Prof. Robert Kennedy
Professor of Corporate Strategy and International Business, Michigan Business School
Director of the William Davidson Institute

I'm happy to be here. I actually come to the conference with a little different perspective, I'm not an expert on the Slovak economy although I lived in Poland for five years in the early 1990's. Over the last five years I actually spent a lot of time taking a look at the globalisation of services activities, which is a relatively new phenomenon. What I'm going to argue is that traditionally most studies on foreign investment and most policies directed at foreign investment have been aimed at the manufacturing sector. While that's a great sector to attract people, I'm going to argue that in many cases you can actually get higher pay-outs for less concession dollars by focusing on services, which are coming forward. I acknowledge right up at the front that I haven't done many studies specifically on the situation in Slovakia, I've done quite extensive work in India, the Philippines, South Africa and Uruguay, and I think those are somewhat different cost bases, but many of the drivers are going to be similar.

So first, as I said most FDI policies have traditionally aimed at attracting manufacturing industries and this is clearly at the centre of what Slovakia is focusing on. Over 80 % of exports from the country are from manufacturing, broadly defined that includes intermediate goods or intermediate manufacturing goods and components. And the focus for the country is to become an idol, which I think makes a lot of sense because there are both forward and backward linkages. It turns out of the reasons I'm here is that the US Embassy is sponsoring several student teams to do some studies and help promotion of the industry. But there is an important reason not to forget about services. First, trade in services globally is growing at about twice the rate of trade in manufactured goods. Since World War II global GDP, trade overall has grown at about twice the rate of GDP, but in the last five years services have grown at about twice the rate of manufacturing and in some countries the countries are going aggressive about this. Like in India services trade's growing at nearly 50 % a year compared to 10 % in manufacturing. So there is a huge, huge upside. The second is that Slovakia's comparative advantage relative to Western Europe is going to be much higher in services than it is in manufacturing. Simply because there is a higher labour input. Capital costs are not so much different between here and Germany and if you go into cost centres back off as processing or even product design and relatively sophisticated services the labour component is typically 50-60-70 % of those industries and therefore, your relative labour cost advantage is going to be much bigger. And then there's the very high export and job creation per dollar of FDI in services as well. I'll present some data in a few minutes.

First of all, there is this puzzle why the tradition has been in the deep globalisation of goods but not in services. I'm an economist by training, but I think it's worth and I'm going to have a short conceptual discussion. But first, we haven't had a lot of trade in services historically because most services even though they account for about 70 %, between 60 % and 80 % of most advanced economies, most services are not amenable to trade, there is either the need for physical presence (people serving you food, people cleaning up, things like that). Many services are very tightly linked to other activities so if you're doing product design you have to work with people in the factory or if you doing accounts receivable you have to work with sales force, those types of things. Telecom costs reliability until recently was low and based on this Japan model most developing countries and transition economies really focused on manufacturing as the driver of their transition.

And then finally, there is this issue of cultural distance. Tell about it a decade ago – doing business in developing countries was very, very different than doing business in developed countries so therefore, if you were General Motors and you wanted to operate in Brazil or Slovakia or Russia you really had to go native. And it was very hard to kind of break up the value chain and put some services abroad because countries insisted on having all the activities there and because they operate behind fairly high tariff barriers and fairly strict regulations, FDI regulations... Each country's operations were fairly independent even if they were within one country. But that's kind of the old world. Now what's happening and this is why we see a tremendous growth in services trade right now. First, it's the digitisation of business processes. A couple of consulting firms did studies a few years ago, they surveyed 400-500 companies and the question was what percentage of back-off and records were in digital form versus paper form, so electronic. In 1980 it was less than 10 %, in 1990 it was about 40 %, today it's over 90 %.

So if your accounts receivable records or sales records are in paper form you really can't move the back-off very far. Once they're in digital form, distances are irrelevant. Policy liberalisation, Central Europe is a great example, but we can talk about Sub-Saharan Africa, we can talk about India and China, we can talk about Latin America... These countries are opening up to the global economy so when they want import things from abroad they're really looking for exports and what's the relative advantage of these countries it's local slavers, it's not capital costs, not manufacturing. Proud less, it's local slaver and they're looking for things to export because they want to import things from the EU and from the United States and Japan. I think everyone in the room is probably highly familiar with the changes in telecom costs, since 1990 they've fallen by about a figure of 10,000 – this is for distance & data telecommunication internationally. And then finally, there has been a big shift, a real spread of global business practice, I probably shouldn't call it the US business practice. But just the way you do business abroad, there has been a really huge convergence in that. Until recently, about six months ago I was at the Harvard Business School and I had alumni relations to Departments to do a study, I had them take a look at the records of emerging markets students and the question was where did they live five years after graduation. For students who graduated in the first half of the 1980's less than 20 % of them were in the home region five years later. For instance, students who graduated in the first half of the 1990's it was 70 %. A part of that is driven by the job down, high-tech bust and the job slump in the US and in the EU. But a lot more of that is by the tremendous opportunities that have been created, so they're going home and start a consulting firm, starting a VC firm and starting high tech firms, and with that they bring US and European business practice and that reduces the cultural distance I talked about a minute ago, and makes it much easier for these developing countries India, the Philippines and Slovakia to interact.

So enough of the conceptual. I have some data just to illustrate the point. Think about the total delivered cost if you're going to put a function overseas, what's the costs savings. We're going to account for transportation costs, telecommunications costs, everything else. If you put auto components overseas, if you move an auto component factory from Michigan to Mexico fully delivered mechanical and regulatory costs you save on average of 20 %, you move textiles overseas you save on average about 30 %. We start moving services overseas. In many cases the labour rates are – you pay one-fifth to one-third. You have some incremental costs, but it's not unusual to once the process has been transferred to save 50 % on this activity. So, software for example move it to India, often you save around 50 %. When you're starting things like payment services that can be routinised and you only need strong English language skills you can save as much as two-thirds. So if you're a country and you want to have a value proposition for the developed country markets you got to be much stronger moving on the services side than in manufacturing. So one is the comparative advantage is larger. These are based on some studies in South Africa, India and Uruguay as I said. But when you attract the FDI there is a question what do you get out of it. Countries attract FDI for a whole variety of reasons – you want to create jobs, you want to create exports, you want to create high wages and we did some surveys. If you see the blue column here, if you take a look at Western number of jobs created per million dollars out of direct investment... in the auto sector these are direct jobs, they don't count up the value chain. In the auto sector most estimates are in the tenth or fifteenth range and the number of people in Volkswagen Bratislava are roughly equivalent to about a billion dollars of investment and 9,000 or 10,000 jobs. If you count the up-stream supply as you may you double that.

If you get into light manufacturing, so we're talking about textiles, plastics, toys and these things. In general for a million dollars of investment you create about 40-50 jobs. Payment services, this is non-voice necessary offshore, so you do things like managing accounts receivable or doing accounting work, create over a hundred jobs per million dollars of FDI. These are not capital-intensive businesses but if you're a country with high employment and a part of what you want is job creation much more effective if you get people to invest in the services industry in this because these are not capital-intensive industries. You invest 8,000 or 10,000 dollars in a cubicle, in a computer and a couple of telecom lines – you've created a job. Perhaps, you've created two or three jobs if people work multiple shifts. Another thing, annual exports per million dollars of investment...these vary a lot by sector, they're pretty high in services as well. The one thing to remember is that on average the wages are actually lower. Because it's very capital-intensive in the auto sector it tends to pay higher wages then in the services sector but you're creating better jobs. So that's just one thing to think about. I'm not actually arguing that you should do services to the exclusion of manufacturing, but you should include it.

Last couple of thoughts and then I will turn it over to my next colleague. One is what type of policies are effective in creating these jobs I mean this is the big challenge for a lot developing countries. They're very different than the standard FDI policies. First, the most important thing is telecom deregulation meaning you can freely get a phone and a data connection and the prices are fairly low and you're backed with it. In India they deregulated the international telecom rates in April about two years ago. Within two weeks international connection prices have fallen 75 % and they also deregulated cellular telephone use and there are now selling about 3 mil. cellular phones a month in India. What happens is all of a sudden it changes the way business is done. It's both much cheaper but it's much more ubiquitous. The second is basic technology literacy. There are few countries – Costa Rica is really leading at the list, India a little bit less certainly in the cities – where people don't need to be software coders but what's very important is they have been exposed to a computer, they understand what cellular phones are, there is decent numeracy. Some places like Costa Rica, for example, they made English mandatory in all public schools, they've given every citizen whether they have a home or not an e-mail account, they have an account where they do interact with e-governance through various computer facilities. These are not incredibly widely used but they're really pushing even among adults getting used to this kind of interacting with people remotely not over the counter but the computer and if you interact with your local government that way it makes it much easier a transition into serving export markets. Foreign languages are important although I wouldn't argue that it makes sense for Slovakia or anyone else in Central Europe to get in the English language market. India and Philippines pretty much have that locked up. But right now these Indian and Philippine companies are really struggling with serving various European markets except for the UK. And to this extent you have an advantage in German or French or all these other languages where you have the advantage over the Indian suppliers.

The last kind of a major point is an entrepreneur-friendly business environment. This is a thing that most of the other countries really struggle with. And that is because they have a history of high regulations. So what they need is to make it very easy to form a firm, to create firms, making private equity very attractive. You don't intend to have people who bring in millions of dollars to invest in things, you have people who bring in 2 mil or 3 mil., not a billion. So there needs to be a small-scale and contract enforcement, the court systems need to work. I'm just going to finish.

In terms of Slovakia's advantage I actually think as you look around Slovakia has several very strong advantages. First is the location. Most applications when you think about disaggregating a value chain, you're going to put some processes abroad, you want them to be able to work during relatively the same time period. Most of the people doing services globalisation right now are offshore and they are on the other side of the world, India, the Philippines are by far the biggest. So you have an advantage there and a very easy access because you can't do everything by telecom. People have to go back and forth to set up these processes, to do training and it's much easier to go here than to say go to India. And then a relatively low cultural distance. It's the same heritage, it's unlike dealing with people from India.

The second big, big advantage I think is that once you're inside the EU there is a whole bunch of concerns about data privacy, if people violate contracts, steal intellectual capital, can you enforce that? Being inside the EU is going to be a huge advantage relatively to the other suppliers.

And then finally, the economic and strategic factors, which are Slovakia's still relatively low income for the EU and there's the first mover potential. Not many EU countries have gotten into this. There is some activity in Hungary and some activity in the Baltic in terms of the future EU centres. But it's going to be a huge market and it's a relatively wide open market. So I encourage as you think about attracting FDI make sure you have some policies for this sector as well. Thank you.