

Executive Summary

*"Something new is going on. America is short of jobs as never before, and the major candidates for our offshore outsourcing are ramping up employment as never before. So yes, I think two and two is four."*¹

*"The essential conclusion remains that offshoring, and more broadly import competition, while clearly having an important effect on some industries, workers, and communities, were not significant causes of the 'jobless recovery.'"*²

Opinions differ about the dynamics of supply and demand in the emerging global market for service labor. Some argue that the potential supply of offshore talent is nearly limitless, while others point to signs of limited supply already forcing wage increases. Having analyzed potential and likely demand for offshore talent in the first report in our series, and quantified potential supply in the second, in this third and final report we look at the fit between the two.

Supply and demand necessarily clear through price, represented in the labor market by wages. Mapping likely demand for offshore talent against the potential suitable supply shows that, as the conflicting views indicate, this market is not clearing smoothly. We discuss measures to improve the market's efficiency that could be taken both by companies on the demand side and by policy-makers in countries on the supply side.

¹ Stephen S. Roach as quoted in "Who Wins and Who Loses as Jobs Move Overseas?" Erica Kinetz, 7 December 2003. The New York Times.

² Charles L. Schnultze. "Offshoring, Import Competition and the Jobless Recovery." August 2004. *Brookings Policy Brief No. 136*

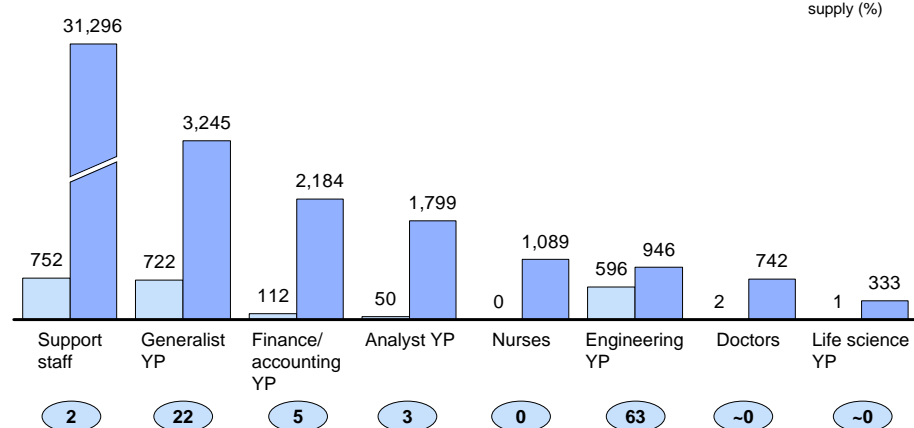
Potential supply of low-wage talent is greater than likely demand

Our results show that, at an aggregate level, the potential supply of suitable talent from the 28 low-wage countries we studied exceeds demand for offshore talent from companies in high-wage countries. This is true for each of the eight occupations we analyzed (Exhibit 1).³ For instance, in 2008 the supply of support staff suitable for employment by multinational firms will exceed demand by 98 percentage points, and the suitable supply of young professional generalists will be 78 percentage points greater than expected demand.

Exhibit 1

POTENTIAL SUITABLE SUPPLY EXCEEDS LIKELY DEMAND FOR GLOBALLY RESOURCED TALENT IN MOST YOUNG PROFESSIONAL (YP)* OCCUPATIONS

Likely low-wage labor demand and suitable supply**, 2008
FTEs thousand



* ≤7 years of work experience.

** Assuming constant suitability rates from 2003 to 2008; aggregated low-wage supply from 28 countries.
Source: McKinsey Global Institute analysis

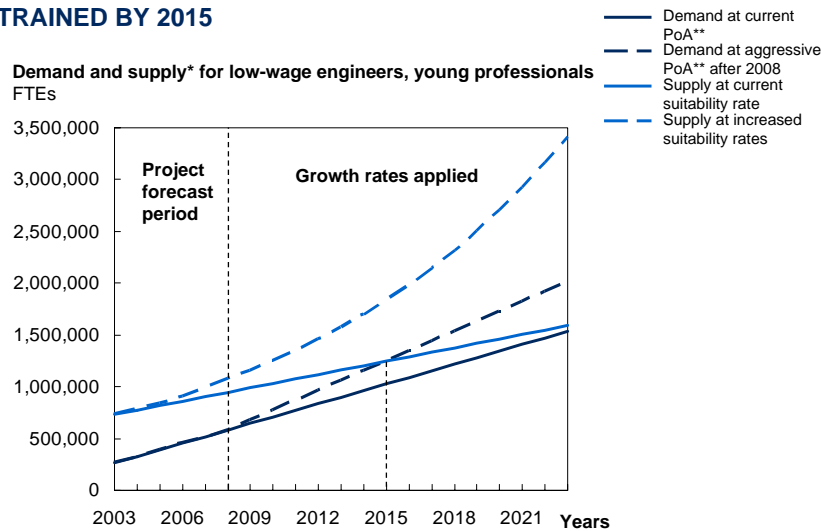
Only the supply of available engineers in low-wage countries is less abundant, contrary to opinion among many engineers in high-wage countries. Even if the combined supply of all 28 low-wage countries we studied is utilized, wage rises for engineers would reflect constraints in low-wage supply as early as 2015 if we assume an aggressive rate of growth in offshore demand for this occupation,

³ The occupations are: engineers, finance and accounting professionals, analysts, life science researchers, doctors, nurses, generalists, and support staff.

and an annual growth rate of 5 percent in the supply of labor suitable for employment in multinationals. If countries were to implement measures to make more of their graduates suitable for such employment, and supply were thus to grow at higher rates, this scenario would likely change (Exhibit 2).

Exhibit 2

AT CURRENT SUITABILITY RATES AND AN AGGRESSIVE PACE OF ADOPTION IN DEMAND, SUPPLY OF ENGINEERS COULD BE CONSTRAINED BY 2015



* Supply forecast is based on extrapolation of 10 low-cost countries to a further 18 low-cost countries and does not include effects of supply fragmentation.

** Pace of adoption is the rate at which companies are pursuing offshoring.

Source: McKinsey Global Institute analysis

Local supply/demand inefficiencies persist

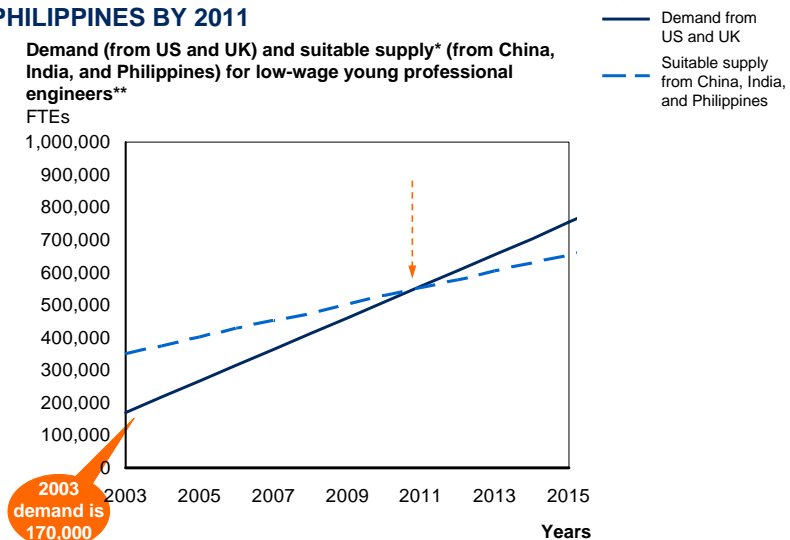
Matching supply and demand at this aggregate level gives an illusory impression of plenty. In practice, misalignment between supply and demand is creating localized labor supply constraints. On the supply side, potential employees are widely dispersed across low-wage countries and far from perfectly mobile. On the demand side, companies hiring offshore frequently follow each other to locations that have a track record in providing offshore talent. The resulting agglomeration of companies in popular locations has some positive effects, such as accelerating improvements in infrastructure, communications and the business environment. But it also leads to a concentration of demand in limited supply pools, which puts upward pressure on local wages and attrition levels.

Agglomeration is already affecting the supply and cost of labor in some cities in Eastern Europe and India. For example, if current demand trends continue, the supply of suitable labor in Prague and Hyderabad will be constrained as early as 2006 and 2008, respectively. (Labor market conditions in these two cities are examined in detail in this report.) And once companies have chosen a location, it is hard for them to switch to another one because of sunk costs in physical and human capital.

Agglomeration effects could also be felt at a country level in certain occupations. At present, India, the Philippines, and China are often the top choices for locating IT and engineering-based services for companies from the United Kingdom and the United States, the main sources of demand. If U.S. and UK companies continue to concentrate their activities on these three countries and current rates of offshoring persist, the demand for engineers from these two countries would fully absorb the suitable supply by 2011 (Exhibit 3).

Exhibit 3

US AND UK DEMAND COULD ABSORB THE ENTIRE SUPPLY OF SUITABLE YOUNG PROFESSIONAL ENGINEERS FROM CHINA, INDIA AND THE PHILIPPINES BY 2011



* Supply forecast does not include effects of supply fragmentation and local demand.
 ** ≤7 years of work experience.
 Source: McKinsey Global Institute analysis

Demand will disperse if companies analyze potential offshore locations rationally according to their specific needs

Companies have different requirements from offshore locations, depending on a host of factors including their home market, their first language, what activity they want to offshore, the scale on which they want to offshore, and whether they want to outsource or set up a captive operation. This means different companies will assign different costs and benefits to the same location. Put another way, there is no single, homogeneous supply curve in the emerging global labor market—every company faces a different curve.

This feature of the market will act as a natural force for dispersing demand to fit supply more congruently, if companies act rationally to harness it. To do so, they need better information about the talent supply that suits their needs, and they also need to know the real costs of employing suitable talent in any potential location. Companies will find more information on the distribution of suitable talent across developing countries in "The Supply of Offshore Talent in Services," our previous report in this series. But each company needs to make its own analysis of location costs for each potential location.

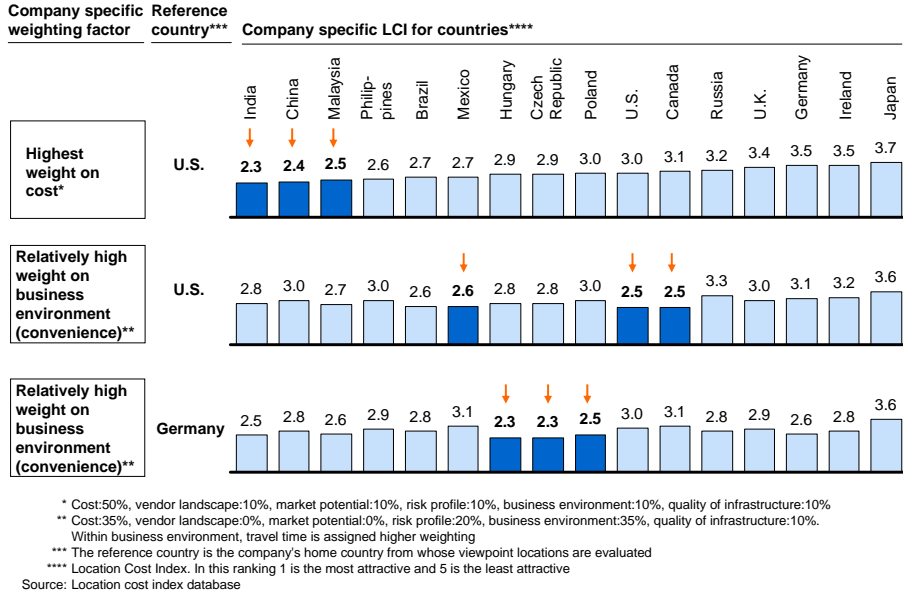
What will that analysis entail? First, a company needs to define in detail the criteria governing its choice of location. At a broad level, these are likely to include: labor cost; the quality of local service vendors; market potential; the intrinsic risks of the location; its business environment; and the quality of its infrastructure. The company can then weigh these criteria according to its particular goals and requirements. When it has gathered the relevant data about the criteria from each potential location, it can calculate its own true cost of offshoring in any of them. (In this report we describe the Location Cost Index, a data-based tool created along these lines for assessing potential offshoring locations.) A company that ranks potential locations in order of their true cost will in effect be drawing its unique supply curve.

If companies consider only current wage levels in their assessments of offshoring locations, then India and China will seem the best choice to all of them, as these three countries at present have the lowest average labor costs for services workers. But when companies rank countries according to their unique cost criteria, more locations will emerge as attractive to more companies (Exhibit 4). Our database on supply countries shows they vary considerably on the basic cost criteria.

Exhibit 4

RANKING OF POTENTIAL OFFSHORE LOCATIONS VARY ACCORDING TO COMPANY'S UNIQUE CRITERIA

■ Attractive country



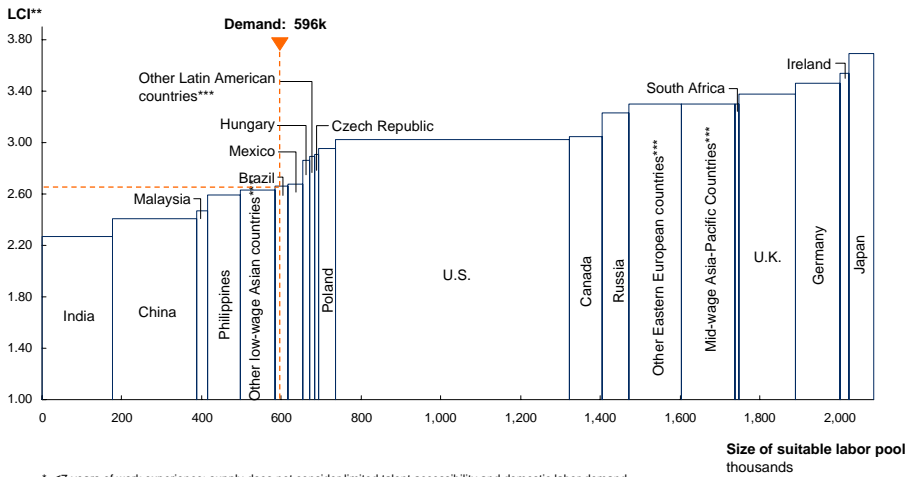
Global resourcing will raise average wages in low-wage countries and have muted impact on employment and wages in high-wage countries

What would be the effect on wages of engineers in low-wage countries if labor cost was the most important factor in the choice of location for all U.S. companies seeking to employ engineers offshore? Our analysis shows that demand would be satisfied by supply from the Asian countries plus a fraction of supply from Latin American countries (Exhibit 5). Average wage levels in countries to the left of the point where the market clears in this analysis could likely double. While wages will increase, making offshoring to low-wage countries less attractive, they will not reach wage levels for the same occupations prevailing in the United States or Western Europe. Instead, the market will clear when wages for offshore engineers are roughly equivalent to the level of wages in Mexico or Brazil, or about 30 percent the level of wages for engineers in the United States (Exhibit 6).

Exhibit 5

IF ALL COMPANIES SEEKING YOUNG PROFESSIONAL ENGINEERS WERE COST-DRIVEN, THEIR LIKELY DEMAND WOULD BE SATISFIED BY TALENT FROM COUNTRIES LEFT OF MEXICO...

Demand for remote labor vs. supply curve – young professional engineers*, 2008

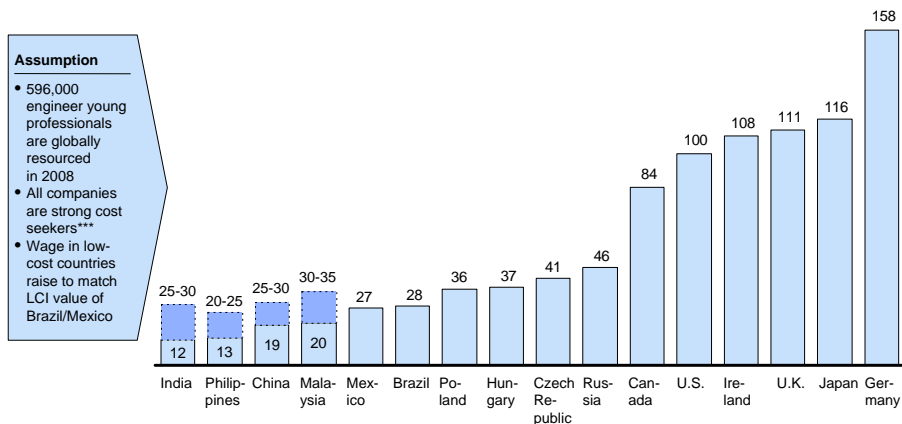


* < 57 years of work experience; supply does not consider limited talent accessibility and domestic labor demand
 ** Location cost index. Applied the weighting of cost: 50%, vendor: 10%, market: 10%, risk: 10%, infrastructure: 10%, and environment: 10%
 *** The LCI values for the other countries are estimated
 Source: McKinsey Global Institute analysis

Exhibit 6

...AND WAGES OF YOUNG PROFESSIONAL ENGINEERS IN THOSE COUNTRIES COULD RISE TO APPROXIMATELY 30% OF U.S. LEVEL*

Comparison of hourly labor cost; Index**, U.S. = 100



* Does not consider stickiness, limited talent accessibility, domestic labor demand and manager scarcity which might inflate wages beyond these levels at least for some occupational categories.
 ** Hourly labor cost reflects average of all job categories within a country
 *** Weighting of labor cost with 50% within LCI
 Source: Watson Wyatt; local sources (e.g., Labor census); interviews, McKinsey Global Institute analysis

Wage costs overall in supply countries will rise more slowly if companies select locations according to their unique requirements. The resulting mixture of rational location strategies will disperse demand so that it fits more evenly with the distribution of suitable supply.

In contrast, local wage inflation will likely continue in some offshoring locations as long as companies concentrate their demand on a few cities. Because it is hard for companies to switch locations quickly, individual companies may see wages in their chosen offshoring location rise above the levels of neighboring countries along their individual cost curve, if demand in their chosen location begins to outstrip supply.

Offshoring will have little effect on wage levels in developed countries because it will have only a small impact on overall employment in those countries in the occupations we analyzed. Consider the impact in the United States. Over the past 30 years, the United States has experienced an 11 percentage point decline in manufacturing jobs, but wages have remained stable. By comparison, we estimate that a total of 9 percent of jobs in services in the United States could theoretically be performed remotely. However, it is unlikely that all these potentially transferable jobs will move offshore over the next thirty years, because of the considerable barriers to offshoring detailed in the first report in this series.⁴ Assuming that half the potentially transferable service jobs—a more realistic estimate, although still high—are actually relocated offshore over that period, the resulting job turnover would be around 225,000 jobs per year—or 1-2 percent of the 16 million jobs created⁵ per year in the U.S. economy.

Countries providing offshore talent can take steps to attract "best fit" companies

Since there is no general, fixed ranking of offshoring locations from the demand perspective, there is no preordained set of "winners and losers" on the supply side. Individual countries seeking to attract offshoring investment should target those companies and sectors whose requirements most closely match what the country can already offer, and then hone their attractive features. That strategy

⁴ The Emerging Global Labor Market. Part I-Demand for Offshore Talent in Services. Available at www.mckinsey.com/mgi.

⁵ Douglas Brown and Scott Wilson *The Black Book of Outsourcing: How to Manage the Changes, Challenges and Opportunities*. Wiley, 2004.

depends on supply countries forming a clear understanding of their potentially attractive features and which sectors or companies might favor them. Countries on the supply side of the emerging labor market will also benefit greatly from marketing their attractions to their target sectors. This is especially true for countries whose characteristics are rather similar to surrounding, and therefore competing, peers.

Concerning the attractiveness of a location's labor supply, the focus of government efforts should be on improving the quality of graduates rather than growing sheer numbers of graduates, as we explain in our second report in this series.⁶ Other important attractiveness factors that governments can influence in the short to medium term are their support for foreign investors, the state of the infrastructure, the competitiveness of their tax regime, and the effectiveness of intellectual property law.

Finally, policy-makers and educational institutions in high-wage countries should equip their graduates to work effectively with their peers in today's low-wage countries. In Europe, for example, those countries and companies that encourage their graduates to look for opportunities to the east, with appropriate language training, funded exchange programs and internships, will be best placed to benefit from the talent pool represented by new EU members, such as Hungary, the Czech Republic, and Poland and by emerging markets in Asia.

* * *

⁶ The Emerging Global Labor Market Part II-Supply of Offshore Talent in Services. Available at www.mckinsey.com/mgi