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Discussion following the Speeches of Mr. Hodgson and Mr. Halpern

Discussion

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DISCUSSION FOLLOWING THE SPEECHES OF MR. HODGSON AND MR. HALPERN

MR. SISTO: Thank you, both speakers, for raising those issues, and the background and destinations, although perhaps we can head off a question from Quebec as to whether there is more than one language in Canada.

Any questions for our speakers?

DR. KING: Sure. One thing on patents, it is generally true that you have to be pretty secure on your patents to do this, and the country has to acknowledge the patents pretty strongly before you do it in a particular country.

Also, I wanted to know about currency. Do you allow for variables on currency in your contracts? For instance, the U.S. currency has gone down in value. Does that make any difference of whether you offshore, or do you have to be protected on it?

MR. HALPERN: On the Canada patent issue, it depends on your technology and whether the –

DR. KING: Well, but –

MR. HALPERN: In some cases, you want to be careful. If your business advantage is built on patent technology, for example, pharmaceuticals and high tech kinds of businesses, your patent protection gives you an advantage against competitors, regardless whether you are outsourcing or not. The issue there is not so much around the patents, but around the trade secrets that surround the patents. When a patent is carefully drafted, the purpose of a patent is to disclose the invention – and that's part of the bargain you make for the protection, to disclose it to the rest of the world – but you always hold a little bit back, and that "little bit back" is how you apply the patent in practice and how you use it. If you have to disclose that to a third-party in any context, in an outsourcing context, you certainly need to be very secure that that third-party is going to keep your confidence, is going to keep your secrets, because a competitor may not be able to replicate the invention on the basis of the patent alone. But, if they have access to this other information, then you do have that issue.

The second question on the currency fluctuations: Interestingly, I did an outsourcing deal a few years back where our client was in Venezuela, and they are the customer outsourcing to the U.S. of all things, and that's the first time I actually faced the question of currency fluctuations in a contract. In South America, they know all about how to handle currency fluctuations, and they were a lot better than the American lawyers. I think the answer is, yes, people are more sensitive to it now than they used to be, but I think we still tend not to deal with it too much in currencies that have relatively been stable against one another, even though there are fluctuations in U.S.-Canadian

exchange rates, and things like that. I think that the pricing structures of the outsourcing have tended to deal with those without having to specifically address the currency fluctuation. So there may be provisions that allow the vendor to increase their prices if their costs go up. So if their costs are going up as a result of a currency differential, that has to be dealt with. That may be different – and I will confess I don't know in a manufacturing environment where you've got issues of a currency fluctuation. I haven't done as much of that kind of work, so I couldn't tell you, but I could see where that would be an issue in those kind of deals.

MR. SISTO: I would add on top of that exchange controls – and you used Venezuelan – the official exchange rate is sometimes confusing to get it into dollars.

DR. KING: Right.

MR. SISTO: Yes, sir.

MR. CRANE: David Crane. Just a little bit of a context first because I am concerned that the offshoring debate is leading to a lot of negative thinking, such as China, this kind of stuff, which is quite putting us off on the wrong step.

It seems to me we are in a period of – almost a transformation in the world. The National Intelligence Council last fall put out a report in which they said what is happening in the world today is similar to what happened when Germany became a major economic power in the latter part of the nineteenth century, and when the United States began to emerge as an international economic power in the early part of the twentieth century. Today, China and India are in a similar process, and they are going to become huge powers in the whole world, and the whole structure of the world economy is going to have to adjust to this.

In a sense, that's what should happen as markets are opened. This is the purpose of opening markets: that we have economic development. Hundreds of millions of people in China, and to a less extent, in India, have been under poverty. It is overwhelming. Hundreds of millions of people are now enjoying some kind of relatively decent standard, which they didn't have twenty-five or thirty years ago. That's what economic development is supposed to be about. At the same time, consumers in our country have – for many people living on fixed income or low income, that is what the original arguments on free trade were about, for a consumer benefit. They were not the kind of mercantile listing.

Today, whereas Glen said exports are good; imports are bad, it used to be seen almost the other way around, not quite. So what I am concerned about is that we, looking at this issue in a broad puppet way, and the wrong way, I think there is a need for people who understand the situation to speak out more clearly and to, indeed, our own population to say we are only beginning

a massive structural change, and this is going to have all kinds of implications.

Our engineering students used to graduate and go into entry-level jobs. Those entry-level jobs are disappearing. We have to change what we teach engineers now so they have to do different things when they graduate. And we are trying to put off that by saying it is China's fault. If they consent to an exchange rate, we wouldn't have to do these difficult things.

On the free trade issue, I think we must avoid a trap on the FTA, and I hear it all the time in Canada, and you did, too, that since the Free Trade Agreement was signed, Canadian exports have gone up by this huge amount. The unspoken second part – and that's because of the Free Trade Agreement – I would argue it is because the U.S. economy went through a huge surge of growth, and we had a very cheap Canadian dollar – but those are principally the things that will face the highest tariffs, such as furniture and clothing, where there was a major restructure, but for the auto, oil, and other goods, the Free Trade Agreement didn't make that much difference. So that is just a point I want to make.

On the issue of the supply networks, you call them "value networks," the challenge for our high value – we see that Nike, for instance, as a business model, designs markets and does all the treasury operations in the United States. They actually make things in other countries where it is cheaper, but it is capturing the value part of that network right in the United States, the best jobs out of that process. So the challenge is to – and we see that in the clothing industry and the design industry in Canada, United States, and Europe, can be made in other places cheaper. Movies: More and more movies are made in South Africa and Moscow, but the scripts will still have to be written here, and set designs will be designed here. So it is what you capture in the value network, recognizing that every industry is going to be a global network – or just about every industry. That's where we have to focus. I guess my question is: How do we get out in the public realm a better understanding of what is at stake here, and a better understanding – and a better understanding that the correct policy response isn't all these silly ideas that a state government can't contract, give a contract to something if any part of it goes to a foreign country? That's totally against what the WTO is trying to do. How do we get more of a focus on how we improve our own competitiveness by our capacity, through education and research, and other means, to do more of the high value things in our own countries? How do we get the debate, in other words, to focus on the right issues?

MR. HODGSON: Well, there is a lot to respond to. I have to do it in four points.

(Laughter.)

MR. HODGSON: First of all, I agree with you entirely on your first point about the fundamental structural change in the real economy. I have given

that talk about – at least ten times in the last year– about the China factor, and Canadians have been very slow to open their eyes to that. I presume Americans have been slow, too. We should have been debating that back when we were coming up with conditions for China's entry into the WTO, 1997, 1998, and afterwards.

But what is happening – I found your reference to Germany interesting. I actually use the United States as an example. The post Civil War period, with the opening of the American west, led to a huge decline in commodity prices around the world because the world markets were flooded with stuff. And Europe actually went into a recession for almost a decade because they were going through the same coping mechanism. They were not prepared to move from that sort of thing, and take advantage of that inflood of cheaper commodities. Presumably, we got through it with the Industrial Revolution and the like, but you are absolutely right, there is a profound structural change going on there, and the challenge is how to harness that.

I take your point on free trade. It was not the only factor. I don't think it was just a cheap dollar, but clearly, we benefited from a very strong period of economic growth in the United States, and that clearly carried – for example, the U.S. economy – part of the reason why the United States has the massive trade and current account deficits today is because it basically put the world on its back after the Asian crisis, and provided the domestic demand it needed to get the Asian economies back on their feet.

MR. CRANE: We didn't increase our market share in the United States. It pretty well stayed flat.

MR. HODGSON: No. You are absolutely right. We took advantage of the rapid growth, and I have argued on other occasions that the FTA tariffs actually didn't come down much either. It was only about in the remaining 10% of goods where tariff protection existed. So it was almost a confirmation that we were allowed to move to another generation of sort of an economic growth model; I take your point there.

The value network, how do we do that? People like you and me constantly go out and talk to people one-on-one, groups of fifty; as we are doing at the border now, you know, we are doing the research on the barriers to competition.

DR. KING: There is one back here.

MR. SISTO: We have one back here in the middle.

MR. LEVEY: Glen had mentioned – it was mentioned a couple other times, during a couple of sessions, about how Canada is really an international trading country. It relies on international trade far more than the United States does. I am wondering if you take Canada's international trade out – if you take the U.S.-Canada context out of it, in other words, you know, 82% of Canada's exports go to the United States, how much of Canada's trade really

is international? Again, consider U.S.-Canada to be one market. That's the first question.

The second question is: Is the next step – and this goes to something you both mentioned – in increasing and enhancing international trade, the free movement of labor, and reducing barriers to that?

Thanks.

MR. HODGSON: You are right. If you take the U.S. out of the equation, Canada's trade is not that liberal. We have actually seen market shares declining in many places, and China is a case in point where our market share has fallen almost a half over the last year. Last year, Canadian exports finally took off to China, but so did everybody else's. So our market share has actually been declining. Part of the reason I point to foreign investment is that I think Canadian business has found another delivery vehicle. They found a need, for example, because we don't have free trade with Europe. I think Canadian business has found another delivery vehicle: European countries. And the most stellar example is in the U.K., where our sales from Canadian affiliates in Britain are triple what our exports to Britain are. So there is diversification through that back door.

On the international movement of labor, do you want to pick that up?

MR. HALPERN: I will pick that up.

Where I see the international movement on the labor issue in starkest contrast through my work, is the influx of highly skilled technical workers, and the whole H1B visa problem of getting enough visas for these people, and I think it goes to a point that was raised before, the issue of how do you capture the value channel? Why is it that U.S. companies are trying to bring these people in? Once they get to the U.S., you are going to pay them, effectively, U.S. wages. You might be able to cut back a little bit, but it is not going to be a major cost savings. The issue is one of understanding what these people are doing and why it is that we don't have U.S. residents or citizens who can do it as well as they can.

There are only two possibilities: One is just an outright shortage of labor in the U.S., which I really don't believe. There are more likely scenarios: It is a shortage of highly skilled labor in the U.S. What's happening is that India, in particular, as a good example, put a huge amount of time, effort, and money into building an educational system that turns out just top notch technical people. These people just have excellent skills. The U.S. educational system is just not the same. It is just not turning out the same kind of volume. It is not operating the same way, and I think part of the political debate over offshoring, outsourcing, and the exporting of U.S. jobs, and things like that, particularly in this last presidential election, and without taking sides, I think both sides were equally guilty of using it as a scapegoat to avoid addressing problems that are much harder to solve, like, how do we improve the educa-

tional system in the U.S. so we are turning out just as many skilled engineers as India is?

So I think that if you free up the movement of people, to some extent it is going to force people to face the real issues and stop trying to deal with it as a commodity trade-barrier kind of an issue. If you think about people – as much as I hate to think about human resources as commodities – to some extent, that's where the visa barriers and stuff come out. They are inputs to the process, and they need to be freed up in trade as much as the other inputs are.

MR. LEVEY: I was going toward a much more modest question, which is the free movement of labor between the U.S. and Canada. In other words, it increases the pool of potential candidates for various jobs in Canada and the U.S. That might be the next step – sort of step in terms of enhancing the U.S.-Canada relationship and efficiency in this.

MR. HALPERN: Well, someone else mentioned – I think – I forget whether it was last night or this morning – Why doesn't Canada just join the U.S. now and become part of the country?

MR. SISTO: It is very easy to present yourself at the Canadian-U.S. border and cross it with just a letter of promise of employment. You don't even have to go through the formal visa requirements any more. So I don't say there is free movement of labor, but it is pretty darn close.

There is a question over here.

MR. PHILLIPS: Actually, you are very kind. I think here in the states we have trouble graduating seniors in high school that can read, much less doing engineering, so you were being very kind.

But I think there are two very big changes that are happening that are going to affect your subject, supposedly – you did a tremendous job of explaining it. It was a very good insightful presentation – First, is that the Rules of Origin obviously are going to change, the “Three Amigos Meeting,” and other things going on. Industry in both Canada and the United States have found that the process of improving the Rules of Origin content have become really difficult, so I think you are going to see a change.

That's to the good side, but the real difficulty that is coming – that is here, although not too evident yet, is C-TPAT, which is the Customs and Trade Partnership Against Terrorists, is now going back to the source, and that is where producers in the United States have to not only specify their own security arrangements, but now they have to go back to the supplier. And, if there is a secondary supplier, “Supplier A” is supplying “Supplier B,” they have to go back and know about whether there is twenty-four-hour staffing, security, lights, fences, et cetera. That's rather difficult when you get into the outsourcing, and particularly several levels of sourcing, and it is a fact that you are not going to get into the United States with goods in a little while, without being part of C-TPAT, again, being a known low producer.

So I think these two elements are going to affect particularly your point about nearshoring, which is going to be a lot more easier than outsourcing. I am talking about, of course, production of goods, not services, which in India and China are a little different.

But I think you might want to indicate whether you think the trend is more toward outsourcing. Do you see it growing in spite of the survey you just did, Glen? You know, your answer was 58% said that they didn't know that they did it well, but 80% are going to do it again, which I think comes back to your point that there was no Canadian supplier to supply the goods, so they almost had to offsource.

MR. HALPERN: I think the question that was missing is, you know, How many people are doing outsourcing and don't even know it?

MR. HODGSON: Can I make a small comment on the Rules of Origin? I just spent a decade in Canada's Export Credit Agency, and over that time, we had to keep relaxing our Canadian content rules to the point where they had been thrown away. And, the model we were using to evaluate whether we should support ongoing Canadian export business, was a Canadian benefits concept. We were supporting deals where there was no Canadian content, but we were looking at the multiple benefits for our national economy from international business. Now, the U.S. Export Bank is still at 75% U.S. content to get your foot in the door. From a competitive position, I hope they stay there.

MR. HALPERN: Just anecdotally, to answer your question about whether outsourcing schemes seem to be on the rise, just judging from the number of deals we are seeing coming into our firm, I think it is on the rise. I think it is coming around in a couple of different ways. There was a pendulum swing, as always. There was a lot of outsourcing. Then it kind of leveled off for a while, and slowed down. Now, it is coming back up again, but it is in a somewhat different form. I think some of what's happening is you are getting blends of outsourcing and nearsourcing, and what have you. You may have a U.S. company nominally entering into the outsourcing relationship, but they themselves have operations in other countries to support the outsourcing program that they just sold to you. So, it is almost a similar kind of issue to the sourcing rules on a services side. You don't know where these services are coming from.

MR. McILROY: I get a kick out of watching popular television programs where they brand people who outsource as being "Benedict Arnolds," and it is almost a traitorous activity. I am wondering, is that having any impact on the process, or are companies continuing to do it, or do they feel that they could lose some of their local market share because there is going to be a backlash?

MR. HALPERN: At least from what I've seen, I don't think there is a big impact on companies doing it. I think they may be a little quieter about it to avoid politicians getting a hold of it and making an issue of it.

I think the one place where you do see a little bit of change in strategy is around things like customer service; your high-touch areas, because there it is not so much, I think, because of the political issue of being branded – then being a “Benedict Arnold” about it. I think it is a quality issue. I think people are saying customers are not comfortable dealing with somebody sitting in Bangalore trying to diagnose their computer problems. They are much more comfortable with someone in Canada trying to solve their computer problems, and, therefore, as a matter of good business, you are going to get a higher quality service and higher customer satisfaction. Even if the technical answer was identical, you are getting higher customer satisfaction from the Canadian outsourcer, so you are going to go to the Canadian outsourcer.

DR. KING: One more question.

MR. SHANKER: The comments – I will try to make it a good one, Henry.

MR. SHANKER: The comments so far, the implications for the future, some very good comments by you on what we must do to prepare for this new future, which I agree with, but when someone comes to me or some politician, whoever it might be, a friend, and asks the question, Are we better off today by reason of the development instead of taking place in outsourcing, or are we worse off? Many think we are worse off. This is to you, Glen. You made the studies. Do you think we are better off as a nation in the economic sense today, than we were fifteen years ago before all this happened?

Is that a good question, Henry?

MR. HODGSON: Well, there is no counterfactual to measure that against. Certainly, you know, my indoctrination for seven years at university and twenty-something years of practice tells me yes, but there is no counterfactual. We can't compare the world of fifteen years ago and see where we were.

What is clear is the point that Mr. Crane was making – is that clearly there is a structural change going on in the world, and you either adapt, or you are going to die. So I think the adaptation is inevitable, and I would counsel for people to go faster rather than trying to hold on to what you've got.

Again, I make the point, if you look at the impact of outward investment or outsourcing, I think – in fact, the economic research shows that there is a net benefit, but it is a net benefit. There are losers as well as winners, and good welfare economics, and I think good government policy is that winners should compensate losers if you are going to have a good, cohesive society, and there is a very legitimate question about whether the design of govern-

ment facilitation programs and adjustment programs is adequate so that the losers don't keep losing, and the winners keep winning.

MR. SISTO: Well, I would like to thank our speakers. That was a very good session.

(Applause.)

MR. SISTO: Obviously, a lot of issues are still to be discussed further in other forums, and in other contexts, and one we shall take with us as far as getting education and word out, whether for or against, training.

(Session concluded.)

