Financial and Economic Review, Vol. 14 Issue 2., June 2015, pp. 173–174.

The leaven of growth*

Tamás Rózsás

David Ricardo, a prominent economist at the turn of the 19th century, argued for free trade against mercantilists by pointing out the possible gain arising from the comparative advantages of countries through the international division of labour and specialisation. In addition, this comparative advantage contributes to narrowing the formidable income gap between rich and poor countries. Indeed, if these under-developed countries export products that can be produced by low-skilled labour force, demand for low-skilled workers will rise, reducing income inequality in the given country.

This model worked fairly smoothly during the first wave of 18th century globalisation both in Europe and in America. Recent events, however, appear to challenge the validity of the model. World Bank data indicate that global inequality, as measured by the distribution of income between rich and poor countries, declined in the period of 1988–2008. However, the picture is far less rosy when we look at inequality within individual countries: inequality has widened in many poor economies. The widening gap observed in developing countries suggests that Ricardo's theory needs updating. Harvard University Professor and Nobel laureate (2007) Eric Maskin attempted to do so at the Lindau Meeting on Economic Sciences.

According to his theory, unskilled workers can be more productive when matched with skilled ones. Assigning a manager to a group of workers can improve the group's performance better than just adding another worker. Maskin classifies workers into four categories: high-skilled workers in rich countries *(A)*; low-skilled workers in rich countries *(B)*; high-skilled workers in poor countries *(C)*; and low-skilled workers in poor countries *(D)*. Importantly, Maskin claims that the Bs are likely to be more productive than the Cs.

Before the current wave of globalisation started in the 1980s, high-skilled and low-skilled employees worked together in developing countries, which improved the productivity of unskilled workers *(Ds)* and thus, narrowed the income gap. However, the latest bout of globalisation has put a spanner in the works: high-skilled workers in developing economies can now work more easily with low-skilled workers in rich

* The views expressed in this paper are those of the author(s) and do not necessarily reflect the offical view of the Magyar Nemzeti Bank.

Tamás Rózsás is an analyst at the Magyar Nemzeti Bank. E-mail: rozsast@mnb.hu.

This review is based on the article entitled "Revisiting Ricardo", published in the 23 August 2014 issue of The Economist and summarized in the first issue of the Global Monetary Observer of the Magyar Nemzeti Bank.

countries. As a result, the *Cs* working with *Ds* end up earning more, while the *Ds* are left on the sidelines with shrinking income.

The booming trade in intermediate goods heightens the demand for skilled workers in developing countries. In Mexico, for instance, wages offered by export-oriented firms are 60 per cent higher than those paid by non-exporting companies. In Indonesia, white-collar workers of foreign-owned companies earned 70 per cent more than their peers working for locally owned firms.

The weakness of Maskin's argument is the lack of data to back up his theory that skilled workers indeed benefit from the process. If he is right, however, the advocates of globalisation will have to figure out how to reap the rewards without leaving the poor employees of poor countries behind.

There is a lesson to be learned in Hungary from Maskin's propositions, as well. On the one hand, incentives should be found to keep high-skilled employees in Hungary, because this would improve the chances of the Hungarian unskilled labour force to increase its productivity and income. On the other hand, efforts should be made to ensure that high-skilled Hungarian workers work together with their low-skilled Hungarian peers rather than with the low-skilled employees of countries more developed than Hungary. Domestic industrial projects – which can engage low-skilled Hungarian workers easily – offer a good opportunity in this regard. Finally, with Maskin's results in mind, it might be rewarding to consider the reinforcement or renewal of Hungarian management training as well: if assigning a manager does more for the performance of a group than the mere adding of another worker, then Hungary will be in need of well-trained managers. Their presence in the workforce may well be the leaven of growth.