American cars in the United States and, in later years, Japanese cars in Japan. The same was true for most other manufactured products. Although services became increasingly important within developed countries, service exports grew more slowly than the service sector as a whole and it was generally assumed that, with some exceptions such as financial services, most services were not tradable internationally.

All that is changing.

Over the last 20 years, industrial production has become increasingly international. A 'Japanese' car may now be made in Britain – although in reality, its parts will be sourced from many different countries. In the developed world, we tend to think of this process of globalisation as being all one way: production shifting from richer to poorer countries, threatening to leave us unemployed. We also tend to think of globalisation as only affecting lower-value-added production and jobs, while comforting ourselves that higher-value-added production and jobs will stay in the developed world. The reality is far more complex. Both low- and high-value added production are shifting around the world, as production and consumption are restructured.

A number of factors – not all operating in the same direction – lie behind this globalisation of production.

- growing competition. As businesses compete for consumers, the pressure to hold down costs can create an incentive to shift production to locations where cheaper inputs are available, be they labour or materials. But the demand for quality counter-balances the demand for lower cost: thus, low-skill, 'commodity' components can most easily be moved to low cost, developing world locations;
- falling transport costs – making it possible competitively to export components and finished goods from one part of the world to another;
- the need to be near consumers. In some sectors – fresh and fast food, for instance – there is an obvious premium on being near the customer. There is no pressure to 'offshore' sandwiches that are delivered daily to UK supermarkets. Ready-to-cook meals, similarly, will tend to be produced within the home market (though some British firms specialising in ethnic foods are exporting to Europe). But modern transport, logistics and storage systems also make it possible to deliver fresh fruit and vegetables to UK stores, two days after they are picked on an African farm;



#### Thales investment in the UK

Following a review of its corporate strategy in the 1990s the Thales Group adopted a “multi-domestic” international investment strategy to create home markets in countries in which it operates. The implementation of this strategy was demonstrated by the acquisition, in 2000, of the UK’s Racal Electronics Group, since when Thales has consistently invested in UK technology and jobs. Over the last 10 years, Thales has invested over £2 billion in the UK and now employs 11,000 people in over 65 main locations and makes use of an extensive UK based supply chain. Thales’ export sales are currently of the order of £400 million per annum, being around one third of its total UK sales.



#### Strength through design

##### Nissan’s UK Design Centre

Nissan established a European Design Headquarters at the Rotunda, Paddington in 2003 strengthening its manufacturing and technology capability in the UK. The Centre is the main focus for Nissan’s development plans in Europe and will carry out design projects for other global markets.

Nissan felt it imperative to have design capability in Europe since vehicles have to appeal to local tastes. The most successful manufacturers design close to market. The UK was chosen for its vibrancy and multiculturalism, as well as its strengths in all media, including fashion, art, architecture and car design and styling. Nissan was confident that the UK possessed the very best talent with the flair that it needed.

The Design Centre complements Nissan’s highly successful Technology Centre at Cranfield which, for the first time, is carrying out full production engineering of new vehicles for the European market. The fragmentation means that Nissan can benefit from efficiency gains, outsourcing and specialisation without moving the whole supply chain.

- 'just in time' production techniques require the delivery of components, perhaps several times a day, to the final assembly plant, making it more efficient to concentrate suppliers in nearby 'supply parks'.
- the revolution in information and communications, which enabled the creation of global financial markets, allows companies to organise production in new ways. Complex engineering and software design can be organised around the clock, around the globe, taking advantage of centres of skilled people in different time-zones and slashing production time. Complex logistics and supply chain management tools enable managers to optimise production in many different and distant locations;
- the emergence of new markets. The process of liberalisation in formerly closed economies is itself creating new consumer markets and new production opportunities – attracting multi-national companies interested and able to serve all their markets, including their 'home' market, from wherever in their global operation it is most cost-effective to do so;
- competitive pressures for quality and innovation. Companies that want to dominate the global market for their products are under intense pressure to find and use the best – the best R&D scientists, designers and engineers, the best-skilled workforce, the best location for production of a particular component. Science and technology are increasingly international, with researchers operating in partnerships (again, ICT-enabled) around the globe: leading-edge business, ever more dependent upon innovation, is increasingly willing to put its R&D investments where they find the leading-edge scientists.

Many of the same factors – particularly the ICT revolution – also account for profound changes in the *structure* of businesses themselves, as companies focus on the most important parts of

their operation, outsource other parts of their work, enter into partnerships with other businesses to acquire new skills or technologies, create new products or enter new markets. Companies operate within networks and, increasingly, operate as networks; and those networks are global.

We shall return to this point in Part 2 where we discuss the kind of support that UK-based businesses, and particularly SMEs, need in the global economy. In the old way of thinking, there was a UK business, manufacturing in the UK for the UK market, which could then be helped to export its goods abroad. Today, more and more companies – even at an early stage in their lives – will be sourcing components from abroad as well as exporting their products, finding the best technology from around the world as well as licensing their own design or invention for use abroad, and entering into joint ventures with partners in other countries in order to enlarge their market reach.

The internationalisation of industrial production is no longer news, although that does not mean we should be complacent about the condition of UK manufacturing industry (an issue we return to later, and one that is addressed in detail in the forthcoming *Manufacturing Strategy Progress Report*, to published by the DTI in July). But the internationalisation of *services* is later news, particularly when it comes to offshoring 'call centres' and other back office jobs.

### Offshoring

In recent months, many of the concerns about the impact of globalisation on the UK, and on other developed countries, especially the US, have focused on the phenomenon of offshoring. Offshoring is an aspect of many of the themes of current business practice described above.

When people talk about offshoring, they usually mean a decision by a company to move part of its company's operations overseas. Much of the



### The Dudson Group

Dudson is a family business dating back to 1891. The Dudson group is a leading world producer and one of Britain's largest exporters of ceramic tableware to the hotel and catering industry, exporting to over 100 countries worldwide. The company, based in Stoke on Trent, employs approximately 650 staff, 95% of whom are based in the UK, and has an annual turnover of £25m.

Rather than outsourcing to a lower cost location, Dudson decided to retain manufacturing in the UK. The decision was based on product quality,

innovation and opportunity. They have an ongoing programme of investment, which includes £7m in new plant and warehousing aimed at meeting the needs of an ever-increasing global customer base. The company has also invested in a number of research projects focussing on new flexible manufacturing systems to improve product quality and efficiency, such as robotics technology and a European project to design and build the first prototype pressure casting machine for the automatic manufacturing of hollowware (tea and coffee pots etc).

controversy over offshoring has been based on high profile relocations of company call centres, especially in the financial services sector. The main destination of offshored service work is India, although other countries such as South Africa, Jamaica, Malaysia and the Philippines are also benefiting.

The call centre industry is a major UK employer. A recent DTI study<sup>25</sup> found that 540,000 people are currently directly employed in call centres in the UK, with an additional 250,000 working as managers and support staff. A significant number of these jobs can be found in areas where manufacturing employment has fallen sharply in recent years. Because call centres have made a vital contribution to easing this adjustment it is not surprising that the challenge from India and other countries causes understandable concern and anxiety. The perception is that the location of a call centre is becoming "commoditised" – in other words, entirely dependent on price, which, in turn,

points to production being located outside the UK where wages are lower.

The reality is more complex.

It is true that advances in telecommunications – both in terms of technology and the structure of the industry – have made international phone calls reliable and cheap. For example, the cost of a telephone call from India to the UK has fallen from 48 rupees per minute (before January 2001) to 7.6 rupees per minute (October 2003). This allows international competition where it would not previously have been possible.

However, the evidence suggests that decisions on whether or not to offshore are driven by many other factors, not just cost. Offshoring also brings with it risks of various kinds. Companies need to judge whether they can keep sufficient control over their operations, whether they can maintain a good relationship with their customers, whether

<sup>25</sup> The UK Contact Centre Industry: A Study (May 2004)

there is any risk to their corporate reputation, and so forth. The importance of cost varies according to the level of complexity of the transactions being dealt with by the call centre, it is easier to offshore the answering of routine customer enquiries. This points to the need for UK call centre providers to build up the skill levels of their staff so that they can take on higher value work.

That said, we cannot assume that countries like India can only compete with us on the basis of cost. The highly educated Indian workforce has the potential to be internationally competitive in carrying out high quality, specialised functions. The UK therefore has to invest in skills to create a more flexible and productive workforce, and support science and innovation to develop new technologies and more efficient ways of working so

as to be able to compete successfully on the basis of high productivity.

The DTI study into the call centre sector concluded that employment in this sector is likely to continue to grow. While some jobs are likely to move offshore, we believe that this will be more than compensated for by future job creation, whether through the expansion of UK companies or through decisions by overseas companies to “onshore” in the UK. The challenge for Government will be to ensure that the right help is available for those who do lose their job, whether for this reason or any other.

The lessons of the call centre study hold good for a growing number of other services functions. There will always be services that can *only* be delivered



#### iSOFT

iSOFT is a global software company, based in Manchester, with a presence on five continents. In 2001 it established a dedicated offshore development business in Chennai, India. Slightly over 50% of its staff are based overseas – where its markets are. By following a global strategy that allowed its business to grow, iSOFT won a Queen’s Award for Enterprise (International Trade) in 2002 and is now a preferred solutions supplier to 60% of Local Service Providers under the NHS’s National Programme for IT. Formed six years ago iSOFT is now the fourth largest software and computer business listed on the London Stock Exchange.



face to face. Looking after children or the growing number of elderly cannot be offshored. Nor can day to day leisure and personal care – everything from pubs, meals and trips out, haircuts, a trip to the gym or a massage – or the maintenance of our homes, buildings and public places.

Nonetheless, modern technology enables globalisation to penetrate the service sector more and more deeply. Take telemedicine, for example. Some years ago, US physicians started having prescriptions and medical records processed in India. Today, it is quite possible for X-rays and scans to be transmitted electronically for interpretation by medical technicians anywhere in the world.

The example of telemedicine illustrates the point that offshoring is no longer confined to lower-value production. Similarly, countries like India and China are increasingly bidding for R&D work. The R&D director of one Indian pharmaceutical company

estimates that, whereas using Western scientists and laboratories means the typical new drug costs the pharmaceutical industry \$1 billion to develop, equivalent costs in India would be \$50 million.

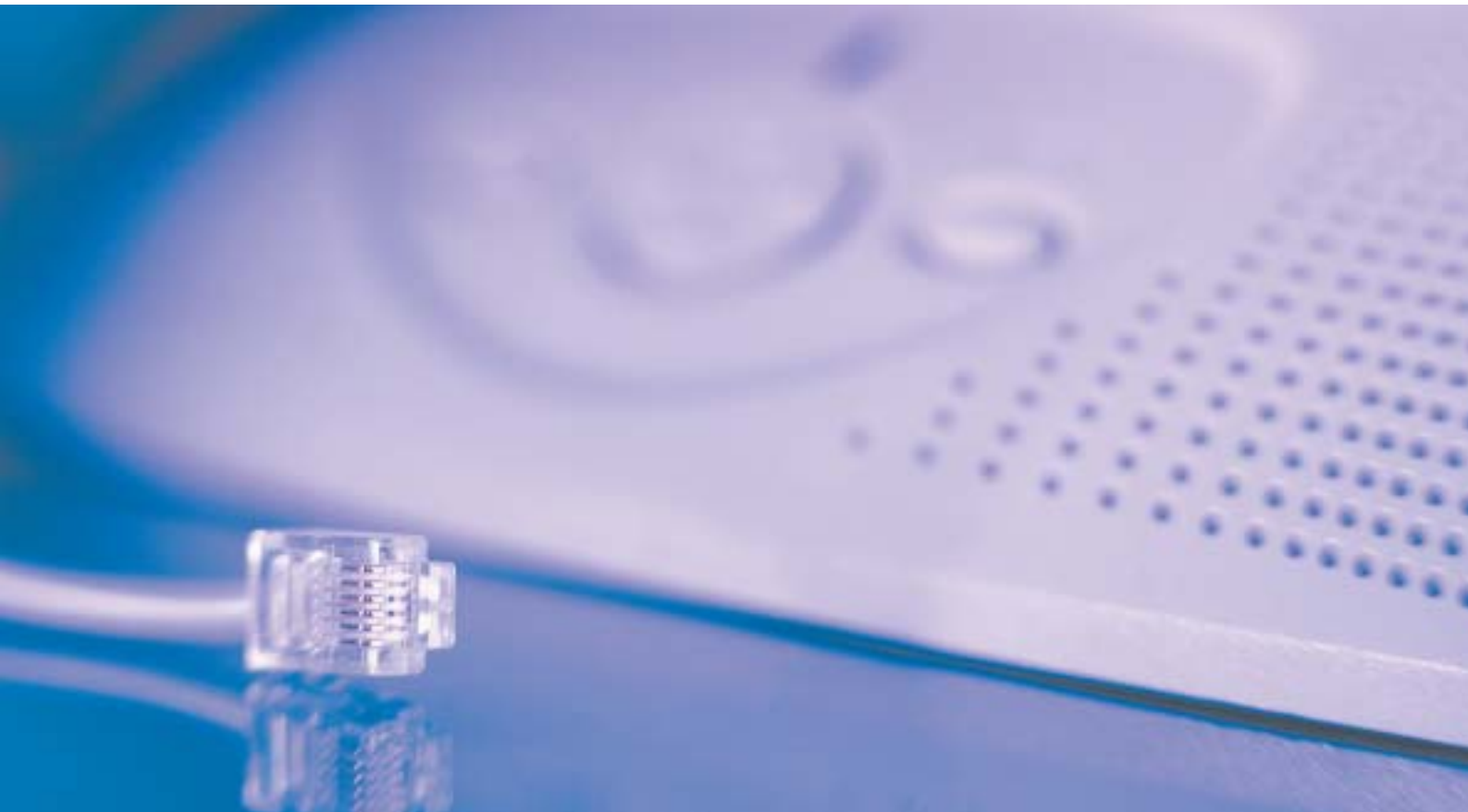
The fact that technology makes it *possible* to do something does not mean, however, that it *will* be done. As we saw with call centres, quality and customer satisfaction are key and will often counter-balance or even eliminate cost savings. Even with modern software tools, the management of complex operations in different sites and different countries may simply be too troublesome. Fears of losing intellectual property protection will be balanced against cost savings in R&D. And citizens in one country may well resist having their financial, medical and other personal information transferred abroad for processing (an issue that has already led EU Member States to ban the export of personal data, other than to countries that uphold privacy standards equivalent to those of the EU). Technology is not destiny.

## Telemedicine

**The remote practice of medicine has become a reality in the Information Age. The ability to monitor and transmit life signs, pathology requests and results, X-ray and other images or conduct teleconsultation over a video link mean that in many instances patients may be miles distant from health practitioners.**

Telemedicine enables patients with chronic conditions (for example, heart failure or diabetes) to be monitored in the comfort of their own homes. It can also connect patients and health professionals across continents allowing access to expertise that is not available locally, balance transnational supply and demand or facilitate cost-effective sourcing of diagnostic expertise.

The UK has a rich heritage in healthcare provision and is at the forefront of innovative solutions. A tele-ophthalmology service between a regional hospital in South Africa and a specialist eye hospital in the UK has been set up with the aim of providing secondary specialist advice in the diagnosis and treatment of difficult ophthalmology cases in South Africa. Over 16,000 patients were seen in one year. Around one in 200 cases was subject to discussion over a high-speed videoconferencing link. In addition to the immediate benefits to patients the South African medical staff valued the educational benefits of the collaboration with UK specialists.



## HCL

While growing numbers of UK and US-based companies are relocating their customer care operations to India, HCL Technologies Ltd, a Delhi-based global IT services and product engineering corporation, has acquired a 90% equity stake in BT's Apollo Contact Centre in Belfast, Northern Ireland.

The Belfast operation of HCL Technologies Ltd, HCL Technologies NI Limited, now embraces a wide range of inbound and outbound activities and employs close to 1,000 people in its four-year-old purpose built Contact Centre.

Mr Shiv Nadar, Chairman, President,  
CEO of HCL Technologies Ltd:

**"Independently-conducted research has established that Northern Ireland's people, infrastructure and cost base make it the best place in the UK – if not in Europe – to set up a customer contact centre. Having been operating here for just over two years, we're delighted at the speed with which we've been able to establish a highly efficient, highly regarded operation in tune with our global ambitions."**

Offshoring can provide benefits, but it also poses challenges to which the government has to respond. In particular we will:

- encourage companies to take decisions on offshoring which reflect their long-term interests of the business and a better understanding of the risks;
- encourage companies to consult their workers properly in decisions on offshoring. The recent agreements between some high street banks and the financial services union UNIFI are a model of good practice;
- address the concern that offshored work may be carried out in conditions that do not satisfy core labour standards. We need to work in partnership with developing countries to encourage observance of core labour standards;
- help UK companies to improve their competitiveness and productivity;
- help British workers improve their skill levels; and
- help people to find new employment as quickly as possible if they lose their jobs as a result of offshoring.

A minority of those whom we have consulted on this issue argued that we should try to stop UK

companies from offshoring. We think that this would be misguided, for a number of reasons:

- there are often good business reasons for offshoring. If a company has concluded that moving one function overseas will increase its chances of growing and prospering in the longer term, then it would be wrong for Government to try to stand in its way;
- offshoring can help developing countries such as India grow and become more prosperous;
- we in the UK have large, diverse and growing services sectors which depend on being able to sell worldwide. In two examples of sectors where offshoring is a major issue – financial services and computer information services – we sell overseas far more than we “import” and we “onshore” more than we offshore. We cannot realistically expect other governments to keep their markets open if we close ours.

It has always been the case that, as trade grows and technology changes, some jobs are created and other jobs disappear: The “churn” caused specifically by offshoring is not, however, particularly large. More generally, since 1997, 60% of new unemployment benefit claimants have found a job within 3 months and around 80% within 6 months. Our challenge is to create the conditions which help jobs to be created and to give people the skills to take them up.



### The Fielding Group

Companies like Dunstable-based The Fielding Group (TFG) are finding ways to work within the global marketplace. With one small UK factory employing 60 manufacturing staff, the company's 95:5 offshore/UK manufacturing ratio may be tiny, but it has an annual turnover of £55m and also employs around 200 staff at its Dunstable HQ involved in higher value-added activity, including design, logistics, distribution and general manufacturing servicing. The company supplies 'private label' clothing to the UK high street from a variety of offshore facilities including Sri Lanka, Bangladesh and Ukraine. The strategically important UK factory acts as a "close to market" short run and short lead-time facility – critical for responding to last minute colour and size demand and fast selling lines during seasonal demand peaks.



### 10BaseCom

10BaseCom is an independent company based in Irvine, Scotland, founded in 1998. In the information technology sector, 10BaseCom's main activity lies in the purchase, refurbishment, re-sale and distribution of excess or end of life technology products. Typically, the company purchases the excess inventory from major manufacturers such as Hewlett Packard, and sells onward to the 3,000 or so customers at the opposite end of the distribution chain.

10BaseCom typifies a new model for small businesses in the increasingly international economy. It maintains UK headquarters, so all the business revenues flow back into the UK, and innovative intellectual property is retained in the UK. However, the sales and marketing functions of the business are carried out closer to the customers in various parts of the globe through channel partners across Europe, the Middle East, Africa and more recently Asia-Pacific.