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Outsourcing vs Insourcing

From Outsourcing to Insourcing: Evaluating global supply chain decisions under economic uncertainty

Last January, President Obama announced that he would step up his effort to improve the economy by encouraging both US and foreign companies to generate more jobs at home of the sort that have been shipped overseas or lost to foreign competitors. This announcement was backed up by tax breaks and $12 million in new resources for the Select USA initiative that began last year.

This might seem like a desperate – and underfunded – political effort to reverse an outsourcing trend that has been going on for almost three decades. What started first with manufacturing more than 30 years ago has extended in the last decade to service jobs. The rush to control costs by moving production to low cost countries has led many American companies to establish manufacturing or sourcing arrangements in China and South East Asia leading to an estimated 2.3 million US jobs lost in 2011 alone.

However, according to the White House, US companies also brought back almost 2 million new workers in 2011, more than in any year since 2005. Over recent months, several studies such as the report published by the Boston Consulting Group *Made in America, Again: Why Manufacturing Will Return to the U.S.,* also identified an emerging trend of companies bringing production back to the US. Production of 10 to 30 percent of the manufacturing goods that the U.S. now imports from China could shift back to the U.S. before the end of the decade, adding $20 to $55 billion in output annually to the domestic economy, according to the same study.

Conveniently coined "insourcing", the new buzzword can be used to describe both a company bringing activities back in-house or – with a more political connotation – bringing activities and jobs back to the US.

"The worldwide economic downturn and its aftermath have had a significant effect on how companies view and approach global sourcing," says a recent report by The Boston Consulting Group (BCG). The report notes that exports from low-cost countries dropped sharply during the crisis -- from $3.6 trillion in 2010 to $3 trillion in 2011 -- and have yet to recover to their pre-downturn levels. Companies are re-thinking their sourcing strategies to take into account the "total cost" of outsourcing production lines to Asia rather than merely looking at labor costs.

Emerging evidence for an insourcing trend is positive but what are the reasons behind this economic shift? Which industries are affected? How does a company know when the time has come to exit an outsourcing arrangement?

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A) WHY IS THE OUTSOURCING TREND REVERSING?

The recent insourcing move by US companies can be attributed to at least 4 main factors:

1. Changing wage structures in many developing countries: Labor costs are lower in places like China, but in many cases, costs in those countries are going up fast. In 2000, the average wage in China was just about 50 cents an hour; now it's $3.50 and should increase by 15% to 20% a year. Companies are realizing that the low cost country of today might not be the low cost country of tomorrow.

2. The steady appreciation of the Chinese Yuan since China's tweak of the Yuan-Dollar peg in 2005 has further narrowed the gap between manufacturing costs in China and the U.S. Despite this recent appreciation the Yuan remains undervalued, relative to all other currencies, by 5 to 20 percent, according to various estimates and it is expected to appreciate by 3 to 5 percent over the next three years.

3. Higher transportation costs: In 2001, oil prices were around $20/$30 a barrel. Now it's around $100 a barrel. Despite the continued weakness of the global economy, oil prices are likely to rise over the next few years, driving up shipping costs.

4. Increased focus on risk mitigation: Heavily publicized product recalls and ever more demanding customers means companies need to focus even more on quality. Spreading your supply chain globally often entails accepting slower responsiveness, poor customer service and additional risk factors such as supply chain disruptions, diminished IP protection and environmental concerns.

With the advantage of sourcing from low-cost countries being gradually eaten up by wage and currency increases as well as supply chain & product risk management concerns, companies are rethinking their global sourcing strategies and reevaluating the benefits of sourcing locally.

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