Global sourcing in a world less flat

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John Maynard Keynes, the great British economist, is suddenly back in vogue. During the current global economic downturn, you hear his name invoked in discussions regarding stimulus packages in the United States, China, Europe, and elsewhere aimed at preventing a 21st century Great Depression.

But Keynes also speaks to those contemplating the potential patterns of global sourcing and trade in the coming decades. In writing *The Economic Consequences of the Peace* in 1919, he considered the state of globalization on the eve of the First World War:

The inhabitant of London [in August 1914] could order by telephone, sipping his morning tea in bed, the various products of the whole earth, in such quantity as he might see fit, and reasonably expect their early delivery upon his doorstep; he could at the same moment and by the same means adventure his wealth in the natural resources and new enterprises of any quarter of the world, and share, without exertion or even trouble, in their prospective fruits and advantages; or he could decide to couple the security of his fortunes with the good faith of the townspeople of any substantial municipality in any continent that fancy or information might recommend.... But, most important of all, he regarded this state of affairs as normal, certain, and permanent, except in the direction of further improvement, and any deviation from it as aberrant, scandalous, and avoidable.

Sound eerily familiar? Almost like the world had been flattened before.

So Keynes reminds us of three basic lessons. First, globalization is not new. Second, the fabric of globalization is woven equally from the warp of politics within and among countries and the weft of individual business decisions. Third, globalization's progress is not inevitable. As Keynes and members of his generation who survived the First World War knew well, globalization can be fragile indeed.

The current global downturn has laid bare the simplistic assumptions under many a global sourcing strategy, as Keynes could have anticipated. A misguided sense of security and predictability began to permeate sourcing decisions during the past two decades. International trade exploded, driven in part by the opening of previously closed markets in both Asia and Eastern Europe. Sourcing from so-called low-cost countries blossomed. China emerged as an economic powerhouse and supplier of

choice in many sectors. Progress and prosperity appeared inexorable. Echoing Keynes' man of London of 1914, many at the start of the 21st century "regarded this state of affairs as normal, certain, and permanent," and bet their sourcing strategies on it.

Then came, in short order, financial contagion, the bust of the commodity boom, the collapse of international trade, and the worst global economic downturn since the Great Depression. The new uncertainties can bewilder. Consider recent headlines on the future costs of sea transportation and their implications: in the summer of 2008 *The Wall Street Journal* and *The New York Times* both suggested high transportation costs might soon make Asian sourcing prohibitively expensive in many industries, and then in January 2009 the *Journal* noted without irony that containers are moving virtually free of charge in a sea of shipping overcapacity. Tracking the headlines leads to confusion, not clarity, in thinking about an enduring strategy.

So how can we navigate global sourcing opportunities and risks in the face of this uncertainty?

We at McKinsey undertook a major research effort, tapping our global network and cross-industry expertise to answer this question.[1] Only charlatans or fools would pretend to predict the exact contours of the global sourcing landscape 3 to 5 years hence, let alone 20 years. However, organizations can and should confront the uncertainties head-on in a rigorous, fact-based way, rather than trying to wish them away. Deep understanding of global forces and scenario-based analysis provides a more realistic approach to test potential sourcing strategies than betting on a single view of the future. While there are many potential industry-specific subtleties that can be teased out using this approach, three major themes emerge.

First, the underlying logic driving global sourcing will endure despite the recent economic turbulence. Whatever the scenario, global sourcing makes sense as long as low-cost countries remain. And there is no reason to believe that significant gaps among countries will disappear. Take labor costs: while Chinese labor costs have been closing in on US costs in percentage terms since the mid-1990s, the gap in absolute terms between Chinese and US manufacturing labor costs per hour is projected to increase to more than $26.00 in 2013, from roughly $17.50 in 1996. Regional variations in material inputs (such as steel) also place offshore sourcing at an advantage in many categories. And we should expect the expansion and increasing sophistication of supplier networks in the major developing countries – such as China, India, and Brazil – that will account for the majority of global economic growth and new consumers in the coming decades. At the same time, balancing out basic price considerations, time-to-market considerations (for example, customized products with short lead times, such as some high-tech items), sensitivities to transportation costs (automobile assembly, for instance), and other factors will keep some level of production close to the consumer.

Second, relative cost advantages are dynamic, not static. We should not be surprised to see intensifying competition *within* low-cost countries, as regions vie to attract investment and jobs. Again, consider labor costs. Just as there can be significant cost differences between, say, factories in Michigan and Alabama in the United States, China is hardly monolithic: we already see significant variations between labor costs between Shanghai and the interior; likewise in India. States will compete with each other for business. At the same time, companies will find intensifying competition for their business *between* low-cost countries. In the lead-up to the current crisis, the Chinese economy's steady growth helped fuel wage inflation that has in turn given other Asian "ultra" low-cost countries a potential edge. For example, in 1997 labor costs were roughly equal between China and Vietnam; a decade later, a Chinese manufacturing worker cost nearly three times as much as his or her Vietnamese counterpart. The impact of such changes is not theoretical. In 2009, for instance, Nike expects to make more shoes in Vietnam than China for the first time in its history.

Third, politics will matter—a lot—to the future of global sourcing. They always have, of course, but the relative stability of the late 1990s and early 2000s masked this reality. Looking to the future, public policies will influence the trajectory and pace of change across many variables commonly viewed as simply "economic." For instance, the Chinese government is not standing idly by in the face of trends that are eroding Chinese competitiveness. While the Chinese government seeks to devise policies to rebalance its economy toward more domestic consumption, value-added tax rebates, industrial subsidies, and currency policy support exporters. The Chinese government can pull all these levers and more to flip the best case economics back in China's favor for strategic industries. But every country can play that game—and they are.

Whether or not countries will agree to play by common rules in international trade or pursue their own nationalist or regional policies will be critical. Today, the picture in overall trade policy remains mixed. World Trade Organization membership grew and average tariff rates fell between 1988 and 2007. Businesses are more interconnected than ever before. Even before the onset of the current crisis, however, there were signs that that global commitment to an open international trading order was eroding. The WTO's Doha Development Round of trade talks have been on life support for years. Since 1995 the number of regional trade deals—which are inherently discriminatory—has increased over three fold. Equally troubling for an open international trading system, BBC World Service polling revealed that majorities in eight of the top ten economies, including the United States, thought that globalization was moving too fast for their tastes by January 2008.

In the current economic crisis, most countries have not yet succumbed to the temptation of significant beggar-thy-neighbor protectionism. But if the downturn broadens and deepens, politicians may not be able to resist the potential short-term political appeal of economic nationalism or regionalism. Last November, the ink had barely dried on G-20 [2] leaders' statement committing themselves to fight protectionism

before protectionism's creep resumed. According to the World Bank, 17 of the G-20 have implemented protectionist measures in the three months following the Washington, DC, summit. So far the wealthier countries have resorted to subsidies—think of the automobile industries in Argentina, Brazil, Canada, France, Germany, United Kingdom, the United States, and others—while developing countries tend to erect trade barriers. Security, safety, and environmental regulations could become new forms of protectionism.

We will not hazard to predict whether during the coming decades globalization will resume, regionalism will rise, or extreme economic nationalism will triumph. But we are confident that the companies most likely to survive and thrive in the coming years will have internalized Keynes' foundational insight that their global sourcing strategy must adapt to a complex interplay of forces, both economic *and* political. As competition heats up among low-cost countries within and among regions, successful companies will develop a deeper understanding of the global forces influencing their sourcing economics, thereby allowing them to anticipate potential "flips" among optimal sourcing locations. In the coming years, executives will need to understand the nuances of the local politics in their critical sourcing countries—for instance, state politics in India—as much as they do their own home states. With investment in the knowledge of local politics and suppliers, companies will be able to lobby and persuade to shape their business environments in other countries. Others may diversify their sourcing portfolios across regions—say, China and Mexico—to hedge against potential shifts in transportation, critical input, and tariff costs. Some US companies may conclude the uncertainties facing their industries are too great and thus decide to minimize risk by moving some sourcing categories back from Asia to within NAFTA [3] and DR-CAFTA [4] or even onshore again. Organizations will recruit, train, and retain different talent to navigate these sourcing decisions, or be left behind.

Whatever the future may bring, the ability to understand global forces at play and employ fact-based analysis that envisions a range of scenarios will provide competitive advantage over those organizations that continue to deny the uncertainties and plan for only one "possible future."

[1] Contributors to the development of and analysis informing this study include Stacey Galvez and Sunil Manhapra, both consultants in McKinsey's Chicago office.

[2] The G-20 member countries are: Argentina, Australia, Brazil, Canada, China, the European Union, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, the United Kingdom, and the United States.

[3] North American Free Trade Agreement.

[4] Dominican Republic–Central America Free Trade Agreement.

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