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Responding to a globalizing labor market: An interview with Rakesh Mohan

Rakesh Mohan is the former deputy governor of the Reserve Bank of India. An expert in banking, monetary policy, infrastructure, and urban affairs, he is currently a senior fellow at Yale University's Jackson Institute for Global Affairs and a professor at the Yale School of Management. Mohan has published several books, including *Monetary Policy in a Globalized Economy: A Practitioner's View* (Oxford University Press India, June 2009) and *Growth with Financial Stability: Central Banking in an Emerging Market* (Oxford University Press, June 2011). In May 2012, Anu Madgavkar, a senior fellow at the McKinsey Global Institute, spoke with Mohan in New Delhi. In this edited interview, he discusses the causes and effects of a globalizing labor force and how developed and emerging markets should respond.

McKinsey Global Institute: *What are some of the problems associated with the way labor markets have globalized?*

Rakesh Mohan: Growth in world trade has been accelerating since the Second World War, but real globalization has gathered pace in the past three decades especially. As a result, a significant proportion of manufacturing and production facilities moved from developed economies to emerging markets, particularly to Asia in this more recent period. Individual economies are feeling the effects of this rebalancing; in the US and other developed economies, for example, manufacturing production has declined, and therefore the demand for low-skilled workers has also fallen. On the other hand, with accelerated technological change—especially the use of information technology in all spheres of the economy—the demand for highly skilled workers has gone up in both advanced and developing economies. With the bargaining power of labor falling in recent decades, the share of labor in terms of income has actually gone down, particularly in the United States and Europe. So economic inequality is becoming increasingly obvious in many parts of the world.

McKinsey Global Institute: *Many countries will soon have too many unskilled workers and not enough highly skilled ones. Which interventions or mechanisms are most critical to helping correct that imbalance?*

Rakesh Mohan: Education is extremely important. In many developed countries—the United States, in particular—the social mobility of lower-income people has been falling since the 1980s. After the Second World War, the expansion of and improved access to higher education in Europe and North America was an important channel for upward mobility for the initially less well off. This channel appears to have become less effective for upward mobility in recent decades. The expansion of higher education has lagged behind the increase in demand, leading to higher wages for college graduates. Governments must improve the quality of secondary education, so that more people from low-income backgrounds can go to college and gain the skills they need to get better jobs. But at the same time, the growth of higher education in the developed world seems to be decelerating. So both of these issues must be addressed: the quality of secondary education and the supply of higher education.

Training is also very important for both developed and emerging markets. Unlike improvements to education, which must be led by governments, businesses can have a much larger role here because they understand the kinds of skills their employees need. Training falls into two categories—training people who are entering the labor force and retraining those who are already working. Technology is becoming part of nearly every aspect of the manufacturing processes, and even in service industries most roles require computer skills. So there is a substantial need for vocational retraining of low-skilled workers who are already in the labor force.

McKinsey Global Institute: *Are there any examples of countries that have particularly good training or retraining programs?*

Rakesh Mohan: In India, the information technology sector is expanding rapidly, and as a result there's been a mushrooming of so-called engineering colleges, particularly in southern India. But IT companies find that graduates of these programs still lack critical skills, so the companies themselves are investing heavily in three-month, six-month, nine-month, or even one-year training courses. They are setting up university-like facilities for retraining their own employees.

Germany has an excellent vocational-training program for new workers too, but it is a combined effort by the central government, the state governments, local chambers of commerce, and individual firms. The central government creates the curricula for vocational training for specific trades; the members of local chambers of commerce actively participate in testing the students; the state governments provide the training facilities; and local businesses hire the workers while they're still in training. A specific country's system can't be duplicated everywhere, but other countries can certainly learn from some of these experiences.

McKinsey Global Institute: *What about job creation? How are other countries creating jobs for low- and medium-skilled workers?*

Rakesh Mohan: China and parts of Southeast Asia, like Taiwan, South Korea, Singapore, Thailand, and Malaysia, have essentially taken over the manufacturing sector—clothing, textiles, shoes, toys, and other consumer goods. So we've seen an unprecedented generation of low- and medium-skilled nonfarm employment in these countries. Developed countries, such as the United States and most of Europe, on the other hand, have lost the kinds of low- and medium-skilled jobs associated with manufacturing. So, again, better education and vocational training are essential to helping people move from low-skilled to medium-skilled jobs. One side effect of expanding training and education is that it actually creates jobs to support the sector itself: there are a number of jobs in education—in teaching, but also in ancillary lower-skilled services associated with education.

Low- and medium-skilled jobs will also emerge in developed countries that have substantial aging populations. We can expect similar aging in other economies, China in particular. As they age, these populations will require additional services related to recreation, health care, and housing. And in the next two decades, we must note that almost three billion people in Asia—in China, India, Indonesia, Pakistan, Bangladesh, and Vietnam, among other countries—will experience rising incomes on a constant basis. This will generate new and increasing demand for the kinds of products associated with basic manufacturing: clothing, shoes, toys, and textiles, along with other household goods. The resulting low- and medium-skilled jobs will be distributed among emerging-market economies, but the growing population will also generate new jobs in developed countries—in design, marketing, fashion, and other comparable industries.

McKinsey Global Institute: *What is India's particular challenge?*

Rakesh Mohan: I do think India has a serious problem. The average education level of the Indian labor force is lower than in China or Indonesia. We have high rates of illiteracy and very low educational levels among workers over the age of 15 who are already in the labor force. In the last decade, the Indian government has made great efforts to expand primary education, and we now have nearly 100 percent participation. But the dropout rate is high. Addressing retention rates is therefore critical, as is an increased focus on both the quality and the quantity of primary, secondary, and higher education. India must overlay its entire educational system with strong vocational programs and should strengthen its programs in science, technology, engineering, and mathematics so that students are better prepared to enter higher education or vocational training in these fields. And of course, we need to accelerate the growth of higher education and improve its quality. Here, again, the government has a role. In fact, parliament recently introduced legislation that will allow for more experimentation and innovation in higher education.

Improving education is only the supply side of the equation—India must also address labor on the demand side. Unlike its peers, India's share of labor in manufacturing has actually decreased in the last 20 years. We must take advantage of the new demand that will be created by the three billion Asians who will need low-tech consumer goods in the coming decades and, accordingly, make special efforts to accelerate the growth of the labor-intensive manufacturing sector in India. As wages increase in China, some of those jobs will leave China for elsewhere. This has already started happening in countries like Vietnam, the Philippines, Indonesia, and Thailand. It is a real opportunity for India. But if we delay, we will miss the boat again, and manufacturing employment will continue to stagnate, thereby also slowing down the rural–urban transformation needed to enhance rural productivity.

McKinsey Global Institute: *What can developing economies learn from advanced ones in the wake of the financial crisis?*

Rakesh Mohan: The "global" financial crisis is really a North Atlantic financial crisis. Asian and Latin American economies were affected, of course, but what is remarkable is that, to my knowledge, not a single financial institution or bank in either of these regions needed to be bailed out in the three years after the crisis. In fact, it seems that Latin American and Asian economies have learned from their own financial crises in the 1980s and 1990s. The average budget deficit of these countries is now much lower than those in Europe and North America, and their inflation rates are much lower than they had been in earlier periods, although they are still higher than in advanced economies. In the last decade, these developing regions have practiced stronger financial regulation than the North Atlantic countries have. Now the question is whether developing regions will continue to operate that way in the future.

But in terms of overall lessons learned—first, in managing overall macroeconomic, fiscal, and monetary policies—it is important to pay attention to growth and long-term financial stability at the same time. Macroprudential regulation can help here. Second, excessive financial expansion and socially unproductive financial innovation should be viewed with caution. Third, since financial crises cannot always be avoided, emerging markets should be prepared to practice fiscal prudence in good times, so that they have the flexibility to implement a fiscal-stimulus plan if necessary. When the North Atlantic economies were forced to implement stimulus programs to address the ongoing financial crisis, they found that their imprudent fiscal policies in previous years left them with little financial headroom. Consequently, their overall sovereign-debt burdens are threatening to become unsustainable.

McKinsey Global Institute: *What do you see as the most serious short- and long-term risks to the global financial system?*

Rakesh Mohan: The most immediate short-term risk, of course, is the very real possibility of the breakup of the eurozone. If Europe is unable to find a solution to its financial crisis and Greece unravels, Italy and Spain are likely to follow soon, and then the crisis will spread outside of Europe.

Another short-term risk is the possibility that the private sector will fail to grow. We have seen monetary expansion and zero percent interest rates as responses to the fiscal crisis, but neither has resulted in higher lending. Instead, the balance sheets of the US Federal Reserve, the Bank of England, and the European Central Bank have ballooned. For any financial institution to lend, it must get a return on its risk. It is possible that one of the reasons lending has not increased, despite the zero-interest-rate policy, is that as interest rates dip, banks see less opportunity for a return on their investment. Hence, adjusting for risk, they find it more rational to invest in central-bank interest-bearing reserves rather than choosing risky low-interest-rate loans to businesses, especially small and medium-sized enterprises. So in the short term, we should be looking at how to increase the growth of credit so that the private sector can actually start expanding. Ironically, for policy makers, this could mean increasing interest rates slightly rather than continuing with zero-interest-rate monetary policies.

In the longer term, we must be willing to scrutinize the financial sector more closely than we have in the past. There is a great deal of discussion at the Bank for International Settlements, the Financial Stability Board, and the International Monetary Fund about reengineering the national monetary system and the international financial system. As you might imagine, this has generated resistance from the financial sector, which is wary of what it considers intrusive regulation. Still, we must tackle the issue of financial innovation head-on by identifying what type of financial innovation is useful and productive and what is not. The aim must be to restore the role of the financial sector as a service sector that exists to serve the credit and other needs of the real economy.

McKinsey Global Institute: *In the absence of interventions, we're likely to see increasing income inequality. What do you perceive as the consequences?*

Rakesh Mohan: It's difficult to distinguish between the social and economic consequences of income inequality. There is an increasing perception that an underlying unfairness is responsible for economic inequality. As a consequence, there is greater resistance to some of the changes that would actually alleviate the effects of the financial crisis. It's important to repair the social contract so that income inequality is not perceived as the result of wrongdoing or special protections or excessively low taxation of higher-income earners. People are tolerant of inequality if it is not seen as unfair. Inequity is resisted, but the same is not necessarily true of inequality. And of course, income inequality is less of an issue when everyone has access to basic public services, like education and health care.

McKinsey Global Institute: *How might the financial and job crises affect thinking about capitalism?*

Rakesh Mohan: Given the fall of the Soviet Union and other socialist economies, there is little questioning of capitalism as a system, but there clearly is discussion about the excesses that capitalism has created, particularly in the financial sector. It's important to remember that we often assume certain things are happening in a capitalist system—higher taxation for higher incomes, universal access to health care and education, and so on—when in fact they might not be. Just as the Reagan–Thatcher reforms, which at the time were correcting some excesses of the welfare state, emerged as a reaction to excessive state intervention in the economy, the time has perhaps come to revisit some aspects of market fundamentalism. It is vital that we recreate a more cohesive social fabric in Western societies.