4. MACROECONOMIC POLICIES FOR DECENT WORK

The June 2009 UN Conference on the world financial and economic crisis committed "…to work in solidarity on a coordinated and comprehensive global response to the crisis and undertake actions aimed at, *inter alia*, restoring confidence and economic growth and creating full and productive employment and decent work for all…."[23] Later, the G-20 Summit in Pittsburgh in September 2009 decided to "put quality jobs at the heart of the recovery," and agreed on "the importance of building an employment-oriented framework for future economic growth."

There are several dimensions to re-integrating employment objectives into macroeconomic policies. These include **fiscal** and **monetary policies**, as well as supporting **sectoral policies** (targeting particular sectors of the economy, often referred to as "industrial policy"). Fiscal policies comprise both public revenues and expenditure as expressed in the government budget. Fiscal policy is typically the province of the ministry of finance or treasury, which thus tends to have ascendancy over other ministries, whether related to labour and social protection, health or the environment. Monetary policy includes policy on interest rates, exchange rates and money supply, and the regulation of the financial sector. Monetary policy is primarily the responsibility of the central bank, which is now most often an independent body, whose degree of democratic accountability to the public is often raised as a major concern with respect to meeting growth and employment goals.

THE FORGOTTEN LESSONS OF THE GREAT DEPRESSION

The prevailing doctrines of "sound" macroeconomic policies (sometimes referred to as "**orthodox**," "**neoliberal**" or "**Washington Consensus**" policies, which include objectives such as limited public intervention in the market, low or zero budget deficits, an exclusive focus of monetary policy on consumer price stability) have been seriously challenged in the wake of the global economic crisis. One of the most important lessons of the Great Depression was that markets are not self-correcting and that government intervention is required to ensure recovery ("**counter-cyclical**" measures). In the aftermath of the 1930s crisis, governments introduced policies that provided automatic stabilizers for aggregate demand and implemented context-specific policy frameworks to reduce economic instability and promote full employment (so-called "**Keynesian**" or "**heterodox**" policies).

Since the 1980s and 1990s, the confidence in the self-stabilizing nature of the market returned, even though it had been challenged with the increased frequency of crises in developing countries the 1990s, especially the East Asian crisis of 1997-98 (UN 2009). The global crisis triggered in September 2008 was different in that it originated in the more advanced

23. Paragraph 11 of the Outcome Document on the United Nations Conference on the World Financial and Economic Crisis and Its Impact on Development.

industrialized countries, and that even governments who were outright opposed to Keynesian-type policies had little choice but to implement them on a scale never witnessed in economic history.

STRENGTHENING THE EMPLOYMENT AND DECENT WORK CONTENT OF STIMULUS PACKAGES

However, the amounts spent on rescuing the financial sector ("bailouts") have far surpassed fiscal stimulus packages directed at the real economy.[24] The ILO has argued that fiscal stimulus packages should be much more focused on employment and social protection. Looking at some 40 stimulus packages announced and implemented by governments as of early 2009, the ILO concluded that on average, direct transfers to low-income households and employment measures constitute the two smallest components – at 9.2 percent and 1.8 percent respectively. Yet, the analysis found that *the greater the employment orientation of the measures, the stronger the stimulus for the real economy.* In particular, the multiplier effects of investments in employment-intensive areas, including infrastructure, is higher than with alternative measures such as tax cuts (ILO/IILS 2009).

In another survey undertaken for the G-20 Summit in Pittsburgh, the ILO finds that where decent work-related measures have been taken, they did make a difference, even though these only managed to limit some of the damage and much more ambitious measures are needed to reduce the time lag between economic recovery and employment recovery (ILO 2009b).

"PRO-CYCLICAL" IMF CONDITIONALITIES?

A number of emerging market economies have been in a position to implement stimulus packages, but the majority of developing countries and some transition economies are confronted with major fiscal space constraints in trying to implement counter-cyclical measures. To receive emergency lending, many have little choice but to turn to the International Monetary Fund (IMF), whose lending capacity has been significantly strengthened as a result of the April 2009 G-20 London Summit decision to triple its resource base (from US$250 billion to US$750 billion). The IMF has announced that it has drawn lessons from the East Asian crisis, when its emergency lending was tied to **"pro-cyclical" policies** (such as fiscal tightening and higher interest rates) that led borrowing countries into even deeper crisis, causing massive job losses that could have been avoided. Its official position now is that coordinated countercyclical policies and large fiscal stimulus packages are the most effective means to compensate for the fall in aggregate demand (IMF 2009).

This new position is applied in some countries that received IMF lending through its new Flexible Credit Line, where the Fund permitted the easing of monetary and fiscal policies

24. The stimulus package in the United States of US$787 billion, while still smaller than the financial rescue package (which many estimate at above US$1 trillion) was proportionally much higher than in other developed countries. It has been argued that the much weaker automatic stabilizers (social protection systems) in the United States as compared with European countries may explain at least partly why a much higher stimulus package was deemed necessary. In addition, unlike the United States, Europe's Stability and Growth Pact places very strict limits on the amount of deficit spending allowed for Eurozone member countries. These strict criteria were broken in the face of the crisis by virtually all members, but it has been argued that they may have acted as a brake on the amount of deficit spending for the various national stimulus packages in the Eurozone.

to fight the recession (Columbia, Mexico and Poland). However, according to a number of UN and civil society sources, the same pro-cyclical stabilization and adjustment policies (reducing public spending, raising interest rates) are binding conditions for crisis-response IMF lending in a sizeable number of other countries in real need of emergency funds (see examples and references in Box 4.1). Nuria Molina of the European Network on Debt and Development (Eurodad) commented in this regard that:

> "Despite making commitments at the G-20 to follow the principles of the Global Jobs Pact concluded at the 2009 ILO Conference by implementing expansionary fiscal policies and the safeguarding and re-enforcement of social protection and decent work, rich countries who control the IMF are still allowing it to impose conditions leaving developing and transition country governments unable to follow these principles of recovery." [25]

BOX 4.1

SOME CRITICAL STUDIES OF IMF PRO-CYCLICAL CRISIS RESPONSE LENDING

Several studies by civil society organizations that have examined fiscal and monetary targets in recent IMF loan programmes find that the Fund has also continued to impose pro-cyclical macroeconomic tightening in almost all recent lending arrangements with developing countries (ActionAid and Bank Information Center 2008; CEPR 2009; TWN, 2009). For example, in the IMF programmes for São Tomé and Principe, and Senegal the target is to bring fiscal deficits down to below 3 percent of GDP, to be achieved through spending cuts where necessary. In Côte d'Ivoire and Ethiopia, the targets for 2009 are even more stringent, below 2 percent of GDP. In Côte d'Ivoire, Malawi and the Congo, the IMF programmes aim to reduce inflation to below 5 percent in the midst of the current crisis (Molina-Gallart 2009).

UNCTAD also documents similar findings. For example, Pakistan had to tighten both its fiscal and monetary policy, including drastically reducing its fiscal deficit from 7.4 percent of GDP in 2008 to 4.2 percent of GDP in 2009. In the stand-by agreement with Ukraine, approved in November 2008, the initial objective was to achieve a balanced budget, even though GDP was projected to fall by more than 10 percent in 2009 and gross public debt was very low. However, in May 2009, the IMF was obliged to accept a loosening of fiscal policy and allow a fiscal deficit of 4 percent of GDP in light of the continued weakening of economic activity, which could have been expected at the outset. Belarus, Georgia, Hungary, Latvia and Serbia have all signed IMF agreements that require very restrictive fiscal policies, which could exacerbate these countries' economic downturns (UNCTAD 2009).

Similarly, DESA notes that "despite pronounced intentions, many recent IMF country programmes contain pro-cyclical conditions that can unnecessarily exacerbate an economic downturn in a number of developing countries" (DESA 2010:99).

25. "Doing a Decent Job? A New Report on the IMF Shows a Leopard who Cannot Change its Spots." Joint press release by SOLIDAR and Eurodad, Brussels/Istanbul, 5 October 2009.

The ILO tripartite constituency took up these issues with IMF Managing Director Dominique Strauss-Khan at the March 2009 session of the ILO Governing Body. Workers' representatives expressed concern with the pro-cyclical policies that the IMF applied in a number of countries seeking financial assistance in the crisis. Mr. Strauss-Khan explained that his institution is in favour of a "global stimulus," which means promoting counter-cyclical stimulus packages "where possible" – that is in countries that are in a fiscal position to do so. For those countries that do not have their public finances in order, the IMF supports fiscal and monetary measures that must first and foremost reassure foreign investors so as to avoid massive withdrawal of external private funds. One important difference from the way the IMF handled the East Asian crisis, he added, is now the IMF insistence on social "safety nets" to protect the most vulnerable in the midst of adjustment.[26]

This would suggest that in such situations, the prevailing priority is to reassure foreign investors even if it is at the expense of domestic enterprises, workers and aggregate demand. This raises a number of questions : insofar as capital outflows are a problem, do policies such as interest rate hikes that worsen the recession ultimately reassure foreign investors, or *de facto* have the opposite effect ? Are these dilemmas linked to currency speculation (the trading of currencies to make profit) ? Are there other means to limit capital outflows in the midst of a crisis ? Could "**capital management techniques**" (combining prudential regulation and capital controls) play a role in taming capital movements that undermine employment and decent work objectives ?

Before addressing these questions, it would be useful to better understand the impact of widespread financial liberalization on growth, employment, income distribution and policy space.

IMPACTS OF FINANCIAL LIBERALIZATION

Many voices have argued that one of the most problematic dimensions of globalization has been the increasing unpredictability (volatility) of capital movements resulting from widespread financial liberalization around the world. This includes measures to free the cross-border movement of capital through **opening up the capital account**. In many developing countries, these policies were applied as part of the stabilization and adjustment policies which marked the 1980s and 1990s (UNCTAD 1998 ; NGLS 2000).

The major expected result from financial liberalization was that it would allow countries to achieve greater economic growth and stability through more efficient allocation of capital. What is the record ?

Impact on growth and employment : As explained in more detail in Chapter 5, a good measure of whether investments are supportive of job creation is whether investments are directed at increasing **productive capacities** (including investments in new equipments and infrastructure). However, the surge in international capital flows in the 1990s pursuant to financial liberalization did not bring the expected growth benefits : actual investment as a percentage of GDP into new infrastructure and productive capacity stagnated. Gross fixed

26. See broadcast : "IMF Managing-Director, Dominique Strauss-Kahn addresses ILO's Governing Body on responses to the current global financial and economic crisis," 23 March 2009 in Geneva, on : http://www.ilo.org/global/About_the_ILO/Media_and_public_information/Broadcast_materials/B-rolls/lang--en/docName--WCMS_103998/index.htm.

capital formation (the most commonly used measure for physical investment) as a percentage of GDP was actually lower on average than in the 1980s and 1970s (Van Der Hoeven and Lübker 2007).

How can one explain the divergence between the speedy growth of capital flows and stagnating productive investments? Many have attributed this discrepancy to capital being allocated to intensified financial intermediation (that can generate very high profits without in itself producing value-added in the real economy); and the fact that much foreign direct investments (FDI) was spent on mergers and acquisitions (companies that merge or are taken over by other companies) rather than into new factories that would generate new jobs (UNCTAD 1998; UNCTAD 2004; Van Der Hoeven and Lübker 2007).

Impact on stability and employment: Worse, this period of financial liberalization was associated with a sharp rise in financial instability and the frequency of disastrous financial crises, especially in developing countries. As also evidenced in the current global crisis, *labour is disproportionately affected* by crises, not only in terms of mass unemployment, but through a permanent deterioration of wages – even when previous employment levels are recouped after the significant time period between economic recovery and job recovery (UNCTAD 1998; Van Der Hoeven and Lübker 2007).

Impact on inequality: A less talked about consequence of capital account liberalization is its contribution to *growing income inequality*. Several extensive cross-country studies have shown robust correlations between capital account openness and inequality, whether measured in terms of the Gini coefficient,[27] or income shares between labour and capital. The most telling measure is that in most cases, there is a consistent correlation between capital account liberalization and significant declines in the share of national income going to labour (wages) vis-à-vis capital. Falling labour shares is evidenced in both developed and developing countries and is persistent over time (studies cited and further developed in Kang-kook and Jayadev 2005).

These negative trends are in great part explained by the fact that the potential for greater mobility of capital reduces the bargaining power of even organized labour to claim a fair share of the benefits of growth. This new phenomenon suggests that, while a great deal of effort needs to go into restoring or extending basic workers rights of association and collective bargaining as part of worldwide efforts to reverse inequality, it may in itself not be enough.[28] These new asymmetries generated by financial globalization need to be factored into the broader decent work strategy.

Impact on policy space: Of equal concern is the impact of capital mobility (or the **threat of capital flight**) on the ability of national governments to introduce socially desirable policies (**policy space**). Heterodox economist Gerald Epstein (2005:6-7), for instance, noted that:

27. The Gini coefficient is a statistical measure for income inequality on a ratio from zero to one (the closer to one the higher the inequality).

28. A recent study in over 50 countries finds that trade unionism and collective bargaining is less effective than in the past at countering inequality. This may be accounted for by the greater role played by factors such as technological changes and the "inequality increasing effects" of greater shares of FDI in national income (Baccaro 2008).

> "[C]apital flight can be a powerful weapon against government policies that threaten the wealth or the prerogatives of the rich. In this role, capital flight has sometimes been called 'capital strike' evoking the idea that capital ... goes on strike against undesired taxation or regulatory policies.... What if the government simply wants to lower interest rates to achieve full employment and wealth holders flee? Is that capital flight or a harmless portfolio decision? What impact will such 'capital movements' have on the ability of governments to make economic policy?"

Another consequence of financial liberalization in developing countries is the significant *build-up of reserves* as a cushion against future crises. This intensifies the "*deflationary bias*" in the current global reserve system that is inconsistent with global full employment. This issue will be addressed in more detail in Chapter 7.

CAPITAL MANAGEMENT FOR EMPLOYMENT AND DECENT WORK

From a human rights perspective, governments have a **duty to protect** the right to work by preventing as much as possible financial instability and crises that lead to the unnecessary destruction of jobs and often permanent deterioration of average wages. They also have a **duty to fulfil** decent work-related human rights, notably through regulating finance in a manner that will maximize productive employment creation. "**Capital management techniques**" can play an essential role on both fronts. They include the flexible and dynamic use of two broad categories of policy options:

- **Capital controls** (managing the flows of capital in and out of the country) and
- **Prudential regulation** (of domestic financial institutions).

These two policy categories are often discussed separately, with prudential regulation being much more accepted in mainstream policy circles than capital controls. However, both sets of policies are needed to be effective and they are mutually reinforcing. They are needed first of all to put an end to the "*boom and bust*" policies of the last two decades, which have been a prime cause of growing socioeconomic insecurity, mass unemployment and income inequality (DESA 2008). They can promote financial stability through their ability to reduce currency flight, fragility and "*contagion risks*" involving the spread of financial crises from one country to another. For instance, capital controls can reduce capital inflows when these are driven by the short-termist "*herd behaviour*" of portfolio investors (that leads to a speculative boom), or limit a "*panic exit*" of capital when the boom turns to bust.

Likewise, when a potential speculative asset bubble is in the horizon, prudential regulation can raise the cost of investing in high risk assets by increasing the capital requirements attached to these assets. **Capital requirements** are the amount of reserves financial institutions have to set aside proportionally to their lending. The higher the reserves required to gamble on very risky speculative investments the less "**leverage**" the institutions have, so the less profitable it is to continue such investments (UNCTAD 1998; DESA 2008; Epstein, Grabel and Jomo 2005).

A key question is the approach taken to prudential financial regulation: should it be based on the principle that "*everything is allowed unless explicitly forbidden*" (the preferred approach in private financial circles)? Or should the guiding principle be that "*everything is forbidden unless explicitly approved*" (the approach used for example to prevent the market-

ing of toxic foods and medicines)? The latter approach is criticised its effects on slowing "financial innovation," but the question involves determining the economic and social usefulness of the many new financial products developed in recent years. The second approach limits the ability of financial innovation to always be ahead of regulators (to bypass regulation), especially if it is complemented with the principle of simplicity: *new financial products should be easy to understand in terms of their risks for the general public.*

The right of countries to use capital controls to complement enhanced and coordinated prudential regulation was a cross-cutting priority in the global civil society consultation that NGLS undertook in early 2009 for the Commission of Experts of the President of the UN General Assembly on Reforms of the International Financial and Monetary System – hereafter referred to as the "*Stiglitz Commission*." That "*governments should have the space to undertake capital account management techniques*" was a prominent feature in the final recommendations of the Stiglitz Commission (UN 2009:81; NGLS 2009a).

Although the mainstream policy thrust of the last two or three decades has been actively pursuing capital account liberalization, the IMF's founding Articles of Agreements actually permit its members to exercise capital controls as is necessary to regulate international capital movements (Article VI.3). [29] The international consensus reached at the June 2009 UN Conference on the world economic and financial crisis in this regard states that: "*Developing countries facing an acute and severe shortage of foreign reserves because of the fallout of the crisis…should not be denied the right to…, as a last resort, impose temporary capital restrictions…in order to help mitigate the adverse impacts of the crisis and stabilize macroeconomic developments.*" [30]

Box 4.2 provides an illustration of how capital controls were used by Malaysia to limit the effects of the 1997-98 East Asian financial crisis from spreading to the real economy and provide policy space for counter-cyclical measures.

Cross-country analysis suggests that capital management techniques can promote socially desirable types of investment and financing strategies (that are employment intensive, long-term, stable and sustainable) by rewarding investors and borrowers for engaging in them (the "duty to fulfil"). Conversely, they can be used to discourage less socially useful or socially harmful investments by increasing their cost or precluding them altogether (Epstein, Grabel and Jomo 2005). [31]

The global financial crisis has dramatically shifted political momentum in favour of re-regulating the financial sector. However, one major obstacle identified notably by civil society organizations and the Stiglitz Commission is the proliferation of trade and investment agreements that legally prevent governments from re-regulating the financial sector and introducing capital management techniques (see Chapter 6).

29. More recently, IMF Managing Director Dominique Strauss-Khan indicated that "there is no reason to believe that no kind of control is always the best kind of situation." "IMF refuses to rule out use of capital controls" in *Financial Times*, 2 November 2009.

30. Paragraph 15 of the Conference Outcome Document.

31. Capital management techniques work best over long periods in the presence of strong "fundamentals" – such as a low debt ratio, moderate inflation, sustainable current account and fiscal balances, consistent exchange rate policies, administrative capacity of the public sector to implement coherent policies, and a government able to maintain independence from narrow political interests and to maintain some control over the financial sector. But conversely, capital management techniques can also help enhance fundamentals, so the causation works both ways. Capital management can certainly enhance democracy by reducing the potential for speculators and external actors to exercise undue direct or indirect influence over domestic policy making (Epstein, Grabel and Jomo 2005).

BOX 4.2

CAPITAL CONTROLS TO STAVE OFF THE 1997-98 FINANCIAL CRISIS IN MALAYSIA

The goals of the capital controls that the Malaysian government introduced in 1998 in the wake of the East Asian financial crisis were to facilitate expansionary macroeconomic policy while defending the exchange rate, reduce capital flight, preserve foreign exchange reserves and avoid an IMF stabilization programme. These included: prohibition measures that stopped offshore speculation on the ringgit (the Malaysian national currency); prior official approval for the export of foreign currencies by Malaysian residents to obstruct speculative outward capital flows; requiring repatriation of export proceeds within six months from the time of export; and imposing a 12-month ban on the outflow of external portfolio capital.

While these measures are still regarded as controversial in parts of the financial community, the evidence suggests that the controls were well designed to limit foreign exchange outflows and speculation on the national currency, while not adversely affecting foreign direct investors. At the same time, the measures did provide breathing room for domestic monetary and financial policies and allowed for a much speedier recovery than would have been possible via the orthodox IMF route (Epstein, Grabel and Jomo 2005).

CENTRAL BANKS AS AGENTS OF EMPLOYMENT CREATION

The previous discussion gives credence to the proposition that central banks, in coordination with executive branches of government, should also be agents of employment creation. However, their primary focus has been on keeping a low rate of inflation (overall price stability). Economic growth and employment objectives, from this perspective, are seen as inappropriate direct targets of central bank policy. Employment and growth objectives are assumed to be met as a "by-product" of an inflation-focused approach to monetary policy that will create the macroeconomic stability needed to favour investment, growth and employment creation (Epstein 2007a).

A stable macroeconomic environment is an essential prerequisite for growth and employment.[32] However, even on this count, the problem is that many contemporary central banks, particularly of economically advanced countries, decided to focus only on one source of inflation: **consumer price inflation**. As the Stiglitz Commission pointed out, they chose to ignore **financial asset price inflation** (what John Maynard Keynes described as "*profit inflation*"), turning a blind eye to the systemic risks posed by financial innovations on risk and liquidity management in financial markets. "Thus while [consumer] price stability was achieved, central banks did not prevent, and may even have contributed to, the gravest financial turmoil since the Great Depression" (UN 2009:35).

32. As British economist John Maynard Keynes had warned only a couple of years before the terrible episodes of "hyperinflation" (commonly defined as 50 percent inflation a month or more) that hit Germany and other neighbouring countries in the early 1920s: "...There is no subtler, no surer means of overturning the existing basis of Society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction..." (Keynes 1963 (1919):78).

Many central bankers claim that even if asset prices should be their concern (some say it is not), they do not have the instruments to deal with asset price inflation. Their argument is that they only have the instrument of raising interest rates, which could provoke a generalized recession in the process. But according to the Stiglitz Commission, central banks have many more refined instruments than the blunt use of interest rates. These include the above-mentioned asset-type-specific capital requirements and other regulatory instruments that can be used to go against the tide of speculative booms that are bound to end in bust. In addition, there needs to be much closer coordination between central banks that deal with trends in the overall economy (the macroeconomic level) and regulatory authorities that monitor individual financial institutions and instruments (the microeconomic level). As the recent crisis demonstrates, the collective impact on jobs and the economy of decisions taken by individual firms and the growth of particular types of financial products can be devastating (UN 2009).

The first challenge is thus to *include the control of these asset-based systemic risks among the core objectives of central banks* in order to live up to the duty to protect people's right to work against the risks of financial instability.

The second challenge (to meet the duty to fulfil the human right to work) is to return to the historical norm of *integrating growth and full employment as a core mission of central banks*, on a par with macroeconomic and price stability. The tendency may not be easy to reverse. In some countries, such as the United States, employment and growth are a core part of monetary policy. In other jurisdictions, such as the Eurozone under the purview of the European Central Bank (ECB), the explicit primary focus is price stability (inflation at below 2 percent). Likewise, a growing number of central banks in developing countries and transition economies have signed on (implicitly or explicitly) to "**inflation targeting**" in the low single-digits as their primary operating framework. This represents a sharp break from historical practice, not just in the developing world, but also in the now developed countries. In the post-World War II period, development and full employment was seen as crucial part of central banks' tasks (Epstein 2007a).

That central banks should be agents of employment creation immediately raises the question of the extent to which central banks should be immune from public oversight. Historic cases of hyperinflation (inflation at 50 percent a month or above) have given good reason to the argument that central banks should not be subject to short-term political expediency. Whether they should be independent institutions or under the direct control of elected governments is a matter of political debate.[33] But in either case, there should be formal and informal mechanisms to hold central bankers accountable to full employment goals (Stiglitz 2003; NGLS 2009a).

This implies greater policy dialogue on a number of fronts:

- Firstly, there should be a much more open and transparent public debate on what is often presented as the "trade-off" between full employment or higher wages and inflation.
- Secondly, it is important to better understand the macroeconomic policy options (heterodox policies) that could lead to more pro-employment growth.

33. This has become an overt political issue in some Eurozone member countries. For instance, in the run-up to the French presidential election in 2007, both the centre-right and centre-left main political parties had included a reform of the ECB statutes to include growth and employment as part of their election platform.

DO HIGHER WAGES AND FULL EMPLOYMENT ACCELERATE INFLATION ?

Annex I explains the history in economic theory on the trade-off (real or perceived) between inflation and full employment. This was taken to its extreme in the highly influential monetarist theory of the **Non-Accelerating Inflation Rate of Unemployment (NAIRU)**, which sets a level of unemployment below which inflation risks accelerating and eventually getting out of control. The basic argument is that any public intervention to promote full employment through fiscal or monetary expansion will not lead durably to more jobs but to higher levels of inflation. There would be "too much money chasing too few goods" as the common adage goes. At best, there is scope to influence "cyclical unemployment" (e.g. through stimulus measures in the face of a recession) when the full productive capacity of the economy at a given time is underutilized (UNCTAD 1995).

Although the validity and usefulness of NAIRU has been seriously challenged in academia, it is still widely used to assess and guide macroeconomic policy (UNCTAD 1995 ; Epstein 2007a). In the United States for example, a reduction in levels of open unemployment that fell below the assumed NAIRU in the latter part of the 1990s (the NAIRU was then fixed at around 6%) was invoked by the US Federal Reserve as a reason to hike up interest rates even in the absence of any signs of inflation rising (Stiglitz 2003). The same argument is applied to wages with a view to preventing a wage-led inflationary spiral. In 2007, for example, the President of the European Central Bank had openly threatened to raise interest rates if European workers' collective demands for wage increases were met.[34]

This particular brand of economic philosophy has not only sharply restricted macroeconomic policy : it has also been used to weaken social policy by arguing that if unemployment remains durably at a higher level after a recession is over, it is due to "*rigidities*" in the labour market. Policy remedies thus include deregulation of labour markets (especially the weakening of trade union rights) and cutting back on minimum wages and unemployment benefits where they exist. These are measures purported to improve the "*supply side*" response of the labour market to the needs of business. *The Economist* magazine actually prescribes these types of remedies as a way out of the current global jobs crisis :

> "Over the next couple of years, politicians will have to perform a difficult policy U-turn ; for, in the long term, they need flexible labour markets. That will mean abolishing job-subsidy programmes, taking away protected workers' privileges and making it easer for businesses to restructure by laying people off."[35]

Some measures to improve the "supply" of labour are essential and need more investment, such as providing re-training for unemployed people with the skills to match labour demand (known as "*active labour market policies*"). But other measures that prevent workers from organizing and bargaining collectively are not only counter-productive from a social justice perspective : as we have seen, they have negative macroeconomic consequences by repressing aggregate demand. Fundamental principles and rights at work are not an "economic distortion" but rather a means to help correct the uneven bargaining relations between workers and employers (Jenkins, Rodgers and Lee 2007).[36]

34. See for example "ECB warns of higher rates if pay levels rise" in *International Herald Tribune*, 2 February 2007.

35. *The Economist*, 14 March 2009, page 11.

36. A modest but important step in the right direction on this front has been the suspension in April 2009 of the "Employing Workers Indicator" (EWI) from the World Bank's highly influential *Doing Business Report*. >>>

To anchor the decent work agenda not just in social policy but also macroeconomic policy, it is essential to understand the conceptual flaws embodied in the NAIRU approach to economic growth. It assumes that the long-term full productive potential of an economy (called "**potential output**") is not influenced by demand, which is why demand-boosting measures are seen to only generate higher inflation in the long run. But this misses a key dimension: *the prospect of strong demand growth provides a powerful incentive for entrepreneurs to invest in expanding productive capacity (expanding potential output); while the prospect that demand will remain weak has the opposite effect*. As UNCTAD had already warned in 1995:

> "Restrictive macroeconomic policies can therefore be self-validating: if demand growth is checked too much on grounds that potential output is not sufficient to satisfy it, the growth of potential output will be held back" (UNCTAD 1995:173).

This then can lead to a vicious circle. Lower rates of investment in capital formation slow the rate of productive employment creation, which is responded to through more labour market flexibility that further depresses wages and further reduces incentives to invest in productive capacity and thus productive employment.[37]

The evidence on whether inflation targeting works at reducing inflation is at best mixed, and the record shows that economic growth and employment generation are rarely, if ever, the by-product of inflation-focused central bank policy. There is plenty of evidence that they can in fact create obstacles to more and better employment (Epstein 2007a; Heintz and Pollin 2008). To move away from this harmful one-size-fits-all approach in central bank policy, a more balanced and pluralistic debate on the monetary policy agenda is needed. Some initial questions could include:

- Is inflation in the lower single digits always appropriate if it disproportionately affects the prospects of employment growth?
- Could inflation targets be relaxed with a better understanding of what constitutes "moderate" inflation (that is good for growth and employment) which depending on national contexts could be much higher but remain below 10 percent or even 15 to 20 percent (Jomo 2007)?[38]
- Should policy makers better differentiate the sources of inflation, such as supply shocks (e.g. caused by commodity speculation on the world market), and oligopolistic rent-seeking practices, which tighter monetary policies do nothing to address?
- Could the dangers of a wage-led inflationary spiral only be valid if wage growth far exceeds productivity growth (ILO 2008a)?
- If so, should the policy agenda rather focus on avoiding further wage deflation and restoring average wage growth closer to productivity growth (including through regularly updated minimum wage legislation, strengthened social dialogue and collective bargaining, and better financial regulation, as called for in the Global Jobs Pact)?

>>> (The EWI essentially gave the best ratings to countries with the lowest level of workers' protection, and has been used by the World Bank and IMF to pressure developing countries to undertake labour market deregulation.)

37. As described in Annex I, the current Chief Economist at the IMF appointed in September 2008, Olivier Blanchard, suggests in his earlier writings that he also believes that expansionary macroeconomic policy can durably increase potential output, while restrictive policy has the opposite effect.

38. A key argument in favour of the low-digit inflation targets is that inflation hurts the poor more than the rich. This is certainly the case for high rates of inflation, but at more moderate levels, when the question is presented as a trade-off, opinion surveys suggest that unemployment rather than inflation is perceived as a bigger problem for those in the lower quintile of income distribution (Epstein 2007).

The global economic crisis has put the single-minded monetary policy focus on inflation on the back-burner. But with the colossal amounts of liquidity pumped into the global economy since late 2008, there is a real risk of a return to restrictive macroeconomic policies once global economic (but not employment) recovery appears to be on a sure footing. The following section explores a range of heterodox monetary instruments that support employment stability and growth. Some of these could be used, in tandem with other policies, to direct credit to employment-generating sectors and may even help protect employment growth from the risks of future macroeconomic policy contraction.

HETERODOX FINANCIAL AND MONETARY TOOLS TO SUPPORT EMPLOYMENT

The still limited but growing literature and research on employment-friendly macroeconomic policies shows that a range of options are available – from modest changes to inflation-targeting to a much broader change in the mandate of the central bank and a focus on "**employment targeting**" within a broader monetary, financial and fiscal policy framework. There is no "one-size-fits-all" (Epstein 2007b).

How would an employment targeting framework operate? The central bank and the government, working together on this, would estimate a feasible target range for employment growth, taking into account the rates that are consistent with moderate inflation. Based on the estimate of the relationship between its policy instruments and employment growth, the central bank would try to achieve its target. This would be part of connecting the target to "real" as opposed to just monetary aspects of the economy: employment, productive investment, the real exchange rate. The priority and the type of instrument used might vary from one context to another, but it would appear that **capital management techniques** discussed above would often play a critical role in the process.

One of the frequently mentioned policy strategies is the pursuit of a **stable and competitive real exchange rate (SCRER) policy** (the "real" exchange rate is the nominal exchange rate adjusted for inflation). Exchange rate policy can significantly affect employment outcomes. For example, an overvalued exchange rate can be a cause of mass unemployment, while exchange rate gyrations are a major source of job and livelihood insecurity. Achieving a stable real exchange rate that enables local firms to compete fairly with imports might involve confronting a challenge in conventional economic theory known as the "**macroeconomic policy trilemma.**" In a nutshell the theory argues that with an open capital account, it is not possible to maintain simultaneous control over both the exchange rate and the interest rate, two fundamental instruments in the pursuit of full employment. The use of capital management techniques is one way to overcome this challenge.

Important lessons can be learnt from the heterodox manner in which the Argentinean government and central bank managed Argentina's post-2001 crisis situation in this respect. The SCRER was part of an explicit policy that placed decent work at the heart of the recovery effort, which included employment targets in the country's national MDG framework (see Box 4.3). One of the lessons is that not all countries may be in a position to pursue a SCRER strategy, at least without more extensive capital controls (Akyuz 2008).[39] In the longer-term there is a strong case in favour of more fundamental international reforms to stave off currency speculation – see Chapter 7.

39. The SCRER does not necessarily work in all country situations. It works best in countries with a strong "tradable" sector (which comprise the export sector and domestic sectors that compete with imported goods).

BOX 4.3

SUPPORTING THE DECENT WORK AGENDA THROUGH UNORTHODOX EXCHANGE RATE POLICY : THE CASE OF ARGENTINA

The introduction of an SCRER policy was part of the post-2001 crisis government's strategy to integrate employment and decent work as cornerstone of a more coherent economic recovery and development strategy.

In the early 1990s, the government with support of the IMF instituted a "currency board regime" which essentially fixed an overvalued Argentinean peso to the US dollar, which meant that local enterprises were crushed by cheap foreign imports and monetary policy was entirely dependent on foreign reserves which got depleted due to a worsening trade balance. Although Argentina was viewed as the "best pupil" of the IMF and its currency board regime hailed as a model for other emerging markets to replicate, this unsustainable system created the conditions for the 2001 crisis, which led to a massive devaluation of the peso.

By mid-2003, the newly elected government decided to break from the policy conditions of the IMF and institutionalized a SCRER policy as part of its official strategy to support an employment-focused recovery. This meant trying to maintain a stable real exchange rate at a level that would allow local firms to regain ground in the local market (roughly 3 pesos to the dollar), while still maintain control of the money supply. To do this, the government and central bank cooperated to : (1) intervene on the foreign exchange market to counter the surge of short-term speculative capital inflows that would appreciate the currency ; and (2) remove resulting excess pesos by issuing interest-bearing central bank letters and notes (an operation known as "sterilization").

This policy was complemented by a range of other measures, including reserve requirements on short-term capital inflows, collective price agreements, social programmes for the unemployed (see Box 3.2 on the *Jefas* programme), extension of social security, investments in public works and periodic hikes in the minimum wage. The record showed that by the first quarter of 2006, the country had reached the highest employment rates since the early 1980s, while steep inequalities were narrowing and poverty levels going down.

These policies would not have been possible if the government had not been in a position to claim policy space by pushing ahead despite opposition from the IMF on a number of counts, notably intervention on the foreign exchange market. The government also built considerable fiscal space through successful agreement on reduction of dollar-denominated sovereign debt combined with taxes on high export earnings. In addition, Argentina experienced only moderate surges in capital inflows since its recovery, which partly explains the success of sterilization policies (Jenkins, Rodgers and Lee 2007 ; Damill, Frenkel and Maurizio 2007 ; Akyüz 2008).

Among other promising heterodox monetary instruments are ***credit allocation mechanisms***. These tools include asset based reserve requirements, loan guarantees, support for pooling and underwriting small loans, utilizing the discount window in support of employment generating investments:

- **Asset-based reserve requirements** are a system in which lending institutions are required to hold low- or zero-interest-yielding reserves as a proportion of their earning assets. In effect, banks earn less the higher the proportion of reserves they need to hold. We already briefly touched upon how higher capital requirements could help counter irresponsible risk taking by financial institutions. Here the same type of policy tool can be used (in reverse so-to-speak) to direct credit where it is most needed to promote employment or strategic economic sectors (such as agriculture, or renewable energy). By lowering reserve requirements on those preferred types of assets, the central bank or government creates incentives to hold these types of assets relative to less desirable assets. These could also build-in a gender lens by preferential lending for activities that employ more women.

- **Loan guarantees** are another possible instrument which could be attributed to banks that lend to cooperatives and small businesses that generate good employment opportunities. These can also support micro-credit institutions to reach out to micro- and small enterprises, or poor entrepreneurs in the informal economy.

- **Special discount windows** of central banks could play a similar function offering credit, guarantees, or discount facilities to institutions which are on-lending to firms and cooperatives that offer promising employment potential (Epstein 2007b).

These types of instruments could be introduced as part of crisis response, but kept in place even when counter-cyclical measures are not deemed necessary anymore. As noted above, this could help protect employment from the effects of a general credit crunch that would be triggered if policy were to solely rely on the blunt instrument of interest rate hikes (Jomo 2007).

It should be emphasized that some of the above-mentioned measures work better in countries with relatively well-developed financial systems. They played a key role in post-World War II reconstruction in Europe and were part of the economic apparatus that many developing countries used to support the actions of State development banks that helped finance between a fifth and half of all fixed capital investments in places like Mexico, Chile, South Korea, Brazil and Indonesia (Espstein 2007b ; Pollin and Heintz 2008).

In low-income countries, the ability to direct private bank lending is more limited. Research on private banking in many parts of Sub-Saharan Africa shows that credit is effectively "rationed," with very large differences between deposit and lending rates (spreads). One of the reasons is that private banks hold excess liquidity and prefer holding short-term government securities rather than long-term credit needed for productive investments. They do not respond well to lowered reserve requirements.

A different instrument to achieve the same purpose is a **prescribed asset** policy, which represents a type of financial quota. Under such a policy, a certain fraction of a bank's (or other financial institution's) assets must be held as investments or loans that support a priority area of economic development. Prescribed assets are not new to African economies. For instance, in the past, banks were frequently required to hold a portion of their assets as loans to the agricultural sector (Heintz and Pollin 2008 ; UNCTAD 2006).

The research suggests the need to go beyond trying to influence commercial bank lending and revisit the role of public **development banks** as a means to channelling more resources to support employment-creating investments. These types of institutions and above-mentioned policy instruments have been rolled back in the last two decades on grounds that they were subject to corruption and political patronage, and were inefficient. While there is plenty of evidence of abuse, *it is important not to confuse the disease with the cure* – which for a long time was assumed to be the more efficient performance of deregulated private banking. But public (development) banks were originally instituted precisely to respond to the short-comings of private banks, which have now become so evident. The ILO notes that in the face of the post-crisis credit crunch in United States, State-owned banks have shown greater readiness to lend to businesses and consumers than their private-sector counterparts (ILO/IILS 2009). It is not just a developing country issue. The aforementioned NGLS global civil society consultation on crisis response revealed consistent calls to give a greater role to public banks, a point that was also emphasized in the Stiglitz Commission.

There is a vital need to ensure that governance structures of public financial institutions have greater capacity, transparency and accountability to handle heterodox financial and monetary tools. An important dimension here is to be clear about the objectives these tools are supposed to serve. This is the subject of the next chapter, focusing on poverty-reduction through expanding productive employment in developing and least-developed countries.