



**ERPS**  
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# **Risk Management for Business with Low-Cost Countries (LCC)**

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## **ERPS – European Centre for Research in Purchasing and Supply**

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## **Risk Management for Business with Low-Cost Countries (LCC)**

### **Contents**

1. Prerequisites for Conducting Business in Low-Cost Countries
2. Business of Interest
3. Influences on Value-Added and Supply Chain
4. Multitude of Risks
5. Possibilities of Risk Limitation
6. Effects of Business with Low-Cost Countries (LCC) on the overall economy and politics  
in High-Cost Countries (HCC)
7. Political Levers
8. Conclusion

## 1. Prerequisites for Conducting Business in Low-Cost Countries (LCC)

Ongoing globalisation and market liberalisation are the foundations on which long-term business with low-cost countries (LCC) can be built. Globalisation itself is a neutral concept of a global economy in which work is divided worldwide to benefit from cost advantages. Highly mobile capital funds made available by investors push the speed in which globalisation is progressing. Globalisation thus offers crucial opportunities to the global economy and many industrial sectors, both in high-cost countries (HCC) and low-cost countries (LCC). Statistically speaking, globalisation leads to an increase in overall personal income levels in LCC, affecting income distribution in HCC, too. There are various aspects to be taken into consideration when evaluating the effects of this development on the global population as a whole.

Positive aspects for LCC are more jobs, a higher standard of living, a general increase in income levels and export activities as well as know-how and knowledge transfers. On the other hand, there are some adverse effects such as environmental issues and diverging social developments.

HCC benefit from lower product and retail prices, better trading possibilities with LCC, a lower rate of inflation and access to new markets. Negative aspects may include a higher market volatility, insecurities in the labour market as well as limiting and lasting structural changes.

Faced with this variety of aspects, decision-makers both in politics and industry have to be aware and carefully consider the consequences of their decisions. Political and industrial viewpoints and considerations may differ in this context as they tend to have different effects on the economy and the social environment.

The same applies to decisions to be taken inside multinational corporations or by a small or medium-sized enterprise (SME). When setting up long-term procurement relationships with LCC, a *Global Player* will usually also look into how to positioning itself in the sales market. This will not be relevant for all SMEs if they are only interested in buying products and services at low prices or they do not really have the capacities to take more permanent steps in the LCC.

An essential prerequisite for setting up a production facility or for buying a major share in a company in a LCC today is the availability of Foreign Direct Investment (FDI). The LCC must provide a number of preconditions: low wages and prices, motivated, well-trained and inexpensive staff, a flexible labour market, easy access to real estate, lean administration and public approval procedures, the timely availability of raw materials and pre-material as well as liberal import and export regulations.

Unlimited access to comprehensive information by means of electronic tools and special agencies allows companies to input their know-how for starting up production and for initiating procurement activities in a LCC.

It needs to be said that the extraordinary and fast development of LCCs was absolutely underestimated in Western Europe for a long time. In the past 15 years capital investments, good vocational training and a strong drive among the population to work and to prosper have created a sound basis for modern, highly competitive enterprises in these countries.

#### **What do LCC have to offer?**

Western European companies will usually find the new member countries of the European Union in Central Europe, i.e. the EU membership applicants Romania, Bulgaria, Croatia and Macedonia as well as some countries in south-east Europe and eastern Europe (the Ukraine, Russia) to be of particular interest for establishing long-term business relationships based on their standard of vocational training and their industrialized mentality. As these countries are in various stages of development, a careful consideration of all relevant factors is strongly recommended.

At present there seems to be less interest in the African states and the Middle East, whereas Latin America is of considerable importance to US-based companies, Spanish corporations and, beyond the regional scope, to the automotive industry as a whole.

Any states which still lack a modern and liberalized approach to industry and commerce (including many African states) may offer low wages but still do not seem to be attractive as partners for long-term business relationships.

It is clearly The Peoples Republic of China, India, Russia and Brazil which are widely considered as the emerging procurement and sales markets of the future.

In future, a special focus will remain on the entire Asian region. However, Japan, Taiwan, Singapore and Korea are no longer considered emerging markets but are about to start pushing their own procurement and direct investment activities in LCC.

The other Asian countries and Russia are frequently referred to as fast growing economic areas and they provide special opportunities for relocating business activities from Europe. Russia offers good chances for the chemical and energy sectors as well as space technology.

China and India as well as the countries of South-East Asia are considered the most important LCC today as they are growing rapidly and boast a highly motivated workforce, a growing percentage of which is quite well trained. China and India represent over 50% of the global workforce. These two countries alone can offer an enormous open labour market with flexible working conditions and particularly low wages. However, within these two individual states there are massive differences in regional developments and infrastructures that also need to be taken into account.

China is already able to offer all preconditions required for almost any kind of products and production, including computer graphics and R&D. India, with its high share of English-speaking workforce, is particularly well positioned for offshoring IT-services and Call Centres, and is also particularly strong in the field of software development and pharmaceuticals. They have all required R+D capabilities. Many other Asian countries find the low wages in China and India attractive drivers for business investments.

However, crucial prerequisites for supplies from LCC are a good infrastructure, safe transport routes and an efficient legal system to resolve disputes. In many countries, and this is still particularly true for China, the establishment of a good personal relationship with one's business associate is the most important factor for successful business transactions.

## **2. Business of interest**

Generally speaking, any products and services with a high share of manual labour can be considered for relocation to LCC. Any such reviews should take into account anticipated labour cost developments, low social/non-wage cost, available capacities and capabilities as well as the possibility to provide a permanent machine workload, i.e. 24 hours/7 days/365 days a year.

Experience shows that short-term purchasing deals can be concluded relatively easily, the establishment of long-term business requires more extensive preparation and consideration. In the long-term it will not suffice to merely base a purchase decision on the fact that the product or service in question is cheaper than when produced in-house. It is obvious that many products and services will be cheaper in LCC than in HCC.

This is based on well-known facts and factors: lower wages, lower social/non-wage cost, shorter vacation times, longer and more flexible working hours, partially less expensive raw materials cost, favourable exchange rates and an almost endless supply of inexpensive labour with a growing level of know-how and expertise. As a result, any labour-intensive products and services might be of interest when it comes to relocating to LCC.

However, there is a number of adverse factors that should also be taken into account: Different cultures, long transport routes, higher logistics costs, problems concerning safety and security, lower productivity, quality issues, at times questionable attitudes and adherence to delivery dates and contract agreements, reliability in general, adjustment cost and – last but not least - resistance within one's own company concerning the relocation project.

All these factors need to be taken into consideration and carefully weighed when preparing a decision as to if and when and to what extent a business relationship with a company in a LCC should be established.

For the day-to-day handling of the business there are a number of possibilities available today:

- Buying individual products, components or services from selected suppliers
- Establishing a Joint Venture with a LCC partner or acquisition of a participating share of a company that already exists in the targeted LCC
- Relocation of products and services to LCC sites ("Outsourcing")
- Transfer of production or services to a company in a LCC overseas ("Offshoring")
- Assembling of components purchased in a LCC either directly in the same or another LCC, or in a HCC
- Transfer of R&D tasks and projects to a LCC partner

Many major companies see substantial competitive advantages to be gained from increasing their share of production in LCC and many are following the trend set by their international competitors. The German industry, for example, has already increased the total share of pre-production supplied from LCC to 40% (figures reported in 2005). These German companies

have managed to secure their market position, increase their profits and maintain their core competencies while reducing their own workforce.

A survey conducted by UPS Business Monitor among European managers in 2005 says that 70 % of them seriously consider China a possible future site for both production and R&D. They say they are mainly driven by cost reasons. Considerable cost advantages in the field of R&D can be gained as some LCC – including China and India – have been starting publically funded research initiatives and training programs.

Further to the cost advantages to be gained from the availability of disciplined, qualified and versatile workers, LCC are also less restricted with a view to research programs and environmental rules and regulations. Significantly lower costs mean that a certain research budget can fund a larger scope of research activities in a LCC than in a HCC.

The advantages of buying products from LCC have to be evaluated carefully and in accordance with the respective industrial sector, the company itself and its market position and buying power, and the planned type and scope of business activities.

There are also advantages to be gained from various types of cooperation between companies in HCC when setting up business activities in LCC. One example is the cooperation of an Austrian company in the automotive industry with the Polish staff of one of their service providers. The Austria-based company employs Polish engineers with English language skills for the repair and maintenance of the machines, equipment and tools of the car manufacturer. The acquisition, planning and financing is done in a HCC (Austria), the day-to-day business operations happen en situ with qualified workers from a LCC (Poland). The company has rolled out its activities world-wide and even in China orders are won at favourable conditions. This is an innovative solution for how to marry the entrepreneurship of a HCC with the numerous possibilities of LCC, thus securing new business opportunities.

In any business transactions with LCC it is important to distinguish between products and services. Whereas it is relatively easy to control and monitor product quality based on industrial standards and quality checks, services need to be characterized by essential criteria and assessed in accordance with customer wishes and depending on the type of service rendered.

It is to be expected that the share and variety of products and services purchased in LCC will continue to increase, and that this trend will follow the general economic development of the LCC.

More details can be found in the next ERPS publication „The five essential criteria of globalisation and its utilization”, a script that summarizes a study of the Boston Consulting Group on this topic.

### **3. Influence on Value Added and Supply Chain**

The pillars for adding value in a company are production, purchasing and sales. If a company decides to downscale or stop its inhouse production, the domestic production depth and value-added is reduced and - to a large extent - taken over by the purchasing function. The primary production value-added is then generated at the respective LCC production site where workforce and machines are employed and through local sourcing. The main value-added for a company is a result of cheaper goods and services bought by the purchasing department and the possibility to sell goods at market prices.

Depending on the type of business relationship with a partner from an LCC there will be several effects: A pure purchase contract with a foreign partner may result in a short-term success due to low-price purchasing without major investments. In case of outsourcing and offshoring with own participation the expenditures required to send one's own personnel to the LCC, train the staff in the LCC as well as the required capital expenditures needs to be checked against the actual advantages to be gained.

An improvement in the financial results is possible provided that the investments required and level of capital employed are lower than in an HCC.

Lower productivity has to be expected when working in a LCC so this is another element to be included in the total cost calculation. Viable offshoring of production to Asia must secure a total cost saving of at least 20% when compared to Europe.

Every decision to establish long-term business relationships with LCC will lead to changes in one's own production and in the existing supply chain. Companies set up new structures and change priorities. The same applies to the supply chain as a whole. Existing suppliers are faced with the problem whether to adjust their prices or be eliminated from the supply chain in future. One part of suppliers will try to buy prematerials and parts for their own production in LCC as well. Some suppliers, e.g. in the automotive industry, can follow their customers to their newly established production sites in LCC (e.g. in the new member states of the

European Union). However, suppliers may also have the chance to use their domestic products to enter into niche markets, or to launch state-of-the-art high-quality products.

Many smaller SMEs (Small and Medium-Sized Enterprises) will not be able to match the new target prices in spite of all their cost saving efforts, and they will also not be in a position to relocate their production due to their lack of both managerial capacity and financial strength. When buying goods and services in a LCC, the future development of the respective countries should be taken into consideration as well. The European LCC are set to catch up with personal income levels in the rest of Europe sooner or later. The same catching up process will most likely take decades in China and India, given the high number of available workforce and the new generations of qualified professionals pushing into the labour market.

In the medium and long-term such developments will also influence present European LCC as labour-intensive work is likely to be shifted into even more low-cost LCC further to the East. If a company sees that its products that are still manufactured in a HCC are increasingly getting under pressure from LCC suppliers, it needs to act. LCC companies can also not afford or survive a later cost increase to a HCC level.

Professional purchasers will therefore need to get a good overview of global price levels and the supplier base as well as market developments in LCC. This will allow them to select the best suppliers from a suitable LCC for their companies and to develop alternative supply solutions. The same is true for the relocation of production that requires any level of capital expenditure. Suppliers from HCC can use the opportunity to defend their advantages and customer retention rate based on quality, on-target delivery performance, flexibility and innovation.

On the other hand, the example of Toyota shows that even this position is increasingly threatened by growing competition from LCC. The suppliers inside a supply chain will need to be prepared for such developments in the long term and obtain part of their pre-materials and parts in LCC as well. As a consequence, the entire supply chain will incorporate partners from LCC to secure competitiveness.

When outsourcing or relocating production to an LCC, it is wise to remember that the latest state-of-the-art is not always the most sought after solution if labour is cheap. Any available information and experiences of competitors should be included in the decision-making process. It will be crucial to what extent competencies, resources and management capacities will be kept in the HCC of the company's operations to strengthen and not to

undermine the company's very uniqueness and market position through sourcing in LCC. Also at times of crises, an effective supply chain must remain intact and permanently available.

#### **4. Multitude of Risks**

The risks of a long-term commitment of a company in a HCC to a partner in a LCC are manifold and difficult to determine exactly, but they have long-term consequences for the company itself and the economic structures of the HCC.

##### **Cultural Issues**

Human thinking and behaviour is strongly influenced by existing cultures and traditions in different regions and countries. Different morals, social structures, mentalities, specific religious beliefs and ways at looking at the world lead to different attitudes in human, sociological, technological and economic contexts. A different culture might have other priorities and a different understanding of certain terms. Translations are often unprecise and require detailed explanations.

Ethics in Asia have a different significance than in Europe. Personal relationships are of the essence. One's own group, one's own (often widely spread) family, one's own network and one's own nation (represented abroad by compatriots) is what matters most. A lack of personal relationships, e.g. in China, can lead to unsuccessful business operations.

In everyday business, appointments and the content of discussions may not be taken to the letter and local idiosyncrasies / difficulties are a given. Many a business person lacks a profound knowledge and understanding of such crucial element of doing business in a foreign country. Even contractual agreements are not set in stone but need to be viewed in a different cultural context. Business associates from HCC are frequently surprised and alienated by this. What Europeans would usually regard as a paradox situation tends to be "business as usual" in Asia. Prime example is politically still communist, anti-capitalist China which is today clearly dominated by the logic of capitalism. There is a strong adjustment movement in people's thinking, and systems are characterized by diverging values. A thorough understanding of a country's culture and a high level of sensitivity are of utmost importance.

From a cultural point of view and with a view to the development stage of a country, it should not be underestimated how problematic it is to influence production and conduct business in a foreign country.

Based on a shared history and cultural background, European companies will encounter far less problems when doing business with other companies in central and eastern Europe than when going overseas. Driven by the European Union, business is also characterized by an ongoing integration and harmonization process.

In spite of all endeavours to understand foreign cultures, cultural differences remain a considerable, permanent and unpredictable risk factor for long-term business relationships with LCC partners.

### **Selecting the Right Partner**

The difficulties start when trying to find a suitable partner in a LCC. Information agencies are not always available or are not in a position to provide real help to businesses. Those partners who initiate contacts with potential customers are not necessarily the optimum partners. Each supplier presentation and information should be thoroughly checked and site audits as well as extended trial periods are strongly recommended. When selecting a foreign supplier, one should not forget to find out about any personal, local, national or political connections the partner might have. The importance of such networks is often underestimated and many companies from HCC struggle to understand the workings of the machinery in Eastern Europe and Asia.

This is where a significant risk may be influenced by changes in the network structures. For a regular business relationship it will be crucial to ensure that the selected partner is financially sound, reliable and flexible. This will be particularly important for a transparent information flow with the LCC partner and is a prerequisite for all necessary adjustments.

### **Legal Risks**

Each country has its own legal system with own legal bodies and legal terms. In continental Europe and throughout the European Union there are increasingly harmonized legal systems and legal terms which are both transparent and predictable. In other regions of the world, e.g. in Asia, there are completely different and historically grown legal systems and legal concepts which can lead to enormous difficulties in legal definitions, interpretations, contract establishment and fulfillment but also in day-to-day business operations. Even with the help of local legal aides, the enforcement of any contractual claims is dubious, time-consuming, expensive and a success much more unlikely than inside Europe. Intellectual property rights (including patents) remain widely unprotected and in many cases are not respected.

For many HCC companies the legal risk is a highly critical question to be raised when establishing business relationships with a LCC partner. There is always a risk when local courts and authorities interpret legal provisions based on national laws and local business conduct. There have been cases in China where courts have decided that copying products and machinery is an acceptable and legitimate approach by local companies to show its own innovation. As a consequence, Japanese companies have frequently been deciding to keep essential parts of their production in Japan, in spite of higher costs.

Another area of legal insecurity are administrative authorities which tend to have very complex organisation that can vary even on local and communal level. Their decisions are frequently heavily influenced by local interests and networks. The duration of any legal proceedings up to a final decision is difficult to predict. The legal risks in LCC need to be taken into consideration as they are high, country-specific and often even local risks.

### **Risk of Overcapacities**

In some countries, e.g. in China, comprehensive and uncoordinated investments can lead to overcapacities that affect returns on investment and investment values.

### **Quality Risks**

Maintaining the required quality of products and services consistently when buying in LCC is widely regarded as an immaterial risk. Quality inspections and evaluations call for suitably trained staff. Reliable quality control should be conducted at supplier's site and should also include the production process itself. In spite of considerable costs and local implementation issues, it is still best to have such tasks executed by inhouse specialists rather than third parties. For any type of key product the ongoing lack of quality poses substantial problems for LCC companies.

The quality risk in case of relocating own production lies within one's own hands as quality requirements need to be fulfilled with own local personnel. In some LCC there are independent bodies now available for monitoring quality performance, however, their very own services need to be evaluated as well. In some Asian countries a number of such bodies have been founded which compete with each other, thus leading to a notable improvement of the product quality level.

### **Risk of Product Piracy and loss of know-how**

A recent survey shows that 65% of managers included in the survey consider the unsatisfactory level of intellectual property rights to be the biggest challenge when doing business in a LCC, and in particular in China.

When working with LCC partners in various forms of cooperations, joint ventures, outsourcing, offshoring or other collaborations, a transfer of know-how can hardly be avoided. As a result many companies have seen their products being copied and sold without authorization or permission. China has even coined a special term for this approach: “Copy Innovation“, meaning the imitation of a product with the intention of further developing it. These copycat products – also in the high-tech business – are not only sold on the local market but also at low prices on the international market where it starts to compete with the original product.

One widely known example is the German-built magnetic levitation train (“Skytrain”) between the airport of Shanghai and Shanghai City. After completion of this pilot project by the German consortium with Chinese partners, it is now Chinese companies which offer this high-tech product without German partners.

When establishing own production sites in LCC, e.g. China, a number of problems can arise. An example: A leading IT-company had decided to relocate a part of its production to China. After having posted a number of European managers in the country directly, they succeeded in setting up a production site and marketing their products – all with European know-how, capital and management. Within a relatively short time-span all production in Europe was closed down. Gradually all positions and tasks of the initially all-European management team were taken over by trained and qualified Chinese managers. Only five years after start of production, all management responsibilities and tasks as well as the production itself were firmly in the hands of the Chinese. The HCC company saw a number of its most capable and qualified managers leaving. The risks here are potential loss of know-how, loss of market share and loss of qualified operative and managerial staff.

### **Risk of increases in wages and prices**

Wages and prices in LCC are subject to a number of different developments, depending on the political and economic situation of a country as well as the labour market situation. Overall speaking, an increase in wages and price levels is expected in all LCC, however, at very different rates and times. Although it might still take years for Eastern European LCC (e.g. new member states of the European Union) to catch up with the rest of EU, the effects of the wage and price increases are expected to be more substantial in this region than in Asian LCC.

Due to the fact that the effects of the expected wage and price increase in LCC cannot be calculated exactly at present, and as cost advantages diminish, there is a risk factor which could alter the entire decision-making basis.

### **Risk of energy supply**

In many LCC, especially in Asia, there may be problems with the energy supply. Additional investment in supplementary energy supply are absolutely necessary and increase costs.

### **Exchange rate risk**

While the member states of the European Union are widely integrated in a uniform European exchange rate system and are striving for the introduction of the Euro, other LCC such as China, India and Malaysia have their own exchange rate policy which enables them to support the competitiveness of their products by means of favourable exchange rates. This is an additional incentive for foreign investors when looking at the setup of own production sites or the acquisition of goods.

A single-handed adjustment of exchange rates might make products more expensive and at the same time reduce the value of the newly set-up production sites.

Risks for LCC business arising from exchange rates are impossible to calculate in the long-term. Suitable security measures can usually only be taken with a short-term view.

### **Management risk**

Finding good management for LCC and threshold countries is difficult in view of the ongoing lack of suitable vocational training opportunities and the lack of experience in a number of these countries. In many cases a company's management in LCC will be posted and trained by the HCC company. If such handpicked and specially qualified managers are headhunted and leave, or if there are management issues, this will affect the business relationship between buyer and supplier massively.

The LCC needs to maintain a positive attitude concerning the business relationships with LCC partners and also needs to be willing to adjust the own organisation to the new requirements. Any problem arising inside a company can ultimately be considered as a management risk.

### **Risk of financial status of business associate**

Whether holding a minor share in a business in a LCC or just buying goods there, companies need to be aware of risks arising from possible insolvency or bankruptcy of their LCC business associates. There is also the risks of an associate being sold, taken over or deciding to merge with a third party.

### **Risk of takeover of company and customers**

If entering into business relationships or joint ventures in a LCC, there is the risks that the business associate might try to take over the business after having obtained all relevant

information about products, production and customer base. If the former associates takes advantage of this knowledge, the market position of the HCC company could be severely affected.

### **Transport Risks**

There are substantial risks in the field of logistics. Defining the right packing and packaging for long transport ways and multimodal transports is a serious problem. Major losses can occur as a result of theft and delays in transit. Experience shows that entire consignments and even shiploads can disappear en route and from interim storage locations, e.g. in container hubs.

Logistics providers have optimized their services massively in recent years and obtained extensive insurance covers. In case such a situation really does occur, the loss itself can usually be recovered, however, the customer will still have the problem of not having received the required goods in time.

Another essential issue is the high costs of logistics in global sourcing. When purchasing goods in China, e.g., logistics costs can amount to 25% of the total value. This is particularly true when trying to work with remote low-cost locations away from the coast and suitable inland waterways. Whenever goods are stolen here, they will usually be sold in local marketplaces far below their real value, thus posing illegal yet serious competition.

A substantial risk management issue in the transport area is how to ensure that goods reach their destination safe and sound, and how to handle problems beyond the transport itself, such as port operator strikes, road restrictions or terrorist attacks.

Another major risk in the logistics area is the ongoing increase in fuel costs, pushing up transport rates relentlessly.

### **Risk of insufficient security**

Differing legal systems in different countries always generate risks concerning security of investments, reliability of deliveries, and security of financial transactions. Whenever there are changes in the social structure or in the government and administration of the LCC, there are also political risks to be taken into account.

### **Risk of further use**

In some LCC companies have no chance to ensure or enforce their right of ownership in an industrial property or production site even if they have built it themselves. Securing local loans or the continuing use of investment objects (e.g. production sites) may not be without complications. Any continued use of a production site specially erected by a company in a LCC might be difficult, especially if this country at some stage ceases to be considered a LCC.

### **R+D risks**

In some LCC there are well trained and highly motivated specialists available for R+D. In China alone there are six million students currently taking science at university. The Chinese government has announced its intention to catch up with the USA in the field of R+D by the year 2020.

Research institutes in LCC are starting to enter into the market and Asian companies are trying to buy European research companies. However, there is the risk that any research findings will not be made available to the HCC customer alone but will also serve the industry and economic development of the LCC. This would signify a limited future market potential of the HCC company as well as a substantial degree of dependency from the research conducted in the LCC.

### **Risk of unforeseeable circumstances**

Any business relationship with foreign partners is threatened by unforeseeable circumstances. This risk, however, is higher the further away a business associate is geographically located, the longer the transport routes are, and the more different the social and political structures are. Unforeseeable risks include natural disasters such as earthquakes, epidemia, or flooding, as well as the political turmoil of wars, revolutions and terror attacks but also strikes, import/export restrictions as well as changes in exchange and interest rates in a LCC and perhaps changes in the environment policy.

To be counted among unforeseeable risks are also actions taken by HCC or within free trade zones (e.g. EU) against cheap imports. The same applies to special obligations to produce supporting information and documents (e.g. Fair Trade vs Global Trade), to taxation adjustments in both LCC and HCC (e.g. implementing a special fuel tax). Such risks do not only potentially lead to delays in delivery and substantial cost increases but may also cause a company to lose its suppliers and even customer base.

### **Risk of extreme dependency**

The opportunities and risks of maintaining long-term business relationships with LCC partners also illustrate the possible extent of dependencies. Dependency is particularly high if a company focuses its R+D activities in LCC or if it procures key components in a LCC.

In spite of excellent general and IT support, in case of offshoring finance, accounting and closings, system disruptions and breakdowns can occur which might hinder or delay regular business and closing procedures (e.g. year-end closing). It will not always be easy to find a satisfactory, fast solution. A high degree of dependency in this field can pose serious problems for HCC.

### **5. Possibilities of risk limitation**

For companies which conduct long-term business with LCC a substantial element of Risk Management will be to define the scope of business to be conducted, and how it will be conducted. What needs to be taken into consideration is to what extent and for what type of products and services it is feasible to establish long-term business with a LCC, what cost advantages can be gained, and what risks would occur.

The risks listed in the present paper show some crucial findings for HCC in two main areas. Firstly: products; secondly: the effects on a company's position in its market and competitive environment.

In preparation for a decision to procure in a LCC, a company first needs to identify suitable partners and LCC. There are numerous organisations and bodies in trade, commerce, banking and finance that can be consulted for this purpose. Information can also be obtained from competitors and from international consulting companies specialized in purchasing-related issues.

The HCC company managers need to learn about the mentality of their potential partners, about their set of values, about business conduct, communication, language, negotiation tactics as well strategies and customs in the individual LCC. This is vital for a company to protect itself from unpleasant surprises.

When selecting consultants of any type it will be crucial to work with local experienced specialists, and to have experts working directly in the foreign subsidiaries and at their sites.

As far as outsourcing (offshoring) is concerned, the most difficult issue to be addressed is which key competencies will strategically need to be kept by the company in the HCC to

secure its own market position. One possible risk management approach could be to only gradually transfer know-how to the LCC partners, but never to disclose the latest state-of-the-art. This could secure the competitive advantage and inhouse product development competencies. The HCC company will also be well advised to keep control of its customer base and relationships, and to advise customers of its outsourcing (offshoring) activities.

In the interest of smooth business transactions with LCC associates, all parties to the business should develop a mutual understanding or purchasing terms, strategies and targets.

If the selected LCC has a completely different system and situation in the LCC, it will be necessary to check what legal and commercial possibilities are available to secure contracts, sites, joint ventures, products, patents and intellectual property. Possible answers might be to try and buy shares of the company in LCC or to promote its already financially strong market position. In any case, experienced local solicitors and public accountants will need to be involved. When concluding contracts legal advisors and public accountants will need to be consulted.

A forward-looking step concerning risk management in the field of energy supply is to invest into an own backup system, a direct an easily available energy supply (e.g. diesel engines) This will ensure undisrupted production and quality.

So as to minimize logistics risks, an experienced logistics provider should be contracted – there are specialists available for all LCC today.

When conducting business transactions in LCC a company should strive for the prior approval of their insurance agencies and commercial banks who should be requested to deploy their most experienced specialists.

Risk Management in the product area will be particularly focused on continuous reliable product quality. This requires contractual agreements and qualified controlling which needs to be executed either by suitably trained staff on site or through an independent quality management agency as third party. For difficult cases it is recommended to involve a highly experienced Risk Manager who can ensure that all necessary steps are taken in direct dialogue with local suppliers.

Training for local management and staff should be handled by internal specialists, and suitable controlling should be implemented.

Foreign business partners can pose a substantial threat to a company when launching copycat products or when further developing copied products. The Chinese owner of Levono, the company which took over the production of personal computers from IBM, confidently states his point of view: "The next generation of personal computers will be built by Chinese engineers better, faster, smaller and cheaper."

Only a strong market position and close customer contacts will protect companies from product piracy and copycat products in the long run. A growing international lobby to protect intellectual property rights might help.

An extremely difficult and tricky issue is the transfer of R+D competencies. If companies do not want to completely open up their own research, development, design and product strategies and data to their foreign partners, they will need to define very exactly what the scope of supply of each partner will be and where the boundaries are. LCC partners might otherwise be tempted to utilize such data and information for themselves or for competitors.

Companies would be well advised to develop a future-orientated vision and strategy of their core business and development potentials prior to entering into R+D activities in LCC. Otherwise they run the risk of eventually being overtaken by their former associates in the race for market leadership. This is particularly true where technological knowhow and R+D is transferred.

The main risk management focus should be on limiting the extent of present and future dependencies from R+D partners and on at least securing one's market position.

Another possibility to minimize risks is to use a variety of insurances, both by specialist insurance agencies and by the government (e.g. for participations in foreign companies) which also cover political risks. For financing purposes local and international banks and institutes, preferably located in the respective LCC itself, should be referred to as security and additional sources of information.

Risk Management should also cover the possibility that a business partner – for whatever reason – might no longer be available and needs to be replaced. Alternative concepts with another LCC or HCC supplier should be prepared for such situations.

In any case, a professionally developed permanent risk management system also for quality control should be put into place by experienced managers when planning to enter into long-term business relationships with LCC partners. The Risk Management system needs to include a comprehensive system of data and information to keep up to date with local and regional political and economic news in the LCC in general and to keep an eye on the supplier's development in particular. Establishing personal relationships with local experts in commerce, trade, law and politics can help minimize any potential risks.

A fundamental truth here is: There is a variety of risks and a lack of transparency when dealing with LCC and most of these risks occur in the country itself. It is vital to have implemented a working risk management and controlling system which covers all relevant aspects and provides alternatives when need be.

## **6. Effects of Business with Low-Cost Countries (LCC) on the overall economy and politics in High-Cost Countries (HCC)**

When relocating a substantial volume of production to a LCC, a company is usually faced with strong price competition in the market (and looking for lower labour and production cost). The US-company Wal Mart is a prime example for the increasing share of cheap goods imported from China and other LCC flooding the US market. As products made in USA are too expensive for the US consumer, so the Americans prefer to buy imported goods. The consequence is a substantial structural change in the US economy and labour market that must not be underestimated.

In Europe it is mainly the small and medium-sized companies (SME) in the supply and repair industries which bear the brunt of such structural changes. They will increasingly have to focus on special know-how and (usually local) niche markets, or they will have to relocate their production as well. A strong decrease in the number of SME which represent the foundation of the European industry would have enormous effects on employment and professional training and qualification of the workforce in the region. It is possible that SMEs in the new member countries of the European Union will take over some of the trade.

However, a major change in established structures in Europe could threaten existing social systems and the political equilibrium in the region. Only positive economic growth will allow the high level of employment and personal income required to support societies which rely on fees, duties and taxation to keep running.

The effects on the labour market would be higher unemployment, a high level of job fluctuation and an increased share of employees working in the low-wage service sector.

As a result, import volumes would increase drastically and eventually exceed export volumes (like in USA today). A long-term external trade deficit would be the ultimate consequence. In such a scenario, rocketing social expenses would either need to be financed by means of budget deficits and increasing inflation, or by severely cutting government aid and social support. European countries would be confronted with a multitude of difficult problems which are already today starting to become an issue in many nations.

## **7. Political levers**

Modern industry and economy is set within a framework which is influenced by the politics and policies of international organisations, of the European Union, the United States and numerous associations and federations. So as to maintain a large share of the value-added and sufficient levels of employment in HCC, the OECD considers the following elements to be key to the general business environment:

- Relentlessly open and clear information about the future economic situation in Europe
- Change in attitude across all social spheres in Europe
- Modern vocational training for the entire workforce (especially the youth), suited for industrial and business requirements
- Motivation to learn and work
- Lifelong learning
- Investment into innovation and applied R+D
- Flexibility of the labour markets
- Reduction of work-related taxes, fees and duties
- Simplified procedures for immigration of highly-qualified experts for target areas (e.g for R+D)
- Faster public approval procedures for corporations
- Encourage and support the establishment of new companies and of companies with high domestic value-added

Information provided by politicians and associations to both employees and employers should focus on the significance and responsibility of maintaining a production base in Europe. Companies and associations are responsible for motivating and continuously

training and qualifying their employees. A strong identification with one's products and corporate identity will be more important in future than ever.

In the field of R+D HCC should provide sufficient but well placed funding for cross-border research to secure competitive advantages. Focal points in future-orientated R+D could be the preservation and conservation of natural resources, the efficient utilization of raw materials, energy, soil, air and water. In the field of environmental technology the HCC could increase their exports substantially while helping LCC prevent severe ecological damage, to the best interest of all parties involved.

The OECD has requested massive reforms from HCC which include required changes in the labour market structure, vocational training and an adjustment of labour costs.

## **8. Conclusion**

Liberalisation and globalisation have created a marketplace for companies and their executive managers which is characterized by increasingly fierce competition. Sourcing and outsourcing are no longer restricted by any geographical boundaries. Sales, production and sourcing activities in LCC open up new opportunities. Any considerations concerning investments, capital expenditures and earnings in this context are focused on lower production costs and purchase prices. Global competition creates price pressures which force companies to take action.

One solution is to procure goods and services in LCC. The present wage level in LCC is so low that salaries and wages presently paid in HCC simply cannot compete. Long-term studies prepared by experts in this field indicate that a harmonization of salary and wage levels in LCC and HCC is not expected in the foreseeable future.

However, many LCC are experiencing their very own developments. India, e.g., was able to secure its market leadership over China in the service sector due to a high number of newly qualified experts entering the labour market. China, on the other hand, is in a position to offer products and services at extremely low prices based on its established qualified workforce and on millions of workers migrating towards the large industrial hubs in China.

Russia will be able to increase its production capacity for technical-mechanical products to HCC industry. There will be R+D capacities and capabilities available in all LCC. Established and newly emerging companies in LCC will start to compete with the big old players also in high-tech segments such as aviation.

Companies in HCC will therefore have to consider very carefully which labour-intensive products and services and which R+D activities they will really want to source in LCC to secure cost and competitive advantages.

All those activities should remain with the HCC company which can secure its present and future market position and progress. This also calls for a highly flexible workforce for product development, specialisation, design, innovation and research. Companies in HCC will need to secure their pole position in technology, know-how, product quality and customer support to maintain their market position and to ensure that their country is supplied with high-quality goods and services.

HCC suppliers and customers alike will have to adjust and find a way to integrate LCC products into their scope of supply. Combining their own know-how with the advantages of LCC will be the way to secure their position in global supply chains.

The industrialized nations that today represent high-cost countries will be forced to provide a suitable setup and framework for flexible commerce and industry that is characterized by a high level of professional qualification. Securing competitive advantages will only be possible in the long run by pushing forward in research and development, continuously redefining what is state-of-the art in an industry, and offering top quality.

As many European countries still have very different frameworks for their trade, industry and commerce and also for their labour markets, the OECD anticipates the necessity of a social restructuring of states. Europe as HCC region is faced with strong global competition from LCC. Adjustment plans and reforms will be required to prevent “Old Europe” from aging and to keep the region attractive for industrial activities and commerce. When lobbying for Europe as attractive location for the service industry, a strong focus will have to be placed on customer-orientated service quality.

For HCC companies the crucial and critical question is not which goods can be produced or sourced cheaper in a LCC. The strategic key question is which production must be kept inhouse to secure the company's market position today and in the future.

When evaluating the possibility of entering into long-term business relationships with LCC, risks need to be identified, analysed and assessed. A good experienced local management team and extensive on-site trainings are prerequisites for establishing successful lasting business relationships with LCC partners.

For issues concerning applicable laws and regulations, taxation, finance and commerce experienced experts should be consulted as described in chapter “Risk limitation”.

Logistics operations as key element of global sourcing should be handled in cooperation with international experienced forwarding agents and insurances.

A suitable information system and data base with all required contact details and controlling needs to be set up and continuously updated.

A well-trained, flexible and experienced risk management team should be installed for the duration of the business relationship.

A good risk management team will include a number of experienced older specialists who are also flexible to travel abroad and work on-site when need be.

The purchasing managers and purchasing specialists of the future will be handling a cross-functional scope of responsibilities and tasks. Their challenge will be to ensure a well-balanced mix within their supply chains and to have backup solutions in place should any trouble arise with contracted foreign partners. This is how purchasing will be able to contribute to securing a company’s market position and achieving company targets.

A well-balanced supply chain could, for example, combine inhouse production with LCC and HCC suppliers, enabling a company to offer competitive prices for proven know-how, innovative technology as well as sustainable product quality.

Globalisation must not be a limiting factor for a company’s growth. If committed to a future-orientated strategy and if investing all required efforts, utmost flexibility and a high degree of innovation into their future, HCC companies will also be able to strengthen their market position and contribute to overall economic growth worldwide.