World of Work Report 2010

From one crisis to the next?

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The **International Institute for Labour Studies** was established by the International Labour Organization in 1960 as an autonomous centre for advanced studies in the social and labour field.

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Editorial

Raymond Torres
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Three years after the start of the financial crisis, the world economy has resumed economic growth and some countries have even witnessed encouraging signs of employment recovery, notably in Asia and Latin America.

In many countries the employment outlook worsened recently…

Despite these significant gains, however, new clouds have emerged on the employment horizon and the prospects have worsened significantly in many countries. In advanced economies, employment is expected to return to pre-crisis levels by 2015, instead of 2013 as expected in last year's World of Work Report (Chapter 1). In the case of emerging and developing countries, it is estimated that employment will reach pre-crisis levels already this year – as predicted in last year's Report. However, over 8 million jobs are still needed to meet the growing workforce in those countries. In many other countries in which employment growth was positive at the end of 2009, more recent trends suggest a weakening of the job recovery or even falling employment.

The longer the labour market recession, the greater the difficulties for jobseekers to obtain new employment. In the 35 countries for which data exist, nearly 40 per cent of jobseekers have been without work for more than one year and therefore run significant risks of demoralisation, loss of self-esteem and mental health problems. Importantly, young people are disproportionately hit by unemployment and, when they find a job, it often tends to be precarious and does not match their skills. Because the labour market has been depressed for so long, many unemployed people are getting discouraged and leave the labour market altogether. By the end of 2009, more than 4 million jobseekers had stopped looking for work in the countries for which information is available.

…reflecting both the shift to fiscal austerity and the fact that the root causes of the crisis have not been properly tackled.

The first reason behind the deteriorated outlook is that fiscal stimulus measures, which were critical in kick-starting a recovery, are being withdrawn. Governments are worried about larger public deficits in view of investors' reluctance to fund these deficits. In the majority of countries analysed in the Report, fiscal policy has shifted to austerity which, if badly designed, will prolong the job crisis.

A second, more fundamental factor is that the root causes of the crisis have not been properly tackled. The coexistence of debt-led growth in certain developed countries with export-led growth in large emerging economies has proved to be the Achilles' heel of the world economy. Before the start of the financial crisis, real labour incomes grew less than justified by productivity gains, thereby leading to growing income inequalities. In certain advanced economies such as the US and several EU countries, this situation pushed households to borrow in order to fund their housing and consumption plans – which was possible because of a dysfunctional financial system. In other advanced economies like Germany and emerging countries such as China, growing inequalities translated into relatively modest domestic demand growth. But this was outweighed by higher exports to high-spending, debt-led economies. The private-debt bubble exploded with the onset of the global financial crisis and for a while was replaced with public debt as an engine of growth. However, there is a limit as to how much public debt can increase in order to stimulate the economy.

For a sustainable exit from the crisis, it is therefore crucial to address both the income imbalances and the dysfunctional financial system.

But there is a sustainable exit from the crisis, involving, first, job-centered fiscal support…

It is still possible to improve the employment outlook. The Report provides evidence on the key role of a mutually reinforcing, three-pronged approach. First, job-centered policies must be strengthened to reduce the risk of growing long-term unemployment and higher informality. Well-designed active labour market policies, work-sharing arrangements and targeted measures to support vulnerable groups, notably youth, are especially relevant in this respect. In countries where recovery is taking place, effective training policies are needed in order to ensure that workers have the right skills.

The Report shows that these measures have been used successfully in different regions of the world and are not expensive to the public purse. Moreover, over the longer run, the measures would support labour market participation and job quality, thereby creating room for reducing public spending and generating more revenues. In the end, public deficits would be lower than would be the case if ill-conceived fiscal austerity is pursued (Chapter 3).

…second, income-led growth in emerging economies and other surplus countries…

The second policy plank is income-led growth in surplus countries in order to move away from debt-led growth and pave the way for sustainable job creation in both surplus and deficit countries. The Report shows that, by ensuring a closer link between increases in labour incomes and productivity in surplus countries,

unemployment would decline in these surplus countries but also in those facing acute deficit problems (Chapter 4). This would be more effective in rebalancing the world economy than currency changes. Indeed, income-led strategies not only support aggregate demand, but also result in enlarged domestic markets and new business opportunities that can be seized by sustainable enterprises.

Income-led growth, in turn, depends on efforts to reinforce collective bargaining and social dialogue, well-designed minimum wage policies as well as employment-friendly social protection systems. Countries like Brazil and India have demonstrated how this can be achieved.

…and third, financial reform.

As stated by the Bank for International Settlements in its 2009 Annual Report "a financial crisis bears striking similarities to medical illness. In both cases, finding a cure requires identifying and the treating the causes of the disease". It is a fact, however, that reforms have so far failed to tackle the "causes of the disease".

As a result, a significant "moral hazard" problem has been created by bailing out banks without imposing deep reforms on them. The volume of credit to the real economy has declined in advanced economies. The situation is especially worrisome for small businesses which are central to a jobs recovery but rely on banks for their investment and hiring plans. Emerging and developing countries too are affected by volatile capital flows which tend to destabilise the real economy.

By reforming financial systems, including through the adoption of measures discussed in international fora, savings would be channelled to productive investment and jobs would become more stable (Chapter 5). Such measures should involve action at both the national and international levels, e.g. through the adoption of a tax on financial activities. Some concern has been expressed, especially among the financial profession, regarding the transition period entailed by financial reform and increased lending costs. However the longer-term benefits of financial reform for the real economy and society are clearly of much greater importance.

Social cohesion is at stake

Social cohesion should figure more prominently in the policy debate. The initial policy response contributed to building a sense that employment and social concerns were taken into account. However, continued social cohesion cannot be taken for granted if the strategy becomes less inclusive.

Already, there is growing evidence of a deteriorated social climate, especially in countries where job losses have been the highest. For example, out of 82 countries with available information, more than three-quarters indicate that in 2009, individual perceptions of their quality of life and standard of living have declined. The unemployment rate in these countries has risen by nearly 3 percentage points more than in the other countries. Even among those with a job, satisfaction at work has deteriorated significantly: in more than two-thirds of 71 countries with data, job satisfaction fell in 2009. Not surprisingly, perceptions of unfairness are growing (46 out of 83 countries) and people have less confidence in governments (36 out of 72 countries) than prior to the crisis. The Report shows that higher unemployment and growing income inequalities are key determinants of the deterioration in social climate indicators (Chapter 2). By contrast, economic growth per se is not a very significant factor behind social

climate indicators. This result reinforces the importance of job-centered policy action advocated by the ILO Global Jobs Pact.

In sum, adopting a job-centered exit strategy would enhance social cohesion while ensuring sustainable recovery from the crisis. This requires carefully-crafted fiscal support to tackle long-term unemployment, efforts to strengthen the links between labour incomes and productivity developments and financial reforms geared towards the needs of the real economy. As stressed by many observers, the crisis should be used as an opportunity to building a balanced global economy. The employment and social outlook suggests that time is running out to make this opportunity a reality.

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World of work outlook: The challenge of job-rich recovery*

1

Main findings

- The current economic recovery is not creating enough jobs and there are concerns about the quality of the jobs being created. Workers are becoming discouraged and leaving the labour market altogether, which could have long-lasting and devastating effects, especially for young men and women:
  - Among 68 countries with available information, 38 per cent show negative job growth in the most recent quarter (either because employment losses continue or because it has fallen after a brief recovery, i.e. "double dip").
  - Among the group of countries now experiencing employment growth, a disproportionate share of the job growth has been part-time – often involuntary. In some developing countries, workers are also working less than desired, and many have resorted to informal employment.
  - The number of people that have been unemployed for more than one year has increased in nearly all of the countries for which information is available – in some cases significantly.
  - Among countries with available information, more than 4 million workers had left the labour market by the end of 2009 and labour force participation rates are declining even in countries with positive employment growth. As of early 2010, close to 1.2 million people have become discouraged and have stopped actively looking for a job – although they would prefer to be working.
- Over the medium term, in *advanced economies* job growth is expected to remain stagnant through 2010 and a return to pre-crisis levels is not foreseeable before 2015. Estimates suggest that almost 15 million jobs in 35 countries will need to be created in 2011 in order to restore the pre-crisis employment rate.

* The authors would like to thank Hui-Yu Chiang for excellent research assistance.

- For the *33 emerging and developing economies* analysed, a V-shaped recovery is expected – with employment having quickly returned to pre-crisis levels in the first half of 2010. Yet, the challenge is to absorb labour surpluses from earlier years as well as new entrants: in 2011 there is an employment deficit of approximately 7 million jobs, which are needed to restore employment rates to their pre-crisis levels.
- Young men and women have been disproportionately affected since the onset of the crisis. Earlier experiences have shown that it takes, on average, over 11 years for youth unemployment to return to pre-recession levels.
- The policy challenge is to build and ensure a sustainable and inclusive recovery – one that is job-rich in terms of quantity and quality. Analysis shows, first, that countries that used an inclusive approach to promoting employment have been the most successful. This approach does not have to be expensive to work. Second, looking ahead, it is crucial to prioritize policies that prevent exit from the labour market (activation programmes, well-designed social protection that facilitates participation, effective minimum wage policies and employment-friendly taxation). Third, policy-makers must be careful to avoid short-term solutions, such as labour market deregulation, that will create long-term labour market and social challenges, including heightened social unrest (an issue explored in Chapter 2). Fourth, a coordinated effort to ensure adequate aggregate demand and balanced growth is needed (addressed in detail in Chapters 3 to 5).

Introduction

In the first half of 2009, employment destruction gained momentum as the effects of the global financial and economic crisis took hold. In the second half of the year, however, world GDP returned to positive territory, but despite the rebound in activity, employment losses continued in countries with available information – albeit at a much slower pace. Employment growth turned positive in the first quarter of 2010 but there are concerns about the quantity and quality of jobs being created.

Moreover, while some economies are now growing fast, others continue to struggle and some face the prospect of a double dip, i.e. a second period of contraction. Indeed, the financial crisis has entered a new phase, characterized by concern over sovereign debt risks – mainly in advanced countries – and fiscal consolidation, associated economic turbulence and potential spillovers. As such, pressures to cut spending, in particular on pro-employment programmes, are growing, which is only likely to delay further the employment recovery.

The purpose of this chapter is to demonstrate the importance of providing appropriate support to the labour market to ensure a sustainable and inclusive recovery. Section A examines recent developments in the world of work, documenting the extent of an employment recovery. It also examines the risks associated with current labour market trends in terms of the quantity and quality of jobs being created. Section B assesses the expected depth and duration of the current jobless recovery. In particular, using a number of different scenario analyses, the section forecasts future employment growth while taking into consideration the growing working-age population. The last section (section C) introduces the rest of the report and in doing so brings to the fore a number of important labour market and social challenges to be considered if policy-makers are to achieve a full, sustainable and inclusive recovery.

A. Employment snapshot

Employment has only begun to recover from the financial and economic crisis…

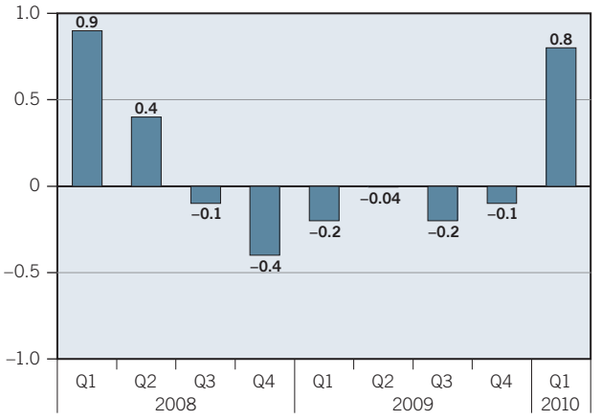
Signs of an economic recovery started to materialize already in the second half of 2009 (IMF, 2010) – but the labour market continued to struggle. In fact, employment in countries with available information fell for six consecutive quarters, only returning to positive territory during the first quarter of 2010 (figure 1.1).[1] In particular, employment grew by 0.8 per cent in the first three months of 2010 but given the extent and duration of the labour market recession, the number of jobs needed to restore employment to pre-crisis levels in these countries stood at 12 million.[2]

However, the current state of the labour market in terms of employment patterns is rather heterogeneous across income groups, in terms of timing, intensity and duration (figure 1.2)[3]:

- *High-income countries*[4] were the first group of countries affected, with losses beginning to amass in the second quarter of 2008, and, as a group, are clearly the most impacted overall in terms of employment losses.[5] The group experienced seven consecutive quarters of employment loss, with 7 million jobs shed in the first half of 2009 alone. While the rate of job loss slowed in the last two quarters of 2009, employment growth only turned positive in the first quarter of 2010. At the beginning of 2010, 14 million jobs (or 3 per cent) were still needed to restore employment to pre-crisis levels.[6]
- Employment in *upper-middle-income countries*[7] was also heavily affected by the crisis, but not until the second half of 2008: in the third and fourth quarters of 2008 employment fell by 2.6 million, or close to 1 per cent. Employment growth returned to positive territory in the second quarter of 2009, but only marginally (very low growth rates). However, employment rebounded in the past two quarters leading up to quarter one 2010, but compared with pre-crisis levels, employment remained lower by over 1.6 million jobs (or 0.6 per cent).

1. The analysis in this section includes 68 countries for which information is available. For a full list of countries, please see Appendix A. These trends are consistent with the global estimates of unemployment provided by *Global Employment Trends 2010* (Geneva, January 2010).
2. This figure corresponds to the net number of jobs needed to restore employment to pre-crisis levels. It disregards the fact that the number of people entering working age and seeking employment has risen over the past two years (see section B for a discussion on the timing of the expected employment recovery and an analysis of employment to population ratios).
3. See for example ILO, 2009b.
4. High-income countries (countries with a gross national income (GNI) per capita of USD 11,906 or more) include: Australia, Austria, Belgium, Canada, Croatia, Cyprus, Czech Republic, Denmark, Estonia, France, Finland, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Republic of Korea, Luxembourg, Malta, Netherlands, New Zealand, Norway, Portugal, Singapore, Slovakia, Slovenia, Spain, Sweden, Switzerland, Trinidad and Tobago, United Kingdom and the United States.
5. Some countries in the group, e.g. the United States, started to incur job losses well before the second quarter of 2008.
6. The number of jobs needed to return to the pre-crisis peak employment level is derived from country-specific figures and then aggregated for the group.
7. Upper-middle-income countries (countries with a GNI per capita of USD 3,857 to USD 11,905) include: Argentina, Belarus, Brazil, Bulgaria, Chile, Colombia, Jamaica, Kazakhstan, Latvia, Lithuania, Macedonia FYR, Malaysia, Mauritius, Mexico, Peru, Poland, Romania, Russian Federation, Serbia, South Africa, Turkey and the Bolivarian Republic of Venezuela.

Figure 1.1 Total employment 2008–10 (change from the previous quarter, percentages)



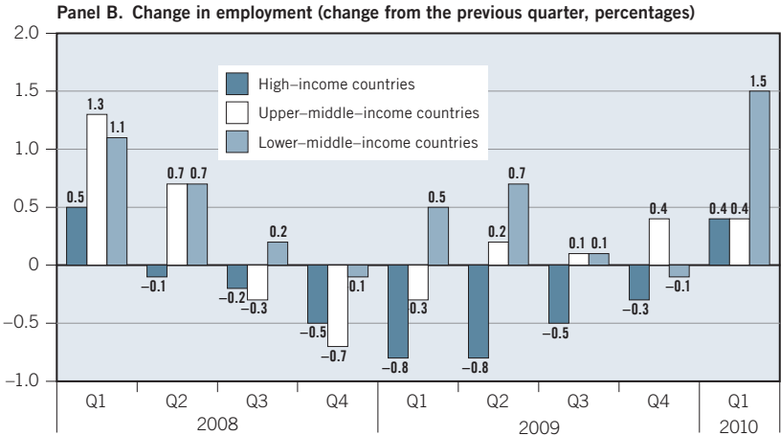
Note: Total employment is estimated on the basis of 68 countries for which information is available (see Appendix A). For some countries, employment figures are estimated using the previous quarters growth rate (Q1 2010: China, Jamaica, Morocco and Trinidad and Tobago; Q4 2009: China). Data are seasonally adjusted.[7]

Source: IILS estimates based on ILO, Laborsta database.

Figure 1.2 Employment patterns since the start of the crisis

Panel A. Change in employment (millions)

Panel B. Change in employment (change from the previous quarter, percentages)



Note: Groups are divided by GNI per capita according to the World Bank country classification. See Appendix A for the detailed list of countries for each country grouping. For some countries, employment figures are estimated using the previous quarters growth rate (Q1 2010: China, Jamaica, Morocco and Trinidad and Tobago; Q4 2009: China). Data are seasonally adjusted.

Source: IILS estimates based on ILO, Laborsta database.

7. Seasonality was corrected through the non-causal ratio-to-moving average method due to the limited availability of time-series data. This technique was also used to extrapolate quarterly employment information for Indonesia given that data is available only on a 6-month basis.

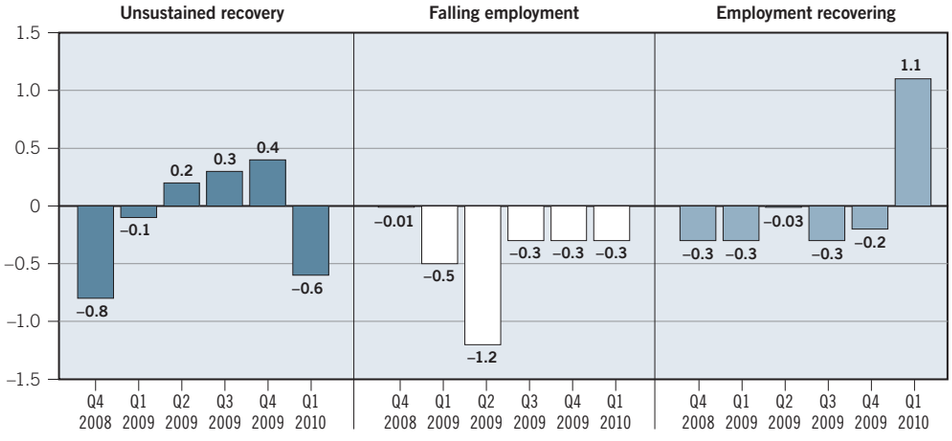
- Finally, the group of *lower-middle-income countries*[8] was the last and – at least for the time being – the least affected by the crisis in terms of employment losses. And during the first quarter 2010 employment grew at an impressive rate (especially in Indonesia and Thailand), wiping away jobs lost during the crisis and even surpassing pre-crisis levels by over 3 million jobs.[9]

…but the figures mask the cross-country variation in job growth as employment continues to fall in many countries.

Wide differences exist in terms of the extent of a jobs recovery. In particular, if countries that have already attained (or exceeded) pre-crisis employment levels are excluded, the total number of jobs needed to restore pre-crisis levels in these countries increases to over 20 million.[10] Moreover, in 38 per cent of the countries analysed, employment growth in the most recent quarter was negative. Employment has continued to fall in a considerable number of these countries, while in some others it has recently fallen after a period of positive job growth (figure 1.3):

- *Employment is still falling*: Employment in over 22 per cent of the countries analysed continues to fall – albeit at a decelerating rate. These countries – the majority of which are high-income countries – have seen employment fall for, on average, at least a year.

Figure 1.3 Employment trends, by type of recovery (quarterly changes, percentages)



Note: This figure shows changes in employment (over the previous quarter, in per cent) for the 68 countries for which quarterly information is available by type of employment recovery. Unsustained recovery includes countries where the most recent quarterly employment growth is negative despite having experienced at least one quarter of positive employment growth since the beginning of the crisis. For some countries, employment figures are estimated using the previous quarters growth rate (Q1 2010: China, Jamaica, Morocco and Trinidad and Tobago; Q4 2009: China). Data are seasonally adjusted.

Source: IILS estimates based on ILO, Laborsta database.

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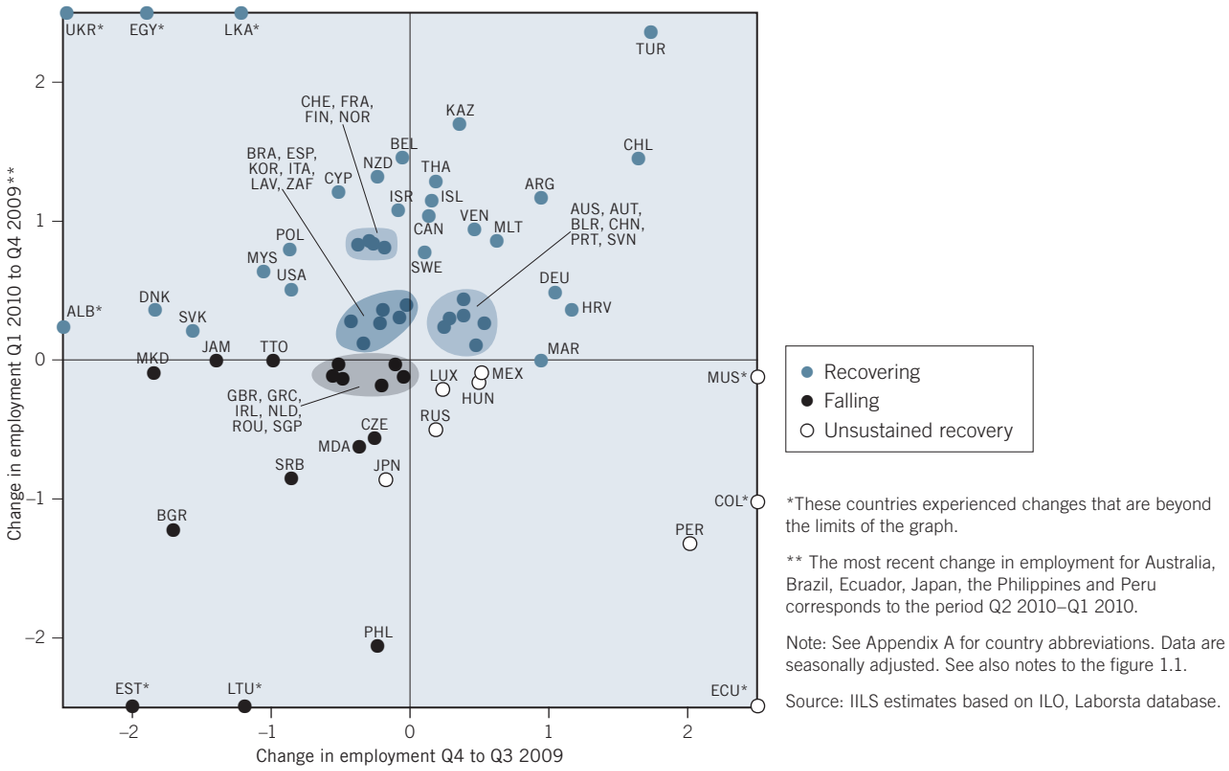
8. Lower-middle-income countries (countries with a GNI per capita of USD 976 to USD 3,856) include: Albania, Bolivia, China, Ecuador, Egypt, Indonesia, Republic of Moldova, Morocco, Philippines, Sri Lanka, Thailand and Ukraine.
9. When this group is analysed without the strong influence of China's figures, employment losses appear higher, but they are still the lowest among country groupings and the pattern of employment developments is not altered. For example, excluding China, at the end of 2008, 344 000 jobs were lost, but employment quickly recovered in the following quarter. And, during the third quarter 2009, employment fell again by 130 000.
10. As of Q1 2010 Argentina, Australia, Belarus, Belgium, Brazil, Chile, China, Colombia, Indonesia, Israel, Kazakhstan, Luxembourg, Malta, Mexico, Peru, Philippines, Switzerland, Thailand and Turkey have attained pre-crisis employment levels.

Figure 1.4 Changes in total employment, by type of employment recovery and by country (percentages)



*These countries experienced changes that are beyond the limits of the graph.

** The most recent change in employment for Australia, Brazil, Ecuador, Japan, the Philippines and Peru corresponds to the period Q2 2010–Q1 2010.

Note: See Appendix A for country abbreviations. Data are seasonally adjusted. See also notes to the figure 1.1.

Source: IILS estimates based on ILO, Laborsta database.

- *Unsustained recovery*: In close to 15 per cent of the countries analysed, the jobs recovery was unsustained, i.e. after initially falling, employment growth returned to positive territory, but only temporarily, as it again turned negative in the most recent period. Interestingly, the drop in employment among this group during this most recent period was notably strong, erasing much of the prior gains.
- *Employment is recovering*: In about 63 per cent of the countries analysed employment growth was positive in the most recent quarter. The country composition of this the group of recovering countries is rather mixed, including upper-middle-income countries as well as some high-income and lower-middle-income countries.

The extent of the cross-country variation in terms of employment developments is particularly evident in Figure 1.4, which examines changes in employment compared with the previous quarter in both the first quarter of 2010 (y axis) and in the last quarter of 2009 (x axis). As such:

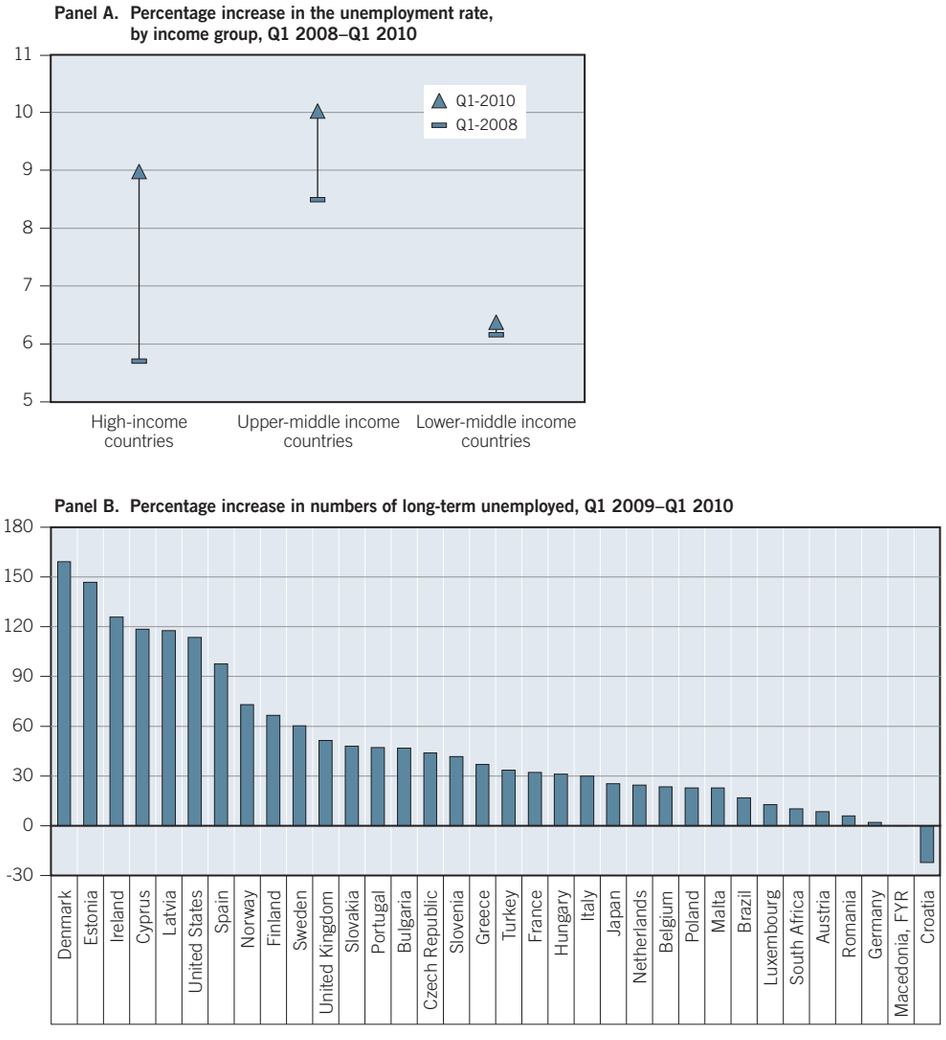
- countries appearing in the upper-right quadrant (less than half of the countries in the group) have experienced two consecutive quarters of employment growth;
- countries in the upper-left quadrant witnessed a return to positive job creation in the first quarter of 2010, including countries such as South Africa and the United States;
- conversely, countries in the bottom two quadrants experienced job losses in the most recent quarter: the lower-left quadrant indicates countries where

employment losses have endured over the last two quarters (e.g. Greece and Ireland) and the lower-right quadrant contains countries that have recently experienced a double dip, i.e. recent job losses that followed a period of growth (e.g. the Russian Federation and Colombia).

As a result, long-term joblessness is on the rise in most countries…

With labour demand remaining weak, joblessness continued to spread in early 2010 – figures indicate that unemployment rates remain stubbornly high across income groups (figure 1.5, panel A). In fact, 85 per cent of the countries analysed have experienced increases in the unemployment rate since the beginning of 2008.[11] For example, in high-income countries the unemployment rate

Figure 1.5 Unemployment and long-term unemployment, 2008 to 2010



Note: Unemployment rates by income group are weighted averages based upon 60 countries with available information. Long-term unemployment in the United States is defined as 6 months or more.

Source: IILS estimates based on ILO, Eurostat database and Laborsta database.

11. By income group, the share of countries that have experienced an increase in the unemployment rate equals 97 per cent for high-income countries; 78 per cent for upper-middle-income countries and 50 per cent for lower-middle-income countries.

increased over 3 percentage points since the first quarter of 2008, reaching 9 per cent in the first quarter of 2010. Among upper-middle-income countries, the average unemployment rate is even higher – over 10 per cent at the beginning of 2010 – although the jump since the beginning of 2008 has been less dramatic given that rates were already comparably high. For lower-middle-income countries, the increase in unemployment has only been marginal, rising to above 6 per cent.

Moreover, as the crisis persists, it is not surprising to see a rise in the number of people entering long-term unemployment, i.e. those that have been unemployed for more than one year (figure 1.5, panel B).[12] Over the past year, the number of workers in long-term unemployment has increased in nearly all of the countries for which information is available – in some cases significantly. Additionally, in more than 80 per cent of these countries, the share of long-term unemployed in total unemployment has also increased. In other words, long-term unemployment is not only growing, but it is growing faster than overall unemployment. It is also worth noting that the trend increase in unemployment and long-term unemployment is occurring regardless of the recovery path, i.e. even in countries where employment growth was positive in the most recent quarter.

…and a deterioration in the quality of employment in many instances.

In some cases there is concern that when the jobs recovery takes place it will not be in full-time permanent employment. During 2009, in countries where employment growth has turned positive (recovering countries), the growth has been disproportionately part-time in nature (figure 1.6). In fact, with the exception of a few countries (Poland, South Africa and Thailand), the share of employment growth that has been part-time during the recent recovery period exceeds the share of part-time employment in total employment prior to the crisis. For example, in the United States prior to the crisis part-time employment accounted for approximately 17 per cent of total employment but during the recent quarters of job growth, part-time has accounted for a disproportionate share of growth, i.e. 20 per cent. And while job-sharing and reduced working hours have been helping to mitigate employment losses in the short term, if this translates into a permanent, involuntary increase in part-time employment it will lead to a deterioration in the overall quality of jobs being created.

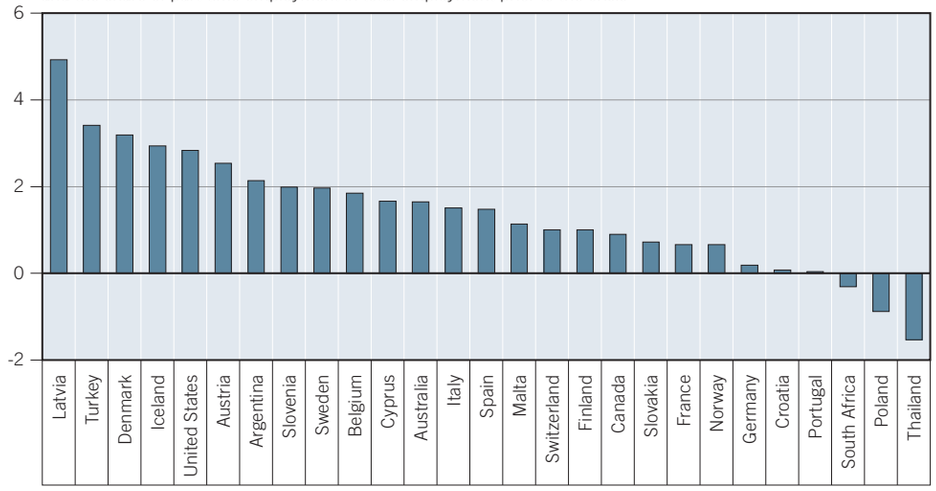
Moreover, evidence regarding the nature of part-time employment indicates that for the recovering countries with available information (21), over 60 per cent have experienced increases in the share of involuntary part-time employment in 2009. The incidence of involuntary part-time employment is on the rise in other countries such as Mexico and Ecuador, where the share of involuntary part-time employment (in total employment) has increased by over 2 percentage points in the two years up to the first quarter of 2010, as well as in Colombia, although at a lesser pace. The issue could exacerbate the jobless recovery as employers – against the backdrop of an uncertain recovery – may in the first instance increase hours of existing employees and thus reduce the overall speed and intensity of employment recovery. Fewer hours worked could also lead to lower wages (see below).

In other instances – especially in developing countries – workers adapt to the adverse effects of weak employment creation by moving to the informal sector or to other forms of precarious employment, which act as a buffer against loss

12. Long-term unemployment in the United States is defined as six months or more.

Figure 1.6 Change in employment composition among recovering countries

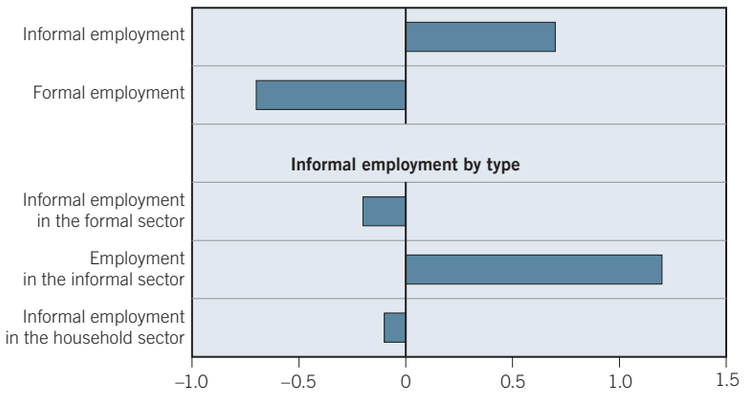
The difference between the share of employment growth during the recent recovery period* which is part-time and the share of part-time employment in total employment prior to the crisis**



* The share of part-time employment in total employment over quarters with positive employment growth.
** Before the crisis corresponds to the quarterly average share of part-time employment in 2006 and 2007 except for Argentina, South Africa and Thailand that refer to 2008.

Source: IILS estimates based on Eurostat database and national labour force statistics.

Figure 1.7 Change in the employment structure, Q2 2009 to Q2 2008 (percentage points)

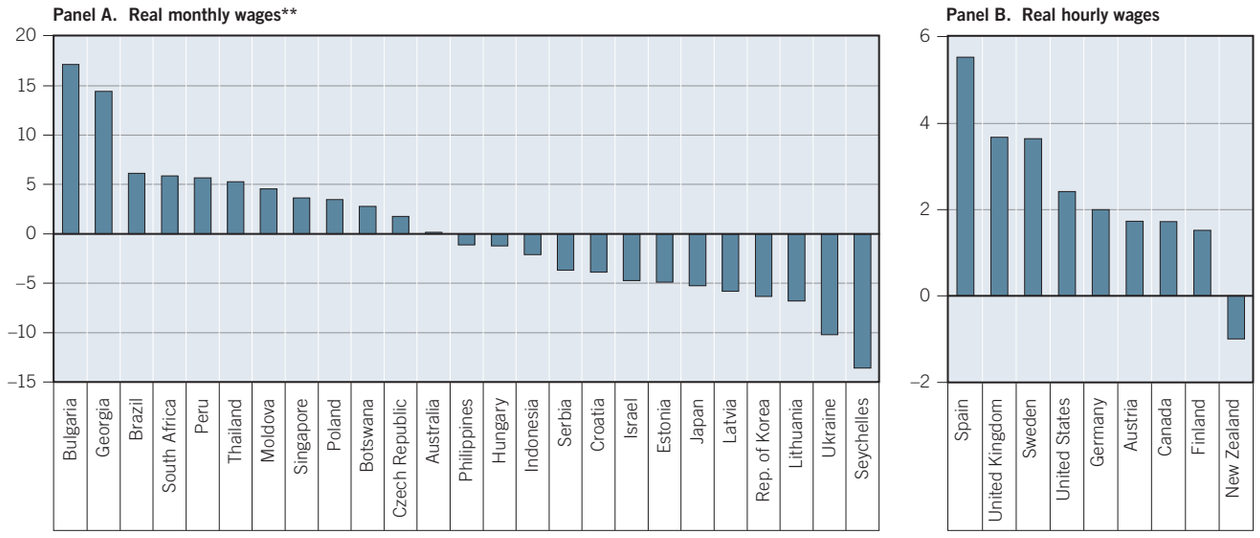


Note: Figures correspond to a group of six Latin American countries: Chile, Colombia, Ecuador, Mexico, Panama and Peru.

Source: ILO (2009a).

of income and employment. In these circumstances, the risk of labour market duality is high as it becomes increasingly difficult for many workers to move out of a cycle of, for instance, informal, often low-skill, insecure and uncertain employment into a high-skilled, relatively secure employment status. Some countries in Latin America have already witnessed increases in informal employment. Available information for six Latin American countries (Chile, Colombia, Ecuador, Mexico, Panama and Peru) shows that between the second quarters of 2008 and 2009, informal employment increased by 0.6 percentage points, while formal employment declined by the same amount (figure 1.7). This illustrates that there seems to be some kind of labour market adjustment, at least in the current crisis, in which jobs that were destroyed in the formal employment are absorbed by the

Figure 1.8 Change in real wages, Q4 2007 to Q4 2009* (percentages)



* Changes for Botswana and the Republic of Korea correspond to the period Q1 2007–Q1 2009; for Finland and Peru to the period Q2 2007–Q2 2009; and for Austria, Georgia, the Philippines, Thailand and the United Kingdom to the period Q3 2007–Q3 2009.
** Figures for Australia and the Philippines correspond to weekly and daily wages, respectively.

Source: ILO, Crisis database and Global Wage database based on national statistical sources.

informal sector.[13] A similar phenomenon occurs in Indonesia – one of the least affected countries in terms of employment loss – where the incidence of informal employment, and of persons switching to lower quality forms of employment, has risen instead of unemployment (ILO, 2010a).

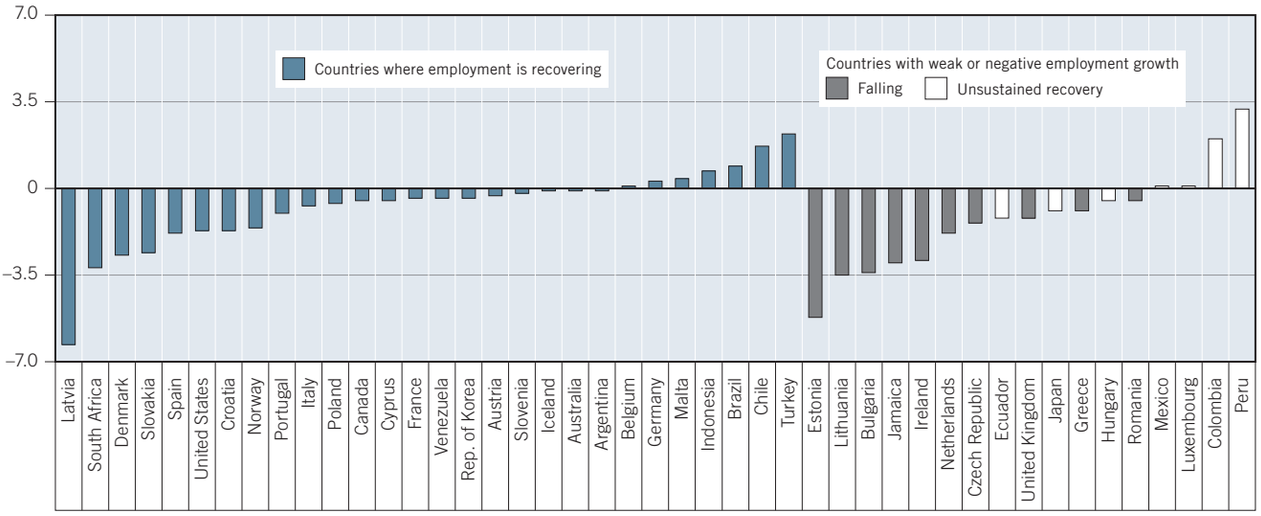
Moreover, general dissatisfaction with job characteristics has increased in some Latin American countries during the crisis. In Argentina and Mexico, for example, the incidence of underemployment, i.e. workers that are actively searching for a new job in hopes of improving their current employment situation – in terms of quality, salary or skills matching – is on the rise. Indeed, in Mexico the number of underemployed workers actively looking for a job increased by close to 17 per cent in 2009. The increase – 35 per cent – is even more dramatic among workers with tertiary education. In Argentina, the rate of similarly defined underemployed jobseekers increased by close to 3 percentage points between the third quarters of 2008 and 2009.

Wages are also an important aspect of employment quality but real monthly wages have declined in over half of the countries for which information is available since the onset of the crisis (figure 1.8, panel A). This decline might be linked to a reduction in the number of hours worked, as discussed above. On the other hand, in the few countries with hourly data, wages have grown in all but one case (figure 1.8, panel B). This may in part be due to the changing composition of employment, i.e. the wages of workers who have maintained their job could be higher than the pre-crisis average, or it could be due to previously agreed upon wage agreements.[14]

13. It is interesting to note that the increase in informality in these countries did not mean an informalization of labour relations in the formal sector – in fact, informality in the formal sector stayed relatively constant (ILO, 2009a). This reinforces the argument of an existing trade-off between formal and informal sector employment during the crisis.

14. For more information regarding the issue of wage developments and productivity see (ILO 2010d).

Figure 1.9 Percentage point change in the employment to population ratio Q1 2010 to Q1 2009*



*Percentage point change in employment rates for Jamaica corresponds to the period Q4 2009–Q4 2008. Indicators for Argentina, Bolivia, Ecuador and Peru correspond to selected urban area data only.

Source: IILS estimates based on ILO, Laborsta database.

Weak job creation alongside a growing working-age population means that employment rates have fallen in over 80 per cent of countries…

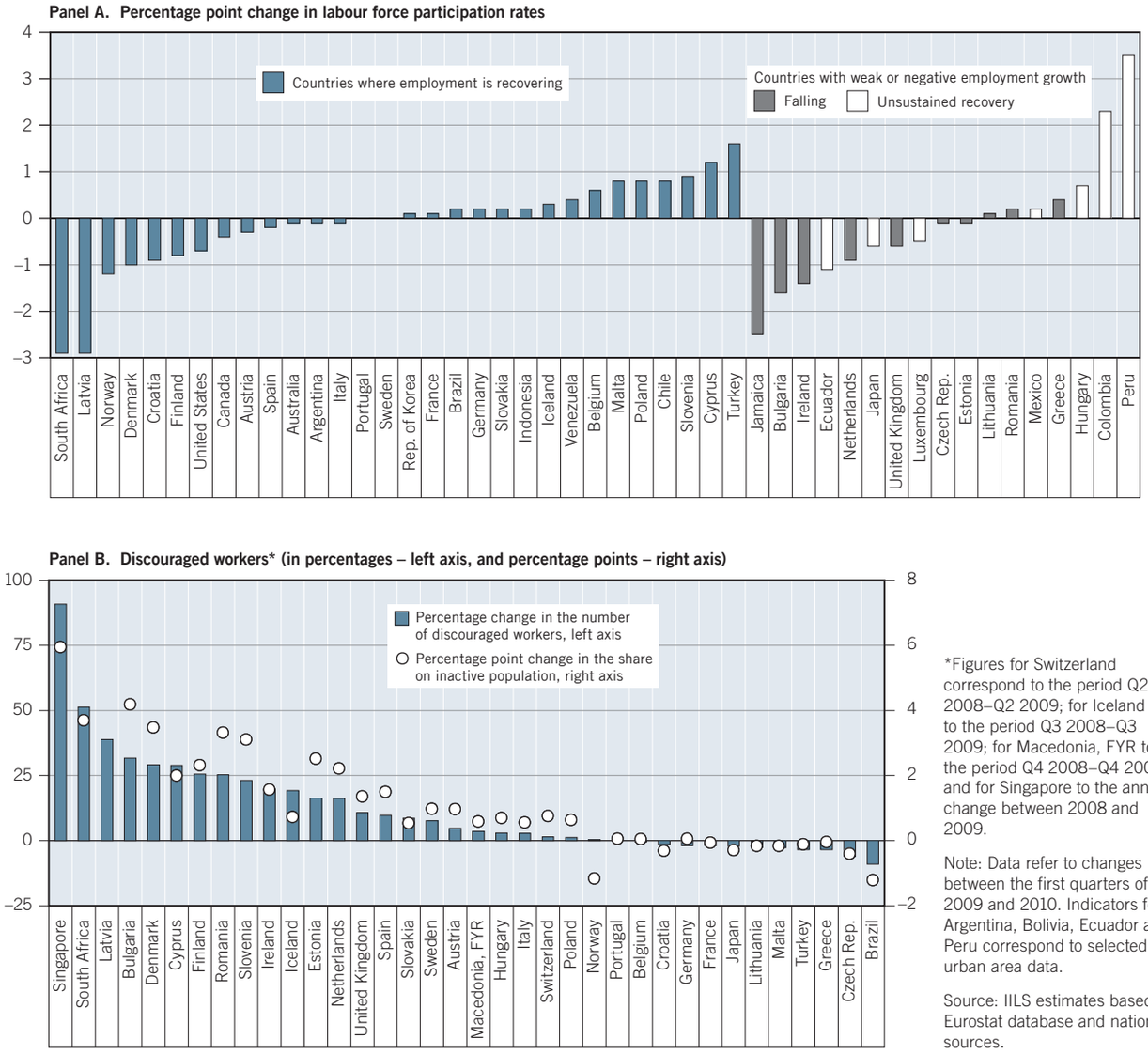
While employment has reacted slowly, the working-age population (persons aged 16-64) has continued to increase in most countries. As a result, the ratio of employment to working-age population, i.e. the employment rate, declined in 2009 in over 80 per cent of the countries analysed – in some cases significantly (figure 1.9). Not surprisingly, the steepest – and most prevalent – declines are among countries where employment continues to fall or growth is stagnant. The problem is particularly acute in countries such as Bulgaria, Estonia and Lithuania as they are confronted with the dual challenge of falling employment and rising working-age populations. In these countries, employment rates have fallen by 3.5 percentage points or more. But even in countries where employment has begun to recover, employment rates have fallen.

…driving many persons out of the labour market altogether.

As a result, many workers have become discouraged and are no longer actively looking for a job. By the end of 2009 over 4 million workers had already decided to leave the labour market – just over 1 per cent of the labour force of the affected countries (figure 1.10, panel A).[15] In particular, in about half of the countries, participation rates have fallen, even among countries experiencing positive job growth; and in the few countries with growing participation rates, increases in participation are negligible. The most striking examples in this group include South

15. Countries with declining labour forces include Bulgaria, Croatia, Denmark, Estonia, Finland, Iceland, Ireland, Italy, Jamaica, Japan, Latvia, Morocco, Netherlands, Norway, Portugal, Romania, South Africa, Spain, Ukraine, the United States and Venezuela, where 4.4 million people had already left the labour market at the end of 2009 (Q4).

Figure 1.10 Discouraged workers and labour market withdrawal, 2009 to 2010



*Figures for Switzerland correspond to the period Q2 2008–Q2 2009; for Iceland to the period Q3 2008–Q3 2009; for Macedonia, FYR to the period Q4 2008–Q4 2009 and for Singapore to the annual change between 2008 and 2009.

Note: Data refer to changes between the first quarters of 2009 and 2010. Indicators for Argentina, Bolivia, Ecuador and Peru correspond to selected urban area data.

Source: IILS estimates based on Eurostat database and national sources.

Africa and Latvia, which reported sharp declines in participation rates in the four quarters to quarter one 2010 – close to 3 percentage points. Labour market exit, however, is most prevalent among countries that continue to experience weak or negative employment growth, with Jamaica having experienced the sharpest decline, over 2.5 percentage points. The challenge is often particularly acute among youth (Box 1.1).

More worrisome is that in 65 per cent of the countries with available information, the number and share of discouraged workers – those who are not participating but would rather be working – have risen. In fact, between the first quarters of 2009 and 2010, the number of discouraged workers has increased by 5 per cent on average (figure 1.10, panel B). This means that close to 1.2 million people became discouraged in the year to quarter one 2010 – close to 450 000 people in countries with negative employment growth and more than 700 000 in countries where employment is already recovering. Similarly, in most of the countries (70 per cent), discouraged workers as a share of the inactive population is also on the rise.

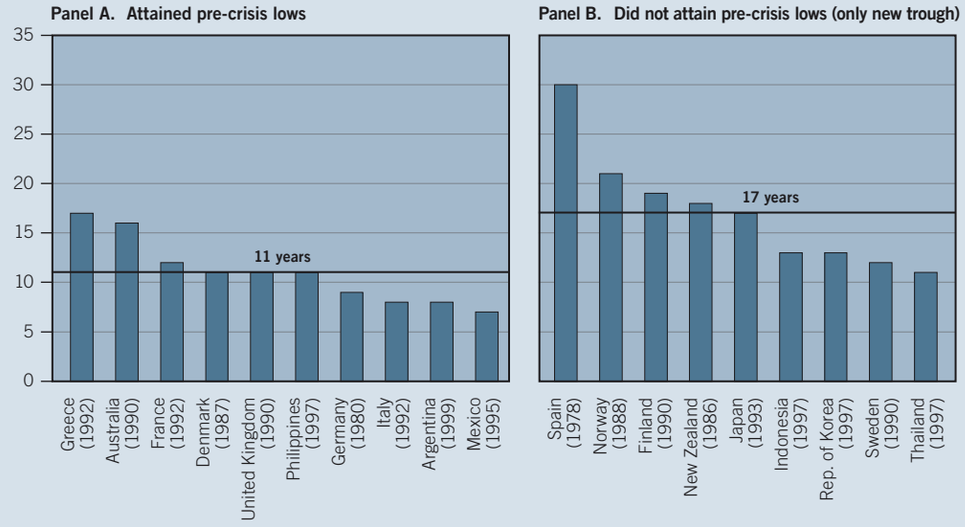
Box 1.1 Special focus on youth: Labour market detachment can have devastating and long-lasting effects on young men and women

Young workers are especially vulnerable to changes in the labour market because they lack relevant job skills, work experience, access to information and suffer disproportionately in their search for employment – a situation exacerbated during times of crisis (Verick, 2009; World Bank, 2007).[1] The current crisis is no exception as the young, inexperienced entrants to the labour market have been particularly hard hit.[2]

Of particular importance is the school-to-work transition, when young workers enter the labour market in search of full-time employment. Before the crisis there was already evidence for developed countries showing that the transition from school to a permanent job takes on average two years – ranging from about one year in Denmark, Ireland and Germany to over two years in Italy, Finland and Spain (Quintini et al., 2007). In developing countries, the transition to full-time work can be more challenging – with many opting for informal or self-employment – and can often take much longer, in some cases up to seven years.[3] In the context of a weak job market, transition times could worsen given the heightened risk that young workers will leave the labour market entirely. In fact, among 32 developed countries with available information, labour force participation rates for youth aged 20-24 declined in approximately two-thirds of those countries, and for youth aged 15-19 it declined in all but four countries.[4]

Moreover, evidence from earlier crises shows that youth unemployment persists long after growth resumes. In fact, among countries able to restore pre-crisis lows in youth unemployment, it took on average 11 years – ranging from 17 years in Greece to 7 years in Mexico (figure 1.11, panel A). Some countries, such as those depicted in Figure 1.11, panel B, never attained the pre-crisis lows – only new, albeit higher, troughs in youth unemployment.[5] For these countries, it took more than 17 years on average to achieve a "partial" recovery. In Spain, for example, the pre-crisis low for youth unemployment rate was 9.3 per cent in 1976, but 30 years later, in 2006 (pre-current crisis low), it stood at more than 17 per cent. Similar trends are present for the other countries in the group: the most recent trough achieved prior to the onset of the current crisis was on average close to two times higher than the pre-crises low. This is of particular concern given that in some countries, including e.g. Brazil, Japan, the United States and the United Kingdom, youth unemployment rates in the current crisis have already surpassed the peak rates during the downturn of the 1990s (Ha et al., 2010).

Figure 1.11 Time taken for youth employment to recover from earlier crises (years)



Source: IILS estimates based on EULFS; OECD and UN database.

In addition, the effects of unemployment on youth can lead in some cases to social exclusion, poverty, erosion of skills and increased likelihood of entering unstable, low-paid occupations,[6] all of which can have severe long-term consequences for potential future earnings, especially among new graduates →

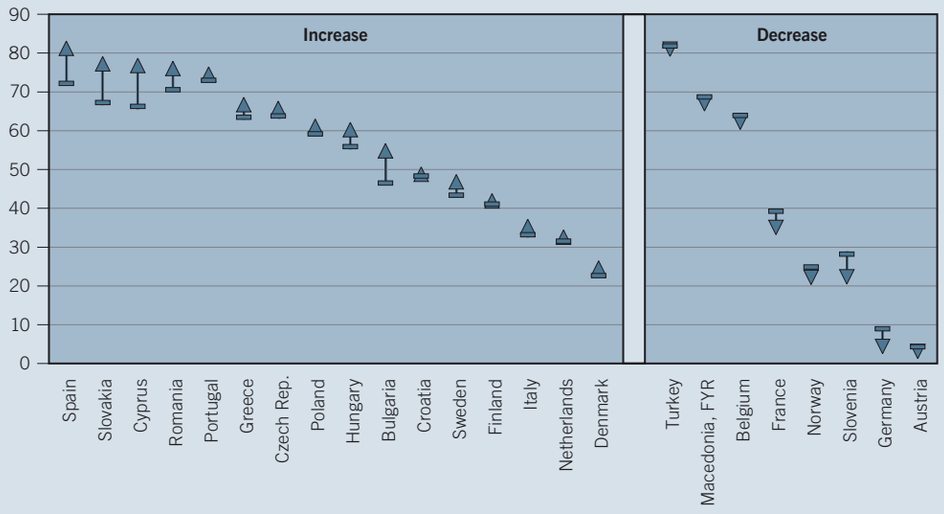
1. World of work outlook: The challenge of job-rich recovery

during times of crisis. For instance, Gartell (2009) finds that unemployment at graduation in Sweden lowers earnings by 30 per cent after five years. In the United States, Mroz and Savage (2006) find that a mere six-month spell of unemployment at the age of 22 years would result in wages after one year being reduced by 8 per cent, and that the impact would be long term as wages earned after ten years would be 3 per cent lower than normal. Similarly, Oreopoulos et al. (2008) find that in Canada, students graduating during a recession have lower earnings, and while their earnings recover partially through a gradual process of job mobility towards better firms, they never catch up.

In this regard, the quality of jobs is an important consideration. In particular, while more flexible working arrangements, such as temporary and part-time jobs, can facilitate the entry of young people into the labour market, these arrangements may also lead to persistent job insecurity (Ha et al., 2010). In fact, the vast majority of youth are in temporary jobs because they could not find permanent ones – and their numbers are on the increase in two-thirds of countries with available information (figure 1.12).[7]

Special policy intervention to address the difficulties faced by youth may be warranted – and sooner rather than later. In particular, it will be essential to keep young jobseekers in contact with the labour market, and for those that return to school, to continue to facilitate a smooth and efficient school-to-work transition – all the while promoting job quality and skills matching. This is of particular relevance against the backdrop of a relatively weak employment outlook (see section B). Moreover, even before the crisis the situation facing youth was unfavourable, and if this persists it may have serious long-term negative implications – both social and economic – for the development of individuals and society more generally.

Figure 1.12 Proportion of temporary workers aged 15-24 who could not find permanent employment, 2009 (percentages)



Note: Data for all countries refer to change between 2008 and 2009.

Source: IILS estimates based on EULFS.

Box 1.1 has been prepared by Uma Rani with assistance from Antonino Barbera Mazzola.

[1] See Scarpetta, Sonnet and Manfredi (2010) for more information on youth unemployment during crisis times. [2] At the end of 2009 there were an estimated 81 million unemployed young people and the global youth unemployment rate stood at 13.0 per cent (ILO, 2010b). See also Ha et al. (2010). [3] ILO has conducted school-to-work transition surveys in eight developing countries over the period 2004–2007 (Matsumoto and Elder, 2010). The length of transition to full-time jobs ranges from 5 years (Egypt) to 7 years (Mongolia). [4] For youth aged 15–19, only in the Czech Republic, Denmark, France and Poland did participation rates increase. [5] The success, or lack thereof, in attaining pre-crisis youth unemployment rates is a function of a number of factors. Importantly, none of the countries that were exposed to the 1997 Asian financial crisis – with the exception of the Philippines – have reached pre-crisis lows. In other cases, e.g. Denmark, Germany and the United Kingdom, and to some extent Mexico, the attainment of pre-crisis lows appears largely due to strong output growth following the crisis. [6] See for example, Bell and Blanchflower (2010); Mincer and Polachek (1974); Pissarides (1992); Biewen and Steffes (2008); and Lupi and Ordine (2002). [7] See also section C for a discussion of employment regulation and temporary work.

B. Employment outlook

This section presents an assessment of the medium-term prospects for employment assuming there is no change in the current policy prescription.[16] In particular, it takes into account (i) the current economic outlook to 2015 and (ii) projections for the working-age population, to estimate prospects for employment rates. The projections presented in this section draw on employment–output elasticities estimated by way of an econometric analysis of the impact of growth on employment during past crises (see Appendix B for methodological considerations). Estimates are first presented by income group and are then regrouped by ILO region. Two scenarios are constructed: (a) a baseline scenario using current growth projections from IMF; and (b) an alternate growth scenario based on UNDESA output estimates – which are 1 per cent lower per annum than the IMF baseline projections.[17] The analysis follows a similar methodology to the one used for the *World of Work Report 2009* (ILO, 2009b).[18] The employment outlook is then constructed by applying the elasticity of the group to the GDP growth projections of the IMF (IMF, 2010) and UNDESA (UN, 2010) by country, from 2010 onwards.

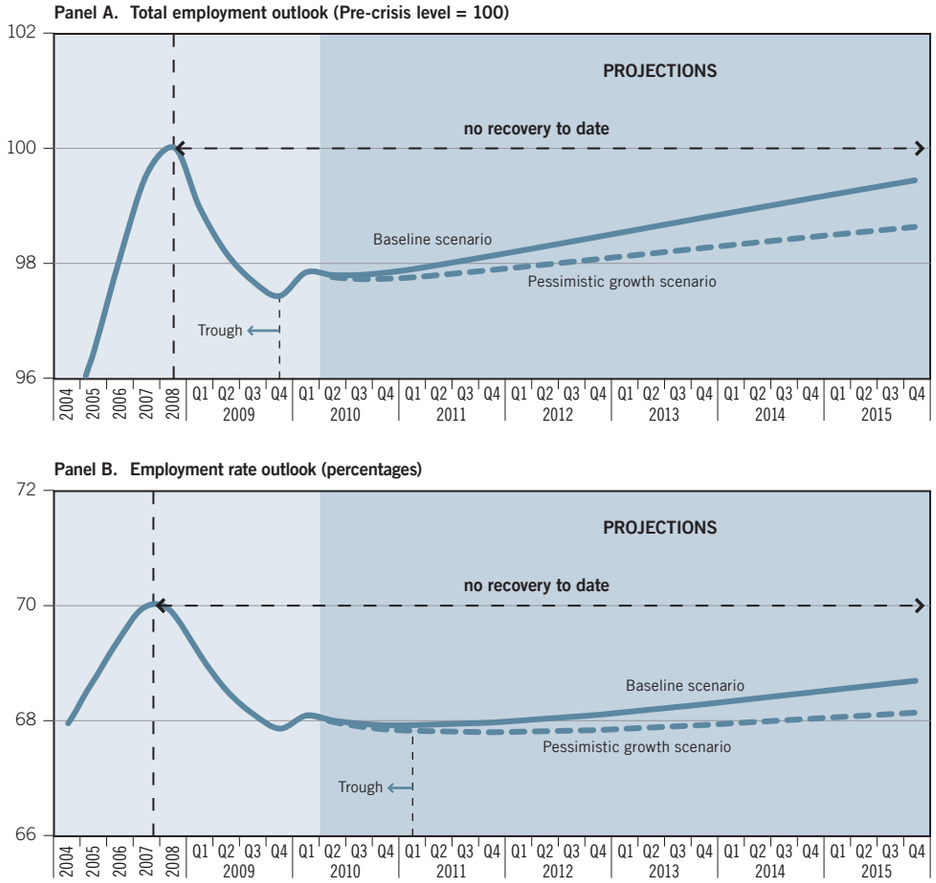
Employment recovery will be sluggish in high-income countries…

The first conclusion that emerges from the analysis is that following the crisis, the employment content of growth is expected to be low.[19] This is particularly the case among high-income countries, where job growth is expected to remain stagnant through 2010 and a return to pre-crisis levels will not be possible before 2015 (figure 1.13, panel A).[20] The expected time to recovery has thus deteriorated compared with estimates from a year ago, where high-income countries were expected to return to pre-crisis levels almost two years earlier, i.e. in 2013.[21] This is likely due to the fact that employment is currently growing more slowly than previously anticipated and therefore the upturn in employment is now expected to occur later. If conditions deteriorate further (pessimistic growth scenario), employment will only begin to grow by the beginning of 2011.

When taking into account the growth in the working-age population, the situation is even more critical (figure 1.13, panel B). While the employment rate is expected to follow a similar trajectory, the trough will only be attained at the beginning of 2011 under the baseline scenario. Moreover, a recovery to pre-crisis employment rates does not seem viable in the medium term; by the end of 2015 the employment rate will still be 1.4 percentage points lower than its 2007 pre-crisis level (and close to 2 percentage points lower when considering the pessimistic growth scenario). Under the current baseline scenario, this finding suggests that by

16. Chapter 3 takes up the issue of the impact of various fiscal positions on the labour market.
17. One per cent per annum is the current difference between the IMF and UNDESA world output estimates for 2010 (4.2 per cent and 3.2 per cent, respectively).
18. Given that employment reacts differently to growth depending upon the business cycle, the analysis estimates the output–employment relations during the recovery periods of the different countries' past crises.
19. Given that employment is considered to be a lagged variable, it is not surprising per se that employment growth occurs after a GDP recovery. However, the findings suggest that during crises, employment reacts more slowly when there is a return to positive GDP growth compared to when GDP falls.
20. For a detailed list of the countries in each income group, refer to Appendix B.
21. ILO 2009b.

Figure 1.13 Employment outlook in selected high-income countries, 2004–2015



Source: IILS estimates based on ILO, Laborsta database; IMF (2010); OECD (2010); UN (2010).

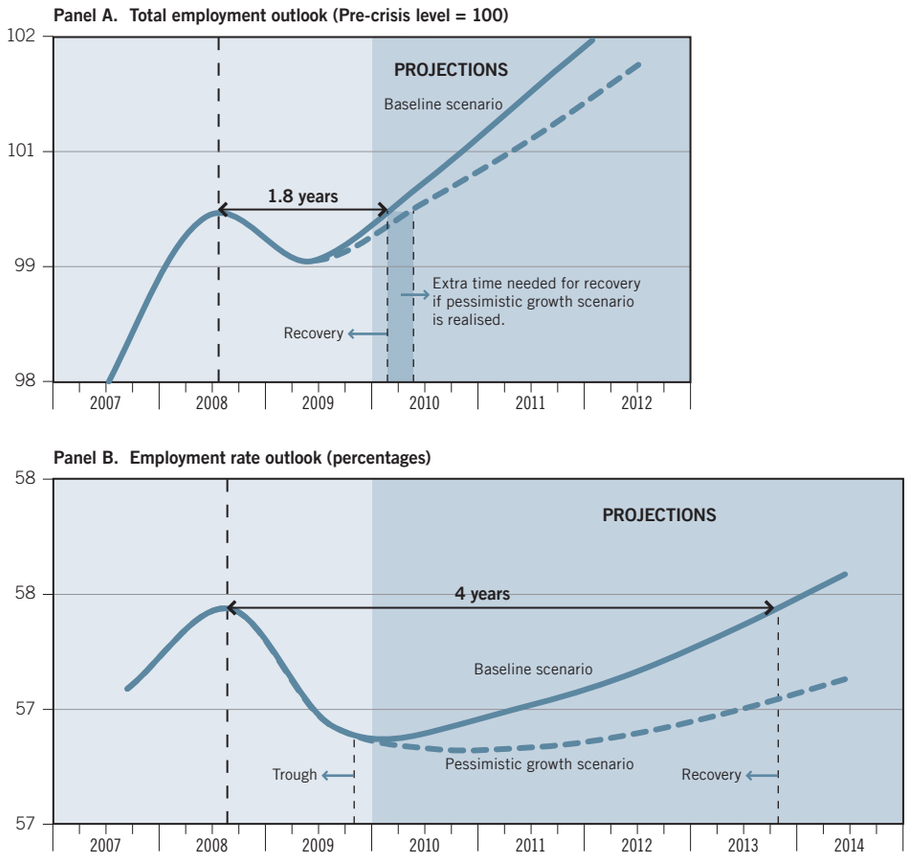
the first quarter 2011, close to 15 million jobs[22] in 35 countries will still be needed to restore the pre-crisis employment rate.

… and faster recovery will happen in emerging and developing countries, though it will take time to absorb the rise in the number of new entrants.

Upper-middle-income countries were clearly less affected in terms of job destruction – as already described in section A – and the overall impact on employment is rather V-shaped in nature, i.e. a quick recovery is also expected (figure 1.14, panel A). In fact, employment is already expected to have returned to pre-crisis levels in the first half of 2010. Even under the pessimistic growth scenario, a recovery in employment levels will only take an additional quarter to be achieved. Despite this relatively positive outlook, the speed at which employment is growing in this group of countries is far from sufficient, given the expected substantial increases in people entering the working-age population. As such, it is expected to take four years for the employment rate to attain pre-crisis levels if the economy grows at the current forecast pace, and not before 2014 if economic growth slows (figure 1.14, panel B). By 2011, even though a jobs recovery is anticipated, there will still be

22. This represents 2.2 per cent of the working-age population of the group in 2009.

Figure 1.14 Employment outlook in selected upper-middle-income countries, 2007–2014



Source: IILS estimates based on ILO, Laborsta database; IMF (2010); UN (2010).

an employment gap of close to 4 million jobs in 22 countries compared with pre-crisis levels.[23]

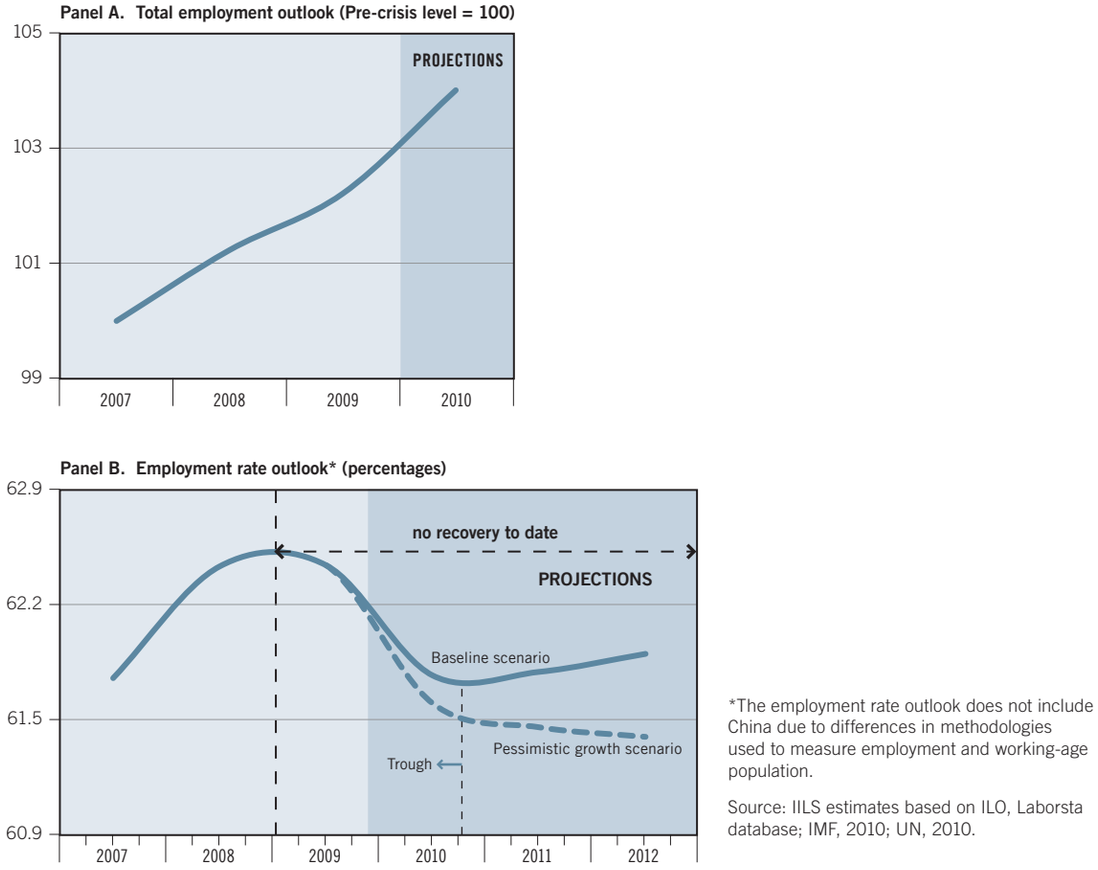
In terms of the final group (lower-middle-income countries), employment did not fall on a year-on-year basis – although, as section A illustrates, there were job losses in the second quarter of 2009 and significant country variation in the impact. Nevertheless, both scenarios call for a continuation in employment growth in the coming years. However, in these countries the growth in the working-age population is expected to continue to outpace the growth in jobs, meaning that the employment rate is likely to decline until the end of 2010 in the baseline scenario, and for the foreseeable future if the pessimistic growth scenario is taken into account (figure 1.15). Consequently, for 2011 there will be an employment gap of approximately 3 million jobs[24] in 11 countries compared with pre-crisis levels.

In 2011, the employment shortfall is estimated at over 22 million jobs vis-à-vis the pre-crisis situation when projections take into account the growing working-age population.

The outlook in terms of geographic regions is also rather heterogeneous. However, in terms of employment levels – consistent with the analysis above – advanced

23. This represents 0.7 per cent of the working-age population of the group in 2009.
24. This represents 0.6 per cent of the working-age population of the group in 2009.

Figure 1.15 Employment outlook in selected lower-middle-income countries, 2007–2012



*The employment rate outlook does not include China due to differences in methodologies used to measure employment and working-age population.

Source: IILS estimates based on ILO, Laborsta database; IMF, 2010; UN, 2010.

Table 1.1 Employment gaps and recovery times in 68 countries by region

World regions	Employment level: Time to recover pre-crisis levels	Employment rate: Time to recover pre-crisis rates	Employment rate gap by 2011: Million jobs
Africa	In 2010	Not before 2015	1.4
Latin America and the Caribbean	Recovering	Not before 2015	2.6
Advanced countries	Not before 2015	Not before 2015	14.5
Central and Eastern Europe and Central Asia	In 2012	In 2012	1.9
Asia	Recovering	In 2015	1.7

Note: Data for Africa refer only to Egypt, Mauritius, Morocco and South Africa. Estimates for Central and Eastern Europe and Central Asia include data for Turkey. In addition, this group of countries is likely to see a recovery in employment rates to pre-crisis levels before a recovery in employment levels due to the trend of decreasing working-age populations. The employment rate gap is the number of jobs needed to restore the pre-crisis employment rate.

Source: IILS estimates based on ILO, Laborsta database; IMF, 2010.

countries are estimated to be the last country group to recover to pre-crisis job levels (not before 2015). Given the substantial increases in the working-age population, however, most groups of countries (except Central and Eastern Europe and Central Asia[25] and Asia) are unlikely to see a return to pre-crisis employment rates in the medium term. Taking these two trends into account, i.e. stagnant employment growth and rising working-age population, the employment gap (number of jobs needed to restore the pre-crisis employment rate) is estimated to reach over 22 million in 2011 in all regions,[26] of which the bulk is in advanced countries (table 1.1). In Africa, Asia, Latin America and the Caribbean, and Central and Eastern Europe and Central Asia, the employment gap will be approximately 7.5 million jobs.

C. Promoting a quality, job-rich and sustainable recovery: The way forward

As the two previous sections illustrate, not enough jobs are being created, especially when the growing working-age population is taken into account. Individuals are adjusting to this jobless recovery by taking up jobs below their expectations (in terms of hours, wages and skills) or, in some instances, in the informal economy. As a result, there are concerns about the quality of jobs, even in instances where employment is growing.

In other cases, individuals are resorting to leaving the labour market entirely, even though many would prefer to be working, exacerbating the challenge of policy-makers to build and ensure a sustainable and inclusive recovery. Moreover, against the backdrop of fiscal constraints, policy-makers must be careful to avoid short-term solutions that – while complying with pressures to cut deficits quickly – will create long-term labour market and social challenges which may prove difficult and costly to undo.

1. Risks of social unrest

A jobless recovery is likely to bring forth a number of social challenges. In particular, as workers become increasingly discouraged by their job prospects, their discontentment could spread and deepen, damaging social cohesion. In addition, as the economic recovery begins to take shape, the social climate may be influenced by the breadth and quality of the jobs recovery. This is of particular concern given that even before the crisis the benefits of the extended growth period were unevenly distributed, i.e. employment growth was in many cases poor in quantity and quality, especially in many developing countries, and income inequality rose in most countries (ILO, 2008b). Decent work is central to people's well-being, and the global social climate is shaped by employment as it provides, among other things, income while paving the way for broader social and economic development.

25. See the note to table 1.1 for an explanation of the employment rate trend for Central and Eastern Europe and Central Asia.
26. This represents 1.5 per cent of the working-age population of the 68 countries analysed in 2009.

These issues are taken up in Chapter 2, which analyses the risk of social unrest. Specifically, it looks at the extent to which people are worried about losing their incomes, jobs, and pensions and whether perceptions of unfairness have grown in recent years. It also examines the extent to which social climate indicators are related to labour market developments, including crisis responses. Indeed, the chapter highlights the role of a job-rich recovery in alleviating social tensions.

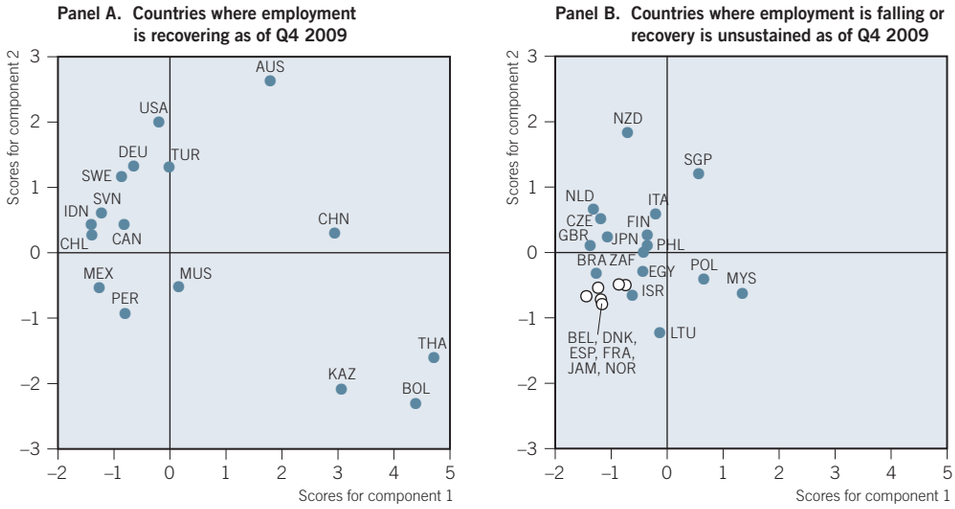
2. Role of labour market programmes

As sections A and B have demonstrated, the duration and intensity of the labour market impacts of the financial and economic crisis – and recovery to date – vary considerably by country. The heterogeneous impact is persistent across income groups and regions. The variation in employment losses is likely to be a function of a number of factors, including structure of the economy, exposure to financial sector and labour regulations (see below), but is also due, to some extent, to countries' different policy responses to the crisis. Indeed, the nature (content) and extent (size) of country responses has varied considerably.[27] Stimulus packages ranged from under 1 per cent of GDP in some cases to over 10 per cent in others. In some instances, efforts were narrow in focus, relying principally on infrastructure investment, for example, while other countries took a more comprehensive and varied approach. As countries look for ways to promote job creation, it is useful to examine the variation in country responses for possible lessons learned.[28] One way is via a principal component analysis (PCA), which reduces the various policy variables in the data set to principal components, where each component is a linear weighted combination of the original variables of country responses. This multivariate statistical technique allows the grouping of countries into predetermined categories (components), reflecting the different types of policy intervention.

To assess the variation in country responses to the crisis, the PCA is undertaken using the following variables: (i) size of the stimulus package as a percentage of GDP, to reflect the magnitude in which countries responded; and (ii) the breakdown of the stimulus into different types of measures, including tax cuts, infrastructure spending, labour market measures and social transfers, as a percentage of GDP, to examine the breadth of policy responses. Two of the components explain around two-thirds of the variation in country responses.[29] In particular, component 1 is explained principally by the size of the stimulus package (as well as by spending on infrastructure investment).[30] In this respect component 1 is indicative of the extent or size of the response. Therefore, a country with a higher score for component 1 can be identified with a larger response, but the response is more focused in nature, i.e. spending principally on infrastructure. Conversely, the variation in component 2 is derived from tax cuts, social transfers and, to a lesser

27. See for example ILO, 2009c.
28. This analysis builds on the country-level examination of lessons learned undertaken in ILO, 2009b.
29. Component 1 explains 44.2 per cent of the variation in the original data and component 2 an additional 20.3 per cent of the variance.
30. Component loadings for these two variables (stimulus spending and infrastructure spending as a percentage of GDP) in component 1 are 0.61 and 0.54, respectively.

Figure 1.16 Principal component analysis scores, by country and type of employment recovery as of 2009



Note: The analysis of employment recovery is based upon seasonally adjusted data.

Source: IILS estimates based on ILO, Laborsta database.

extent, labour market measures.[31] As such, component 2 is representative of a varied approach to addressing the crisis.

For the purposes of this analysis, country scores for each of the two retained PCA components are presented in two separate graphs: one for countries where employment is recovering, and another for countries where employment is still falling or is unsustained (figure 1.16, panels A and B). The analysis illustrates that countries where employment growth has turned positive in the most recent period (panel A) have – with the exception of Mauritius, Mexico and Peru – positive scores (relatively high in most countries) for either component 1 or component 2. Moreover, the results indicate that in the majority of these countries, the government response could be characterized as more varied than large, i.e. more countries with higher scores for component 2 than for component 1, and therefore tax cuts, social transfers and labour market measures played a more important role than the overall size of the stimulus. Conversely, countries where employment has yet to recover (panel B) are concentrated primarily around the axis, i.e. their responses were neither larger and focused nor varied – the exceptions in this group are Malaysia, New Zealand and Singapore, where employment seems to have reacted less to government measures.

This highlights the importance of having an integrated but varied approach to promoting employment; but it also reinforces the fact that programmes do not have to be expensive to work. This is crucial given that policies to promote (and retain) employment are at risk of being discontinued or downsized in the face of calls to control government spending. Indiscriminately cutting labour market and social measures – especially in countries where an employment recovery has not yet taken place – would have a number of adverse consequences, including potentially derailing the economic recovery. These issues are taken up in more detail in Chapter 3 which focuses on the effectiveness of labour market programmes to

31. Component loadings for these three variables (tax cuts, social transfers and labour market measures as a percentage of GDP) in component 2 are 0.71, 0.47 and 0.40, respectively.

foster job creation and limit further employment losses. In this respect, governments can improve the state of both their public finances and the labour market situation by reorienting action towards certain areas, including the more widespread use of active labour market policies. The chapter highlights a number of measures where such an investment would provide long-term positive returns for both individuals (in terms of jobs) and balance sheets (in terms of cost-effectiveness). The chapter also stresses that an early exit from current measures and the hasty implementation of consolidation plans is likely to worsen the sovereign debt crisis that is looming in some countries.

3. Properly designed labour regulation: Avoiding labour market duality

To address labour market challenges, policy-makers also often turn to examining the role of labour market regulations – in particular, employment protection legislation (EPL).[32] Less strict EPL, by facilitating the hiring and firing process, can promote job creation and job destruction and the reallocation of workers to sectors that are more productive, e.g. ones with improved technologies.[33] More stringent EPL, however, can enhance income and job security for workers. It can also promote longer-term employment relationships and firm-specific human capital which in turn can have positive outcomes for employment and efficiency. Indeed, a more comprehensive approach to labour regulations can have social development and economic benefits (Sengenberger, 2005).

In times of crisis, the debate regarding the appropriate level of strictness of employment protection gains momentum.[34] This was particularly the case for the Republic of Korea during the 1997 Asian crisis. In exchange for financial support from the IMF, the Republic of Korea undertook a number of structural reforms, including those aimed at enhancing labour market flexibility by easing EPL. However, like reforms in other countries during the 1990s, the deregulation focused almost exclusively on temporary forms of employment rather than on regular employment.[35] As a consequence, the incidence of non-regular workers accelerated following the labour market reforms of the 1997 financial crisis. On the one hand, this contributed significantly to overall employment creation and the overall recovery, with growth in non-standard work rising rapidly. On the other hand, these developments led to a high degree of labour market segmentation: the divide between non-regular and regular workers widened. For temporary workers this translated into (i) lower employment quality, (ii) reduced access to existing social protection measures and (iii) fewer rights at work (Box 1.2).

Of particular concern in the context of the current crisis is the issue of vulnerability of non-regular workers to employment destruction. For the Republic

32. EPL refers to a set of regulations governing the hiring and firing process, both for regular and temporary employment and also for collective dismissals (the more onerous hiring and firing process is indicative of a higher EPL). Country-level EPL indicators have been developed by the OECD.
33. For example, in an attempt to reduce high unemployment rates and the incidence of long-term unemployment, most advanced economies since the mid-1980s – especially in Europe – relaxed EPL, especially on temporary forms of employment
34. For more information on the role of internal flexibility and EPL in the context of the current crisis, see Eichhorst et al. (Forthcoming).
35. Over the past two decades, the average EPL level for OECD countries for temporary employment dropped from 2.5 to 1.8, decreasing by 0.7 points, while the figure for regular workers remained more or less unchanged

Box 1.2. Labour market deregulation during periods of crisis: The case of the Republic of Korea

In late 1997, a financial crisis broke out in Asia. The government of the Republic of Korea turned to the IMF for financial support and agreed to a USD 56.8 billion bailout loan package. In return, the country had to comply with some IMF requests, including tight monetary and fiscal policies, liberalization of trade and the capital market, and economic reforms, mainly massive restructuring of *Chaebol*. The government also had to adhere to a number of labour market reforms; in particular, regulations regarding collective dismissals and the hiring of temporary workers were relaxed significantly (temporary work agencies were legalized in 1998).

Within the year following the 1997 financial crisis, Korea's overall EPL index level fell from 2.7 to 2.0. The change, while promoting overall employment growth, also promoted a certain degree of labour market segmentation as job creation was principally temporary in nature (figure 1.17). In particular, following the crisis there was a decline in job quality for non-regular workers:

- The ratio of average hourly wages for non-regular workers to regular workers was 68.0 per cent in 2008.
- Almost half of non-regular workers remained at the non-regular job after one year, while only 33.7 per cent moved into regular employment.
- Less than 40 per cent of non-regular workers have access to employment insurance and the national pension system, while the comparable figures for regular workers are 66 per cent and 77 per cent, respectively.
- Non-regular workers' unionization rate is very low, at 2.7 per cent, compared with 23.7 per cent for regular workers. As a result, non-regular workers tend to be systemically excluded from collective bargaining.

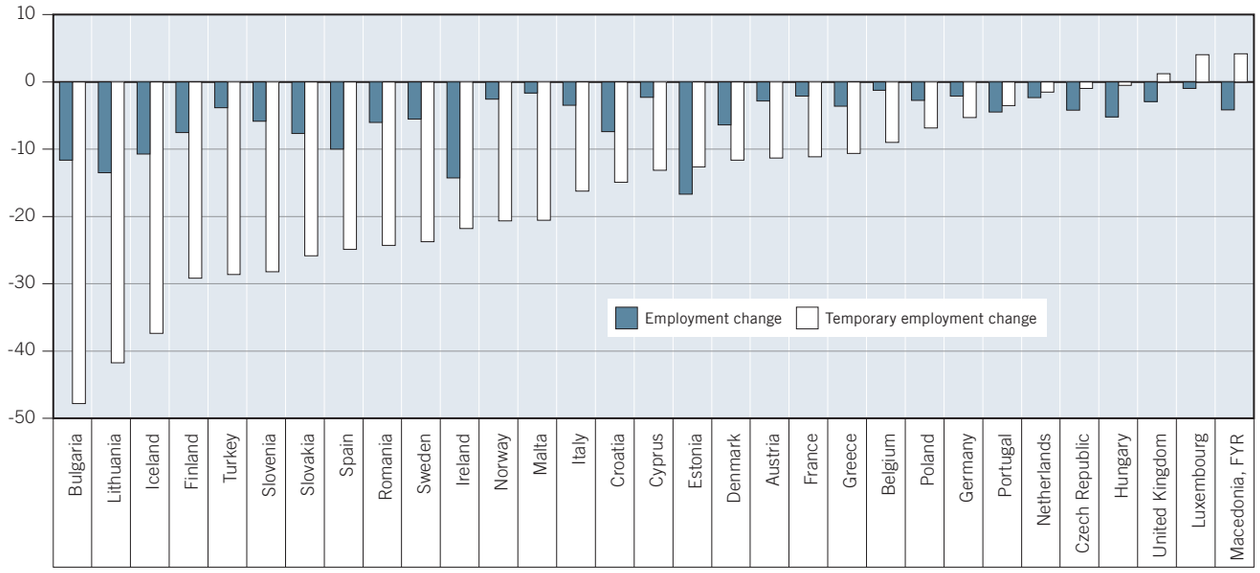
Figure 1.17 Employment shares by type of worker in the Republic of Korea, 1996–2002 (percentages)

Note: Non-regular workers include temporary and daily workers, which are classified by type of contract.

Source: Korea National Statistics Office, Economically Active Population Survey.

of Korea, for example, between the second quarter of 2008 and the first quarter of 2009, over 200 000 temporary jobs were lost – but permanent employment remained relatively stable. A similar trend is present in other countries, where temporary workers have borne the brunt of employment losses (figure 1.18). And much like the case of the Republic of Korea, temporary workers tend to be less well protected in terms of access to labour market support, such as unemployment insurance. As a result, non-standard workers are disadvantaged twice: first, in terms of employment stability, and second, in terms of access to adequate social benefits and active labour market support.

Figure 1.18 Employment losses during the current crisis*, by type (percentages)



*Changes in temporary employment are changes measured from peak to trough (by quarters); where a trough has not yet been attained, the latest available information is used. The beginning of the crisis is country-specific and is measured as the first term showing a negative change in total employment.

Source: IILS estimates based upon EULFS and national sources.

Policy-makers rightfully explore all avenues in seeking ways to encourage job growth and the reallocation of resources from less to more productive sectors. However, a certain level of regulation is necessary to protect workers from arbitrary decisions regarding dismissals and to ensure that firms internalize some of the social costs of labour turnover. Moreover, poorly designed deregulation – that which encourages the hiring of non-standard workers only (temporary, casual etc.) – may only serve to exacerbate existing dualities between these workers and permanent workers.

Instead, in the first instance, labour market reforms should consider job quality as well as job quantity. Second, given that the current labour market adjustment mechanism falls disproportionately on non-standard workers, reforms should work towards providing better social protection measures for these workers, including seeking ways to promote a better transition from non-standard to standard work. Finally, as discussed above – and to some extent in Chapter 3 – active and passive labour market programmes can play a key role in the efficient (re)allocation of labour resources while meeting employment and social objectives.

4. Rebalancing growth: The role of trade and consumption

A sustainable recovery is not possible without structural adjustments. There is a need to rebalance international trade and consumption between deficit countries in the developed world and surplus account countries in the developing world. Chapter 4 highlights two key challenges. First, the adoption of policies to raise domestic consumption and lower savings rates in surplus countries. Simulations of different policy scenarios and their respective effectiveness are considered. Second, the rebalancing of trade among surplus countries that have relied upon exports of

price-sensitive, labour-intensive goods to developed country markets, which will involve greater South–South trade; but addressing the fragilities of export dependency will require a broader set of industrial and labour policies.

5. Reforming the financial sector

Finally, while the financial sector played a key role in the onset of the crisis – and its devastating impact on the labour market – reform in this area continues to be lacking. The final chapter, Chapter 5, takes up the debate regarding reform proposals, but it takes a broader view of the issue. It presents a number of scenarios regarding reform options and their implications – and importance – for a sustainable recovery. In particular, the chapter argues that the benefits of stricter regulation in the form of lower economic volatility might outweigh the higher cost of financing which such regulatory changes will imply.

Appendix A

Country groupings by type of recovery and income level

Country	Income-level group[1]
Bulgaria (BGR)	Upper middle income, 3
Czech Republic (CZE)	High income, 4
Estonia (EST)	High income, 4
Greece (GRC)	High income, 4
Ireland (IRL)	High income, 4
Jamaica (JAM)	Upper middle income, 3
Lithuania (LTU)	Upper middle income, 3
Macedonia, FYR (MKD)	Upper middle income, 3
Moldova, Republic of (MDA)	Lower middle income, 2
Netherlands (NLD)	High income, 4
Romania (ROU)	Upper middle income, 3
Serbia (SRB)	Upper middle income, 3
Singapore (SGP)	High income, 4
Trinidad and Tobago (TTO)	High income, 4
United Kingdom (GBR)	High income, 4
Albania (ALB)	Lower middle income, 2
Argentina (ARG)	Upper middle income, 3
Australia (AUS)	High income, 4
Austria (AUT)	High income, 4
Belarus (BLR)	Upper middle income, 3
Belgium (BEL)	High income, 4
Brazil (BRA)	Upper middle income, 3
Canada (CAN)	High income, 4
Chile (CHL)	Upper middle income, 3
China (CHN)	Lower middle income, 2
Croatia (HRV)	High income, 4
Cyprus (CYP)	Lower middle income, 2
Denmark (DNK)	High income, 4
Egypt (EGY)	Lower middle income, 2
Finland (FIN)	High income, 4
France (FRA)	High income, 4
Germany (DEU)	High income, 4
Iceland (ISL)	High income, 4
Indonesia (IDN)	Lower middle income, 2
Israel (ISR)	High income, 4

Country	Income-level group[1]
Italy (ITA)	High income, 4
Jordan (JOR)	Lower middle income, 2
Kazakhstan (KAZ)	Upper middle income, 3
Korea, Republic of (KOR)	High income, 4
Latvia (LVA)	Upper middle income, 3
Malaysia (MYS)	Upper middle income, 3
Malta (MLT)	High income, 4
Morocco (MAR)	Lower middle income, 2
New Zealand (NZD)	High income, 4
Norway (NOR)	High income, 4
Poland (POL)	Upper middle income, 3
Portugal (PRT)	High income, 4
Slovakia (SVK)	High income, 4
Slovenia (SVN)	High income, 4
South Africa (ZAF)	Upper middle income, 3
Spain (ESP)	High income, 4
Sri Lanka (LKA)	Lower middle income, 2
Sweden (SWE)	High income, 4
Switzerland (CHE)	High income, 4
Thailand (THA)	Lower middle income, 2
Turkey (TUR)	Upper middle income, 3
Ukraine (UKR)	Lower middle income, 2
United States (USA)	High income, 4
Venezuela, Bolivarian Rep. of (VEN)	Upper middle income, 3
Colombia(COL)	Upper middle income, 3
Ecuador (ECU)	Lower middle income, 2
Hungary (HUN)	High income, 4
Japan (JPN)	High income, 4
Luxembourg (LUX)	High income, 4
Mauritius (MUS)	Low income, 1
Mexico (MEX)	Upper middle income, 3
Peru (PER)	Upper middle income, 3
Philippines (PHL)	Lower middle income, 2
Russian Federation (RUS)	Upper middle income, 3

[1] Income groups are based on GNI per capita according to the World Bank country classification, available at: http://go.worldbank.org/K2CKM78CC0. High-income countries are countries with a GNI per capita of USD 11,906 or more; upper-middle-income countries are countries with a GNI per capita of USD 3,855 to USD 11,905; and lower-middle-income countries are countries with a GNI per capita of USD 976 to USD 3,856.

Appendix B

The impact of financial crises on employment: An empirical analysis

Section B of this chapter provided employment projections from 2010 to 2015 which are based upon the following countries that experienced a crisis in the past and for which there is sufficient historical time series data:

- *High-income countries:* Econometric analysis for this group is based on 22 countries, 26 crises[36] and 737 observations. Countries in this group include: Australia, Canada, Czech Republic, Denmark, Estonia, Finland, France, Germany, Hungary, Iceland, Israel, Italy, Japan, Republic of Korea, New Zealand, Norway, Portugal, Slovakia, Spain, Sweden, the United Kingdom and the United States.[37]
- *Upper-middle-income countries:* Based on 26 countries and 33 crises: 211 observations were taken into account in the analysis, for Algeria, Argentina, Belarus, Brazil, Bulgaria, Chile, Colombia, Costa Rica, Dominican Republic, Jamaica, Kazakhstan, Latvia, Lithuania, Former Yugoslav Republic of Macedonia, Malaysia, Mauritius, Mexico, Panama, Poland, Romania, Russian Federation, Serbia, Suriname, Turkey, Uruguay and the Bolivarian Rep. of Venezuela.[38]
- *Lower-middle-income countries:* Based on 17 countries and 21 crises: 115 observations were taken into account in the analysis, for Albania, Armenia, Bolivia, China, Ecuador, Egypt, El Salvador, Georgia, Honduras, India, Indonesia, Moldova, Nicaragua, Paraguay, Philippines, Sri Lanka and Thailand.[39]

These projections draw on output–employment elasticities, which have been estimated by way of the econometric analysis of the employment impact of the recovery phase during past financial crises. The projections are constructed by applying the employment elasticity of each group to the GDP growth projections from the IMF

36. The following crises were taken into account in the analysis of this group: Australia, 1989–92; Canada, 1983–85; Czech Republic, 1996–2000; Denmark, 1987–92; Estonia, 1998; Finland, 1991–95; France, 1994–95; Germany, late 1970s; Hungary, 1991–95; Iceland, 1975; Iceland, 1989; Israel, 1977; Israel, 1985; Italy, 1981; Italy, 1990–95; Japan, 1997–2001; Republic of Korea, 1997–98; New Zealand, 1987–90; Norway, 1991–93; Portugal, 1983; Slovakia, 1998–2000; Spain, 1977–81; Sweden, 1991; United Kingdom, 1974–76; United Kingdom, 1980s–1990s; and the United States, 1988. The crises of all groups have been identified on the basis of Laeven and Valencia, 2010 and 2008.

37. Note that the high-income group contains more observations than the other groups because the analysis of the former is based on quarterly information rather than annual information.

38. The following crises were taken into account in the analysis of this group: Algeria, 1990–94; Argentina, 1989–91; Argentina, 1995; Argentina, 2001–03; Belarus, 1995; Brazil, 1994–98; Bulgaria, 1996–97; Chile, 1981–85; Colombia, 1982; Colombia, 1998–2000; Costa Rica, 1987–91; Costa Rica, 1994–95; Dominican Republic, 2003–04; Jamaica, 1996–98; Kazakhstan, 1999; Latvia, 1995–96; Lithuania, 1995–96; Macedonia, 1993–95; Malaysia, 1997–99; Mauritius, 1996; Mexico, 1994–96; Panama, 1988–89; Poland, 1992–94; Romania, 1990–92; Russian Federation, 1998; Serbia, 2000; Suriname, 1990; Turkey, 1982–84; Turkey, 2000; Uruguay, 1981–85; Uruguay, 2002–05; Venezuela, 1994–98; and Venezuela, 2002.

39. The following crises were taken into account in the analysis of this group: Albania, 1994; Armenia, 1994; Bolivia, 1986; Bolivia, 1994; China, 1998; Ecuador, 1982–86; Egypt, 1990; El Salvador, 1989–90; Georgia, 1999; Honduras, 1990; India, 1993; Indonesia, 1997–2001; Moldova, 1999; Nicaragua, 1990–93; Nicaragua, 2000–01; Paraguay, 2002; Philippines,1983–86; Philippines, 1997–2000; Sri Lanka, 1989–91; Thailand, 1983; Thailand, 1997–2000.

Table A2.1 Definitions and sources of variables used in the regression analysis

Variable	Definition	Source
GDP annual growth rate	Annual growth rate of real GDP, in national currency	IILS calculations based on the IMF *World Economic Outlook* (WEO), April 2010
GDP quarterly growth rate	Quarterly growth rate of real GDP, in national currency	IMF, IFS database and OECD, *Economic Outlook* No. 87
Employment growth for high-income countries	Quarterly growth rate of total employment	OECD, *Economic Outlook* No. 87
Employment growth for upper-middle-income countries	Annual growth rate of total employment	ILO, Laborsta database
Employment growth for lower-middle-income countries	Annual growth rate of total employment	IMF, IFS database
Frequency of financial crises	Time frames of financial crises in the countries analysed	Authors' estimates based on Laeven and Valencia, 2010 and 2008.

Table A2.2 Regression results [1,2]

	High income	Upper middle income	Lower middle income
GDP (annual growth rate)	0.0238 (3.39)**	0.2785 (5.69)**	0.0481 (0.61)
Lag 1 of GDP	0.0311 (4.16)**		0.2624 (3.45)**
Lag 2 of GDP	0.0347 (4.52)**		
Lag 3 of GDP	0.0289 (3.75)**		
Lag 4 of GDP	0.0124 (1.68)*		
Lag 5 of GDP	0.0126 (1.88)*		
Constant	0.0123 (0.37)	0.4126 (1.51)	0.3731 (0.81)
Fixed effects	Yes	Yes	Yes
Observations	737	211	115
Number of crisis episodes	26	33	21

[1] Estimated based on ordinary least squares. All regressions are controlled for country-fixed effects. Absolute value of *t*-statistics in parentheses. Significance levels: * significant at 5 per cent; ** significant at 1 per cent.

[2] For details of the countries included in each group see footnotes 37–40.

(from 2010 on) at a country level.[40] In this sense, all statistically significant partial elasticities emerging from the inclusion of lagged GDP growth rates were taken into account by applying them to the GDP growth rate of their corresponding period by country.

The elasticities of employment growth (e_{it}^{L}) to GDP changes are calculated by means of Okun Law panel regressions (following the methodology developed in Escudero, 2009) for the three groups of countries listed above. The following equation was estimated independently for each of the three country groups:

$$(1)\ e_{it}^{L} = \beta_1 Y_{it} + \beta_2 Y_{it-n} + \varepsilon_{it}$$

40. Country-specific annual forecasts from IMF were converted into quarterly rates using the "effective periodic rate" calculation and were then used to establish future quarterly growth rates of employment for the high-income countries group.

Table A2.3 Alternative estimators [1,2]

Panel A. High-income countriess

	Baseline equation (heteroscedasticity)	GLS	GLS (heteroscedasticity)	GLS (autocorrelated errors)
GDP (annual growth rate)	0.0238 (3.39)**	0.0291 (4.05)**	0.0658 (6.31)**	0.0571 (6.17)**
Lag 1 of GDP	0.0311 (4.16)**	0.0397 (5.27)**	0.0839 (8.29)**	0.0840 (8.28)**
Lag 2 of GDP	0.0347 (4.52)**	0.0455 (5.98)**	0.0724 (7.21)**	0.0756 (7.26)**
Lag 3 of GDP	0.0289 (3.75)**	0.0399 (5.28)**	0.0669 (6.72)**	0.0673 (6.48)**
Lag 4 of GDP	0.0124 (1.68)*	0.0207 (2.82)**	0.0407 (4.09)**	0.0427 (4.19)**
Lag 5 of GDP	0.0126 (1.88)*	0.0167 (2.42)*	0.0223 (2.21)**	0.0235 (2.56)**
Constant	0.0123 (0.37)	-0.0233 (-0.69)	-0.1517 (-6.96)	-0.1529 (-4.99)
Observations	737	737	737	737
Number of crisis episodes	26	26	26	26

Panel B. Upper-middle-income countries

	Baseline equation (heteroscedasticity)	GLS	GLS (heteroscedasticity)	GLS (autocorrelated errors)
GDP (annual growth rate)	0.2785 (5.69)**	0.3140 (6.70)**	0.3063 (9.21)**	0.3025 (8.95)**
Constant	0.4126 (1.51)	0.3165 (1.11)	0.4423 (2.24)*	0.4303 (1.98)*
Observations	211	211	211	211
Number of crisis episodes	33	33	33	33

Panel C. Lower-middle-income countries

	Baseline equation (heteroscedasticity)	GLS
GDP (annual growth rate)	0.0481 (0.61)	0.0138 (0.18)
Lag 1 of GDP	0.2624 (3.45)**	0.2536 (3.20)**
Constant	0.3731 (0.81)	0.2829 (0.60)
Observations	115	115
Number of crisis episodes	21	21

[1] All regressions are controlled for country-fixed effects. Absolute value of *t*-statistics (*z*-statistics in the tests for autocorrelation) in parentheses. Significance levels: *significant at 5 per cent; **significant at 1 per cent.

[2] For detail of the countries included in each group see footnotes 31–40.

where L_{it} corresponds to the annual (or quarterly for high-income countries) growth rate of employment and ΔY_{it} is the explanatory variable, measured by the annual (or quarterly for high-income countries) growth rate of GDP of the countries analysed. One or more lags of the growth rate of GDP are included in the estimations, depending on which group of countries is analysed. An overview of the different variables used and their sources and definitions is given in table A2.1.

To construct the panel, data on employment growth around the years of crises were collected and centred in t_0. This crisis-specific central time period corresponds to the year when the country experienced the lowest GDP annual/quarterly growth rate. In this way, a panel was constructed with an average of 34 observations for employment growth around the recovery phase of past crises

(t – 8 to t + 25) for high-income countries and nine observations for employment growth around the recovery phase of past crises (t – 2 to t + 6) for upper-middle- and lower-middle-income countries. Table A2.2 gives a synthetic review of the econometric estimates reporting these elasticities.

To take into account the peculiarities of the data set, regressions have been re-run to account for heteroscedasticity. To ensure that one or some of the countries did not influence the results, reduced regressions were also estimated by excluding the countries analysed one at a time. Moreover, table A2.3 presents GLS estimates and controls for autocorrelated error terms. As can be seen in all panels of table A2.3, all coefficients remain highly significant, and the absolute sizes of the estimated effects change relatively little between different estimation methods, giving some confidence in the estimated effects.

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2 Global social climate: Trends and challenges for policy*

Main findings

- Recent survey data indicate that there has been a general global decline in life satisfaction and historical data show that this decline is unprecedented. Compared with the data from the 1980s and the 1990s, developed economies in Western Europe and economies in Central and Eastern Europe show some of the most severe declines in life satisfaction.
- Confidence in government has also declined, as have perceptions that policies are fair or lead to a better future. These trends are most common among advanced economies. Among Western European countries, there is a perception of growing political extremism and social discontent. Perceptions of unfairness have increased in Latin America and remain high in Asia and, to a lesser extent, sub-Saharan Africa.
- There have been documented cases of social unrest related to the financial and economic crisis in at least 25 countries. These cases have taken the form of protest against governments' crisis responses and austerity measures aimed at repairing government balance sheets, protests against employers, and violent clashes between the government and protesters. As governments try to contain the fallout from the crisis, the social contract between State and citizen has been put to the test.
- Empirical analysis suggests that higher unemployment and income inequalities are key factors behind growing social unrest. These two factors are more important in determining the risk of social unrest than falling GDP per se. These findings stress the importance of crisis responses based on job-rich, balanced strategies, in line with what is recommended in the Global Jobs Pact.

* Excellent research assistance by Phillip C. Bastian is gratefully acknowledged.

- The longer-term objective should be to reduce income inequalities while promoting efficiency, notably through financial reforms (see Chapter 5). Elevated unemployment resulting from the crisis has caused the bottom of the earnings distribution to fall off relative to the median, which in turn has increased inequality in earnings. It is important to address rising inequality in order to restore the global social health. And in order to reduce the growing income inequality, emphasis should be placed on better redistributive policies, especially progressive taxation and better social protection.

Introduction

In the wake of the financial and economic crisis, the global social climate faces numerous risks, in particular from the elevated unemployment rates and sluggish job growth. As Chapter 1 has documented, despite the economic recovery that started in the second half of 2009, employment growth is expected to remain sluggish, especially when the growing working-age population is taken into consideration. The ILO's mission statement says that work is central to people's well-being. In addition to providing income, it paves the way for broader social and economic development, strengthening individuals, their families and communities. Hence, it should not come as a surprise that employment loss is one of the most important risks facing the global social climate. The crisis has also had a disproportionate impact on low-income groups, which had not benefited much from the expansionary period. Thus, job losses combined with growing income inequalities pose a threat to the social climate.[1]

However, the discussion of social climate is fraught with problems, the foremost being that there is no one indicator of social climate. For example, decline in life satisfaction, decline in job satisfaction and increased perception of unfairness are some of the many indicators of social climate but there are many others indicative of social health. Most of these variables tend to be interlinked, but taken together they provide an overall picture of social climate. Meanwhile, social unrest in the form of protests against the government is a visible manifestation of an unhealthy social climate. For the purpose of this chapter, social unrest is defined as protest against governments' crisis responses and austerity measures aimed at repairing government balance sheets, protests against employers, and violent clashes between government and protestors. The primary objective of this chapter is to assess empirically the risks and challenges facing the global social climate by exploiting recent data covering several social indicators.

Section A documents the trends in various social indicators in over 150 countries since the start of the crisis. The indicators include perceptions of unfairness, trust in government and its ability to handle the crisis, perception of one's standard of living getting better, life satisfaction, job satisfaction and a society's endowment of trust and happiness (Parvin, 1973; Jenkins, 1983; Jenkins and Wallace, 1996; Oswald, 1997; Clark et al., 2008). Unlike all other indicators, the data on trust and happiness are pre-crisis. Section B examines the extent to which these indicators are related to labour market developments as well as crisis responses, in line

1. For more on the threat facing the global social climate, see: Economist Intelligence Unit, 2010; European Commission, 2010; United Nations, 2009; OECD, (forthcoming).

with earlier studies (Lehman-Wilzig and Ungar, 1985; Walton and Ragin, 1990; Clark and Oswald, 1994; Auvinen, 1996; Oswald, 1997; Bohrer and Tan, 2000; Clark et al., 2004; Norris et al., 2005; Clark, 2006). The concluding section of the chapter calls for a job-rich recovery in line with the Global Jobs Pact (GJP) as the key to reducing the risks facing the social climate.

A. Social climate since the start of the crisis

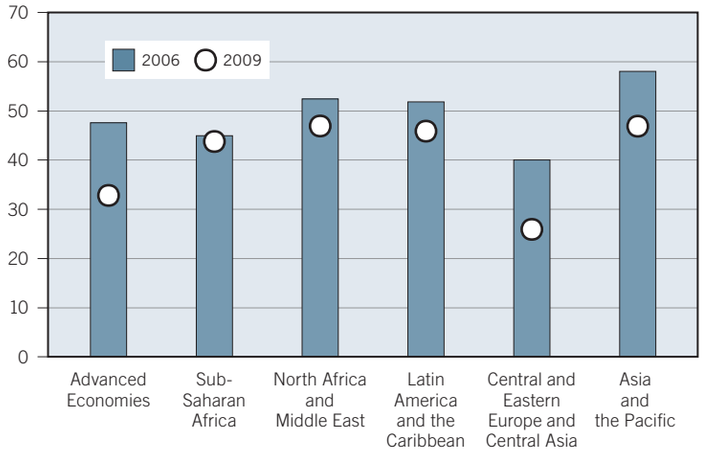
A global survey of over 150 countries and territories has been used to assess social perceptions about the crisis. The indicators collected from the survey are sparse and not necessarily related. However, they all point towards a picture of heightened socio-economic insecurity around the world, although with considerable cross-country differences. So far, the sense of insecurity has not led to widespread collective protest or social unrest.

Pessimism about quality of life has increased since the start of the crisis…

As economic insecurity has risen, people are becoming increasingly pessimistic. Many report that they do not expect their standard living to be better in five years' time. This is significant, as it suggests that people expect the fallout from the crisis to continue well into the future, even though output has recovered in many countries.

For example, in 2009 only 32 per cent of respondents in advanced economies said that their standard of living was getting better, down from 48 per cent in 2006 (figure 2.1). Central and Eastern Europe and Central Asia saw the biggest decline in people's perceived standard of living – in 2009 only 25 per cent of people in these countries said that their standard of living was getting better, down from 40 per cent in 2006. Other parts of the world also saw a decline in people's perception that their standard of living was getting better. The general global trend shows that people are not happy with the direction their country has been taking in the past two years.

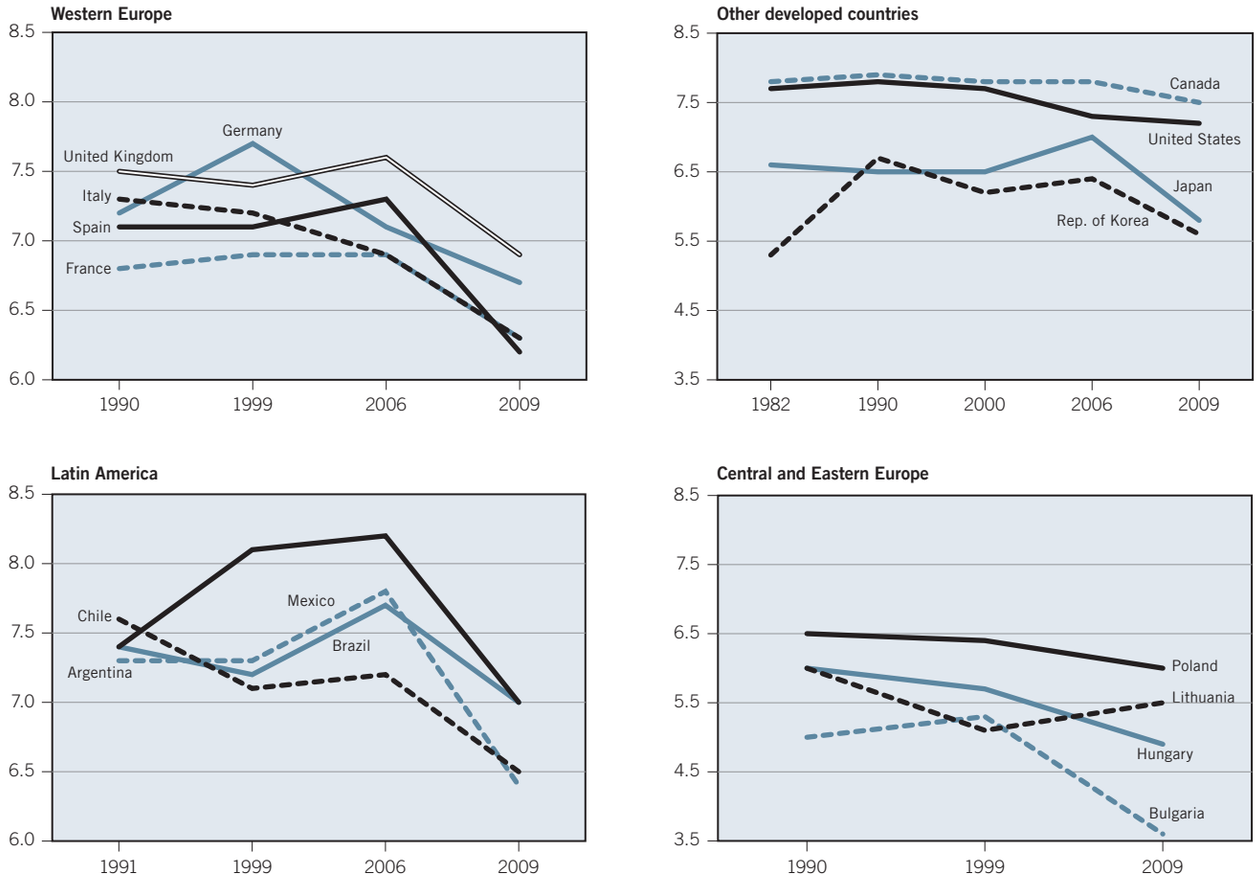
Figure 2.1 Perceived improvement in standard of living, 2009 vs. 2006



Note: Percentage of respondents that answered that their lives were getting better.

Source: IILS, based on Gallup World Poll Data.

Figure 2.2 General global decline in life satisfaction after the crisis



Note: Selected countries based on availability of historical data.

Respondents were asked to rank from 0 to 10 how satisfied they are with their life. Mean values for each survey year are presented in the figure. Surveys were conducted with gaps of several years, ranging from five to ten years.

Source: IILS based on World Values Survey and Gallup World Poll Data.

This decline is unprecedented in the historical data (see figure 2.2). Among Western European countries, Italy and Spain have seen the sharpest declines in people's satisfaction with their lives. The decline in Spain was particularly severe, reflecting the dramatic change in the Spanish economy between 2006, when the country was enjoying rapid growth, and 2009, when the bubble burst, causing extremely high unemployment.

Among other developed economies, Japan has seen the most severe decline in life satisfaction. Countries in Latin America and in Central and Eastern Europe have also seen sharp declines in people's satisfaction with their lives. Argentina and Mexico have seen some of the most severe declines, although this may reflect other recent political developments. Meanwhile, Bulgaria and Hungary show the sharpest reduction in people's satisfaction with their lives among Eastern European countries.

Furthermore, among advanced economies, people are worried that their children's future is not as secure as they would like it to be. When asked whether children have the opportunity to learn and grow in their country, a smaller percentage of respondents in 2009 said yes than in 2005. For example, 73 per cent of Germans in 2009 said that their children had the opportunity to learn and

grow, down from 84 per cent in 2005.[2] Similarly, in the United Kingdom and the United States, around 80 per cent of people were optimistic about their children's future in 2009, down from 90 per cent in 2005.

People in Central and Eastern European Countries and Central Asia are also less optimistic about their children's future, again reflecting how hard these countries were hit during the crisis. However, other regions of the world show no discernible change in people's attitudes. In some cases, such as sub-Saharan Africa and North Africa and the Middle East, people are actually more optimistic about their children's future now than in 2005.

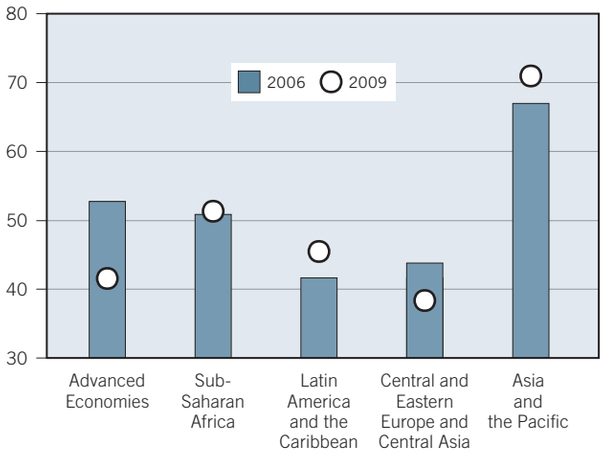
…hand in hand with lower confidence in government, with the exception of Asia and Latin America…

Lower confidence in government usually serves as an indicator of people's dissatisfaction towards the status quo. Among advanced countries, confidence in government declined from 52 per cent in 2006 to 41 per cent in 2009 (figure 2.3). Likewise, among countries in Central and Eastern Europe and Central Asia, confidence in government was down to 38 per cent in 2009 from 43 per cent in 2006. Not surprisingly, the recent bouts of social and political unrest have been primarily limited to advanced economies, especially those in the European Union. In other parts of the world, there has been either no discernible change or an actual increase in people's confidence in their governments.

…and growing perceptions of unfairness among advanced economies, in Eastern Europe and Latin America.

Rising economic insecurity and its manifestation in the form of social unrest is a more visible consequence of the financial and economic crisis of 2008–09, but there are other consequences that tend to be more latent and invisible. For example, people's perception of fairness has suffered in the last two years. When asked whether they could get ahead by working hard, a higher percentage of people said no in 2009 compared with 2006 (see figure 2.4). Among advanced economies and

Figure 2.3 Lower confidence in government, especially among advanced and Central and Eastern European economies (percentages)

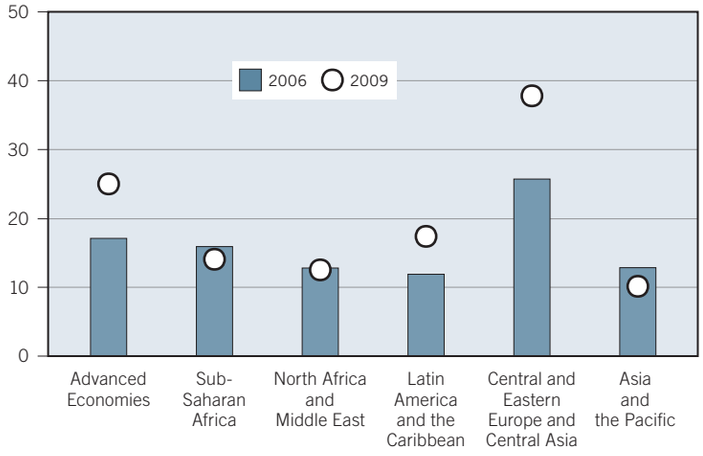


Note: North Africa and the Middle East not included because of small sample size.

Source: IILS, based on Gallup World Poll Data; surveys conducted in 2009.

2. Source: Gallup World Poll Data, 2010.

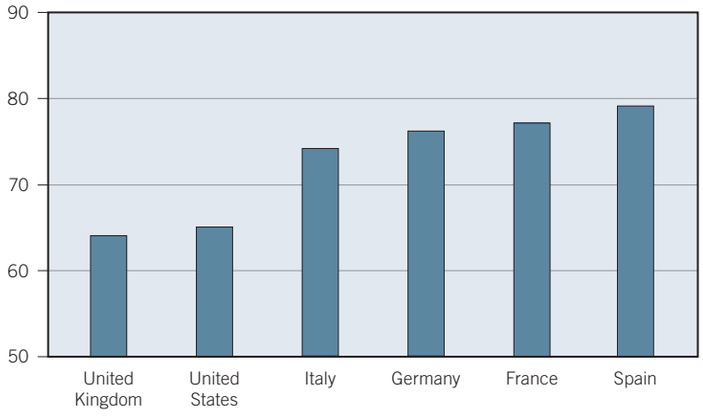
Figure 2.4 Recent trend in perception of unfairness (percentages)



Note: Survey respondents were asked: "Can people get ahead in this country by working hard or not?"; the chart shows percentage of respondents that said "no".

Source: IILS, based on Gallup World Poll Data.

Figure 2.5 Public opposition to government bailouts of banks (percentages)



Note: Data available only for France, Germany, Italy, Spain, the United Kingdom and the United States.

Selected countries based on data availability.

Source: Based on Harris Poll; surveys conducted in March, 2009.

countries in Eastern and Central Europe, perceptions of unfairness were already high in 2006, but in the aftermath of the crisis they increased even further. For example, in Greece and Italy, 40 per cent of the respondents to the World Gallup Poll reported that their countries were "unfair" in 2009. Similarly, in Lithuania and Ukraine, 64 and 58 per cent of the respondents, respectively, believed that their countries were unfair.

Among the advanced economies, people's perception of increased unfairness appears to stem largely from a general disapproval of government bailouts of banks and financial institutions (see figure 2.5). On the one hand, there is talk of reining in public spending and of fiscal consolidation while, on the other hand, there are news reports of banks and financial institutions handing out huge bonuses. Politicians, unions and media personalities seized upon this outrage to further their own causes, which intensified public anger.

There have been some collective manifestations of social unrest associated with crisis responses…

There have been documented cases of unrest related to the financial and economic crisis in at least 25 countries (see table 2.1). These cases have taken the form of

protests against governments' crisis responses and austerity measures aimed at repairing government balance sheets, protests against employers, and violent clashes between government and protesters. As discussed before, the main source of this unrest is loss in employment and a decline in economic activity. Meanwhile, protests against employers stems from workers' dissatisfaction with pay cuts, benefit reductions, and mass lay-offs. But another cause is the fiscal consolidation aimed at repairing government balance sheets.

In order to weather the global economic slowdown, close to 2 per cent of world GDP was spent on fiscal stimulus measures (Khatiwada, 2009). Most countries engaged in expansionary fiscal and monetary policies. However, economic and financial activity still remains low, which in turn has reduced revenues. With declining revenues and elevated levels of public spending, public debt has skyrocketed, especially in advanced economies. Moody's, a rating agency for financial products, warned in March 2010 that even countries such as France, Germany, the United Kingdom and the United States could risk losing their high-grade credit rating (which keeps borrowing affordable) if they did not reduce their debt levels (Schneider, 2010). It is no surprise that in order to remain competitive in the global financial markets and continue enjoying access to international capital, many countries have announced austerity measures in the form of increase in taxes and/or reduction in spending. In the case of the European Union (EU), the very future of the euro as a multinational currency is dependent on whether countries can rein in their public spending.

The most prominent case of severe scaling back on spending is Greece. Austerity measures announced by the Government of Greece on 1 May 2010 include cuts in public sector salaries, scaling back of pensions for retired workers, a rise in value added tax from 21 per cent to 23 per cent, elimination of public sector annual bonuses amounting to two months' pay and a 10 per cent increase in taxes on fuel, tobacco and alcohol. To date the Government has made no announcements regarding rules for layoffs in the public sector (one out of three workers are employed in the Greek civil service). Overall, the increase in taxes and reduction in spending amounts to 10 per cent of Greece's GDP. By the most optimistic estimates, Greece is expected to be in recession until 2012. Greek workers and labour unions have taken to the streets to protest against the austerity measures, and in summer of 2010 the protests turned violent. The sacrifice asked of Greeks by their Government is severe, and will be a real test of the political and social cohesion of the country.

Other countries, including Ireland, Portugal and Spain, have also seen similar pressures. For example, in Spain, workers have been protesting in major cities against the Government's plans to cut spending and increase the retirement age. Similarly, in Portugal there is a popular outcry against the Government's plans to freeze public sector workers' pay. In Ireland, there have been protests against the Government's austerity measures. In other EU countries, there have been protests against governments' perceived failure to respond to the crisis. For example, in France, unions have joined forces to protest against the stimulus measures implemented by the Government. The unions claim that the measures are inadequate to address the labour market and social problems facing the country. Similarly, Italy has seen public protests against the Government's response to the crisis.

Eastern Europe has been especially reactive, as many of these economies, which grew rapidly during the earlier part of the decade, have been particularly hard hit by the crisis. Bulgaria, Estonia, Latvia and Lithuania have all seen major protests critical of their governments' handling of the economy. In Latvia, for instance, where total employment declined by almost 16 per cent between the third quarters

Table 2.1 Documented instances of social unrest, 2009–10

	Public protest against austerity measures (spending cuts)	Protest against govt's response to the crisis	Protest against employers[1]	Violence or property damage
Australia			×	
Canada		×	×	×
Brazil		×	×	
Bulgaria	×		×	
Chile		×	×	
China			×	×
France	×	×	×	×
Germany	×		×	×
Greece	×	×	×	×
Iceland	×	×		
India	×	×	×	
Ireland	×		×	×
Italy			×	
Japan	×			
Republic of Korea			×	×
Latvia	×			×
Lithuania	×			×
Mexico			×	×
Portugal	×		×	
Romania	×	×		×
Russian Federation		×	×	×
South Africa		×	×	×
Spain	×	×		
Thailand	×	×	×	×
Turkey	×		×	×
Ukraine		×	×	
United Kingdom		×	×	×
United States	×	×		

Notes: [1] Includes public sector workers protesting against the government in its role as employer.

An «X» denotes an action in that area.

Source: IILS, based on national sources.

of 2008 and 2009, protests were larger than any since the country became independent from the Soviet Union. As austerity measures were announced in these countries, more protests followed. In Romania, union members protested as the Government announced 25 per cent cuts in wages for state sector employees and 15 per cent cuts in unemployment benefits and pensions to meet requirements for an International Monetary Fund (IMF) rescue package.

While countries of the EU have been the most active, there have been other incidents of social unrest around the world. In the United States, where the crisis began, the focus of unrest has been on government expenditure to save the banks and rescue the economy. The so-called Tea Party movement has staged several demonstrations in US cities to protest against expensive measures taken by the Bush and Obama Administrations aimed at restoring the US economy. Even in China, where there is a strong economic recovery, there have been some incidents of protests. While these protests are not generally well documented, former workers have staged demonstrations in response to plant closures as the country reacts to slowing export demand.

…along with a general increase in number of strikes and lockouts…

Not surprisingly, recent data illustrates that the total number of strikes and lockouts rose in 2009.[3] This increase is particularly acute in emerging economies in Latin America, such as, Argentina, Brazil, Chile and Peru. Other countries, notably, Australia, China and Rep. of Korea have also reported increase in number of strikes and lockouts. Meanwhile, the number of work days lost because of protest has increased among advanced economies in Europe, along with a general increase in the total number of strikes and lockouts.

… and there is also fear of political unrest or extremism.

Instances of public unrest have so far mostly been reported among Central and Eastern European economies and advanced economies in Europe. However, among major economies, such as France, Germany, Italy, Spain, the United Kingdom and the United States, there is still considerable fear of social unrest.[4] Besides the documented cases of social unrest, there is a real danger that the situation could worsen in the coming months. According to a recent poll, 95 per cent of French and 90 per cent of Spanish citizens believed that an increase in the number of strikes and demonstrations were highly probable. Likewise, more than 80 per cent of British, German and Italian believed strikes and demonstrations highly probable. Meanwhile, augmenting earlier trends in these countries, more than 50 per cent of the population in these countries believe that political extremism is on the rise.

The World Gallup Poll conducted surveys in Latin America and the Caribbean in 2008 and 2009, where respondents were asked whether their countries were headed towards political and social unrest. The number of respondents agreeing with the proposition increased in 2009. In Brazil, for example, 34 per cent of respondents believed that the country was headed towards unrest in 2009, up from 28 per cent in 2008. In Honduras, the increase was most dramatic: 50 per cent of the respondents believed that their country was headed towards unrest, up from 37 per cent in 2008. In 13 out of the 16 countries where the surveys were conducted, more than 30 per cent of respondents agreed that their country was headed towards unrest.

As expected, risk of unrest shows significant linkages with social indicators.

The Economist Intelligence Unit (EIU) undertook a global risk assessment in 2009, and ranked countries from 0 to 4, 0 being the least likely to go through a period of social unrest and 4 being the most likely. This analysis took into account political, social and economic development in the aftermath of the financial and economic crisis of 2008–09.[5] According to the EIU, most of the world remains at

3. Source: ILO Statistical Department, 2010
4. Source: Harris Poll, March 2009; data available only for France, Germany, Italy, Spain, the United Kingdom and the United States.
5. According to the EIU, "the ratings and scores for the operational risk model rely on the expert opinion of our analysts working in regional teams. These analysts have a wide range of open and closed sources at their disposal. One of the main closed sources is our network of in-country experts who provide detailed, regular information on conditions within a country. The business operating risk model also draws on the existing analytic work already developed at the Economist Intelligence Unit through its Country Risk Model (available through the Country Risk Service) and business environment rankings model (available through the Country Forecasts)."

"medium" to "very high" risk of social unrest. It rated 62 of 179 included countries as being at "high" or "very high" risk of social unrest. Furthermore, another 64 countries were rated as being at "medium" risk of unrest. It is important to note that the EIU assessment is an overestimation of the actual situation as it was conducted in the second half of 2009, when much of the world was still reeling from the crisis. Furthermore, the assessment is subjective and is likely to be influenced by day-to-day events that have no medium to long-term consequences.

Despite the limitation of the EIU data, it is possible to make meaningful deductions by comparing them with other indicators. Countries where people reported the lowest job satisfaction and lower confidence in government were also the countries with a higher risk of social unrest. For example, among countries at low risk of social unrest, 81 per cent of survey respondents said that they were satisfied with their job. Meanwhile, in countries at high risk of social unrest (ranking 3 and 4), 72 per cent and 69 per cent of survey respondents, respectively, said they were satisfied with their job. The story is similar when it comes to confidence in government. Among countries at low risk of unrest (0 and 1), a little less than 60 per cent of respondents said that they had confidence in their government. But in contrast, among countries with high risk of social unrest (3 and 4), only 38 per cent and 47 per cent of survey respondents, respectively, said that they had confidence in their government.

Pre-crisis data on societal trust and happiness, in comparison with the 2009 data on social unrest, show that countries with higher endowment of trust and happiness are least likely to see social unrest. For example, trust among countries that have low risk of social unrest is 0.53 (that is, 53 per cent of respondents said that most people in their country could be trusted), while it is only 0.23 for countries that are at high risk of unrest. The level of trust drops precipitously as we move from countries at low risk to those at high risk. Countries where more people report that they are happy are also the ones that are at low risk of social unrest. For example, among countries at low risk of social unrest (rank 0), 93 per cent of people say that they are "very happy" and/or "quite happy" with their life. Conversely, among countries at high risk of unrest, only 67 per cent of people say they are "happy" or "quite happy" with their life. Hence, it seems that individual happiness is associated with high levels of social cohesion.

Past evidence of social unrest provides a wake-up call to policy-makers.

Now that it is evident that the risk of unrest is interlinked with several social indicators, it is important to take stock of the past to understand the consequences of unrest. Past evidence shows that social unrest usually follows a severe economic downturn (see box 2.1). It is common for people to express their dissatisfaction with their life, their employers, and their governments by taking to the streets. Indeed, protest is the oldest form of collective expression of social discontent. In the majority of cases from the twentieth and twenty-first centuries, the prevalent consequence of social unrest (protests) was a change or reshuffle of government. In other cases, protests were held against IMF austerity measures, which in turn forced governments to change course and adjust economic policies to quell risks to the social environment. If there is one lesson that can be drawn from history, it is that the current environment of social malaise should be a wake-up call to policy-makers to put in place the right set of policies to address people's needs while paving the way for a sustainable recovery.

Box 2.1 Economic downturns and social unrest: Lessons from history

Economic downturns have historically been a major source of social unrest. From a sociological point of view, recessions are prime opportunities for unrest. In his 1962 essay "Toward a theory of revolution", James Davies states that: "Revolutions are most likely to occur when a prolonged period of objective economic and social development is followed by a short period of sharp reversal" (1962, p. 5). While this definition is generally used in terms of politics and not economics, this is exactly what happens when a boom is followed directly by a recession.

Downturns can also create a great deal of social conflict: a lack of work often leads to migration when basic needs are not met, and nativism is often the result. This can also lead to crime, as desperate people turn to theft and squatting to meet their needs. Recessions have led to violence and extremism, and even brought down regimes.

The United States, not usually known for social unrest, saw widespread civil unrest during the Great Depression. One in four Americans were out of work, and that had a serious impact on the social climate. But protests due to economic reasons are more common in developing and emerging economies. For example, during the peso crisis in Mexico in 1995 (also known as the tequila crisis), Mexican peasants shut down the country's stock market. Likewise, the Asian crisis in the late 1990s was a source of a great deal of unrest in Asia. Indonesia, Republic of Korea and Thailand saw mass protests against their governments' responses to the crisis. For example, in the case of Indonesia, street protests brought down the Government.

Austerity measures also have a long history of leading to social unrest. The IMF has become infamous for imposing austerity measures on developing countries, which has often provoked anger from constituents of these countries. While these austerity measures are intended to promote currency stability and export market openness, there are almost always losers. In many cases, these measures hurt the lower and middle classes through removal of government subsidies and public services.

Of the approximately 80 countries that received IMF assistance in the 1970s and 1980s, 26 experienced austerity protests, most of which were during the 1983–85 period. These took different forms, from food riots in Morocco to violent demonstrations in Chile. In some countries, such as Haiti, the Philippines, Sudan and Turkey, demonstrations eventually toppled governments (Walton and Ragin, 1990).

Austerity measures have also been used in developed countries, and have found detractors there as well. After the Yom Kippur War in Israel in 1974, the Government imposed drastic austerity measures to restore currency reserves, including a drastic devaluation of the Israeli pound, which led to mass protests in Israeli cities (Brilliant, 1974). Likewise, in 1977, Paris and other major French cities were brought to a standstill by a nationwide strike to protest against the Government's austerity measures under Prime Minister Barre. These issues have continued to lead to strikes in the twenty-first century. In 2001, when Argentina faced a currency crisis, austerity measures aimed at cutting the country's budget deficit led to massive protests and vandalism.

Seen through this lens, the latest round of protests is part of a tradition of social unrest in response to government action and inaction. The majority of these protests ended relatively quickly and with limited violence. Nevertheless, growing unrest points to frustration with governments and is a wake-up call to politicians that their constituents are unhappy with their country's performance. This has led to the downfall of governments, and even regimes, in the past, and should be a lesson for the present.

B. Explaining changes in social climate: The role of unemployment and income inequality

The preceding section has shown that the global social climate has worsened since the start of the present crisis. This section examines the possible determinants of this deterioration, with a special focus on labour market and economic developments.

Past episodes of social unrest point to the role of inequality, poverty and high unemployment…

Studies have shown that unemployment spells reduce one's life satisfaction and general social well being – even after finding employment (Clark and Oswald, 1994; Oswald, 1997; Clark et al, 2001). There is also a connection between reduced social well being and the duration of unemployment. This is of particular concern as long-term unemployment and discouragement – as documented in Chapter 1 – is on the rise. Indeed, as Section A illustrated, life satisfaction is already on the decline in several parts of the world.

But, in order to understand whether the decline in people's perceptions of the quality of their lives could manifest into social unrest, there is a need to look at relevant literature to understand what factors that could potentially play a role.[6] Studies have shown that high levels of inequality, social exclusion and perceived unfairness in social relations pose serious risks to social cohesion (Alesina and Perotti, 1996; Sala-i-Martin, 1996; Schock, 1996; Easterly and Levine, 1997; Gurr and Moore, 1997; Elbadawi, 1999). Justino (2005) says that persistent poverty and inequality have been shown to increase a society's propensity for engaging in social unrest.

In their study of developed countries, Green et al. (2006) show a negative relationship between income inequality and social cohesion – that is, higher income inequality is associated with lower degree of social cohesion. The authors define social cohesion as "a property that binds whole societies together", and that it includes shared norms and values, shared identity and belonging, continuity and stability, risk sharing, equitable distribution and strong civil society.

In their study of Indonesia, Tadjoeddin and Murshed (2007) find that economic contraction and increase in poverty are positively associated with level of violence. They show that growth and poverty reduction are good for social harmony. However, they point out that there is an inverted-U-shaped relationship between violence and stages of economic development, hence human development is more important if a country were to reduce violence at all levels of development. Dimensions of human development that are especially important are distributional issues (income inequality or relative deprivation) and access to opportunity in terms of education and labour market.

Walton and Ragin (1990) apply sociological theory to explain mass protests in the developing world from the mid-1970s to the 1980s. These protests formed in developing countries as governments implemented austerity programmes imposed by international organizations such as the IMF and the World Bank. The authors use factor analysis to assign a measure of unrest, based on number of incidents, whether or not there was rioting, number of cities and extent of the protests. They

6. Note that the studies covered in this section are intended to provide a quick overview rather than an exhaustive examination of the literature.

show that the greatest impacts come from over-urbanization and the involvement of international agencies in domestic policy.

Auvinen (1996) presents an alternative to the commonly believed hypothesis that IMF intervention and austerity measures create social tension. It is his contention that countries go to the IMF in times of economic crisis. Thus, while protesters take to the streets because they oppose austerity measures, interventions may have saved countries from much worse protests had governments failed to solve economic crises on their own. His results indicate that IMF intervention only plays a role when interacted with other variables. Thus, it may be that IMF programmes are more likely to cause protests in countries where there is a high level of urbanization and economic development and a democratic political regime.

Lehman-Wilzig and Ungar (1985) show that per capita GNP and GNP growth were both positively correlated with protests, suggesting that improvements in output result in a greater number of protests. This can be explained by rising income inequality during times of rapid growth. High unemployment and inflation, however, are also positively correlated with protest events. Thus, it seems that improvements in output performance coupled with high unemployment and inflation are likely to create the potential for unrest.

Parvin (1973) presents an econometric analysis of social unrest, which he defines in terms of deaths resulting from group violence per million population. He uses this measure because it is an unambiguous measure of the extent of social unrest. His independent variables are per capita income, income distribution (the Gini coefficient), income growth, socio-economic mobility, modes of communication (radios per capita) and urbanization. He finds that per capita income, income growth, income distribution and socio-economic mobility are negatively correlated with social unrest, while communication intensity and urbanization are positively related to unrest.

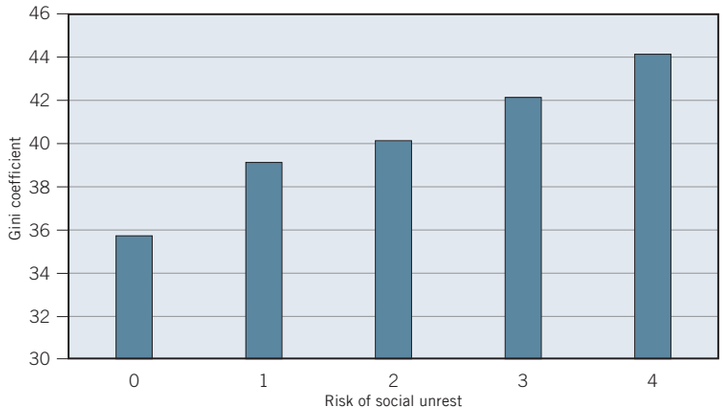
Norris et al. (2005) use data collected in Belgium to analyse the types of people who attend protests. They are interested in whether protesters are typically extremists and troublemakers, which is how they are often portrayed in the media, or if they are primarily citizens who are exercising their right to express political opinions. The authors find that most protesters are politically active and belong to traditional civic associations, such as political parties and unions. They also tend to be disproportionately left wing, but not far left. Young people are more likely to participate, but protesters come from all social classes.

…and this is confirmed by new empirical analysis of the determinants of social unrest…

Higher risk of social unrest is associated with higher income inequality (figure 2.6). Moreover, experience from past economic downturns shows that low-income households (lower percentiles in income distribution) are the ones most severely affected by a crisis. Rising unemployment causes the bottom of the earnings distribution to fall off relative to the median, which in turn increases inequality in earnings (Heathcote et al., 2010b).[7] In the absence of targeted social measures to cushion the fall in earnings for these households, income inequality could worsen.

7. Decline in earnings among poorer households can be persistent. For example, in the United Sates, earnings at the 10th percentile declined by 20 per cent in the 1980–82 recession and it took more than ten years to return to pre-recession levels. Labour earnings are not the only source of income for households, especially for the ones at the lower end of the income distribution.

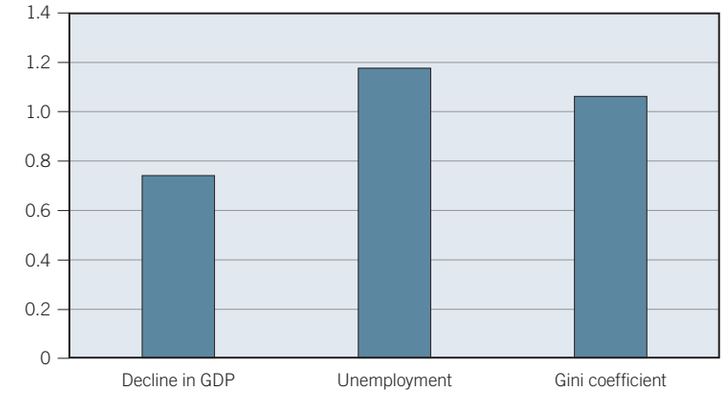
Figure 2.6 Income inequality associated with risk of social unrest



Note: Estimates based on a sample of over 150 countries.

Source: IILS calculations based on EIU, 2009, and *Human Development Report 2009*.

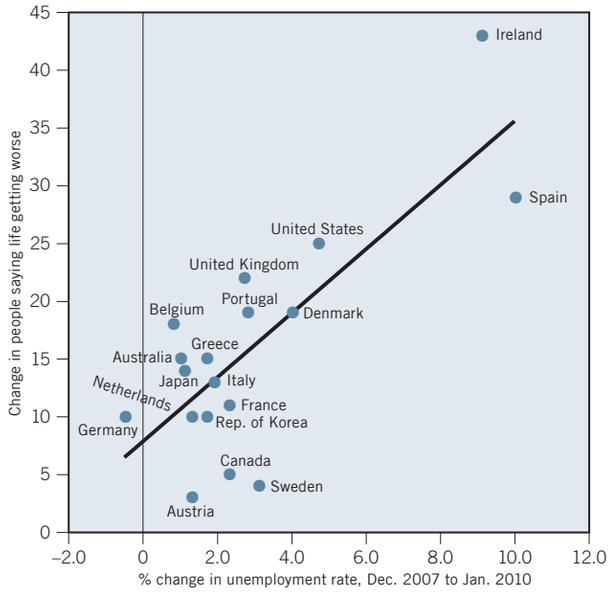
Figure 2.7 Risk of social unrest highest with unemployment (odds of belonging to higher risk category for social unrest)



Note: See Appendix A for the model and results.

Source: IILS calculations.

Figure 2.8 Rising unemployment and perceived decline in quality of life (percentages)



Source: IILS, based on Gallup World Poll Data; surveys conducted in 2009.

Government and private transfers, such as unemployment insurance, welfare and pension income, are some of the counterbalancing sources of income that tend to increase when earning fall, thus damping the increase in income inequality.

An original analysis, using a methodology developed for this report, shows that the risk of social unrest is highest with increase in unemployment rate (see figure 2.7).[8] For example, a 1 unit increase in unemployment increases the odds of being at higher risk of unrest by a factor of 1.2. The second important contributor is income inequality, as measured by the Gini coefficient. A 1 unit increase in Gini coefficient increases the odds of being at high risk of social unrest by 1.1. Decline in GDP does increase the odds of unrest, but the effect is weaker compared with unemployment and income inequality. A 1 unit decline in percentage change in GDP increases the odd of social unrest by 0.7. The findings presented in this section reveal that a job-rich recovery is the way to reduce social tensions and lower the risk of unrest.

Interestingly, among the advanced economies, the ones with the biggest increases in unemployment rates also saw larger proportions of people reporting declining quality of life (figure 2.8). For example, Ireland and Spain, which had the largest increases in unemployment rates among the advanced economies, had the largest proportions of people who said that their lives were getting worse. The story is similar for the United States. In general, pessimism about the economic future is most prevalent in countries with high rates of unemployment.

Young people have been disproportionately affected by the global crisis, which in turn has exacerbated earlier challenges. There is concern that the situation for youth will become unsustainable in some countries, representing a threat to social cohesion (Ha et al., 2010). Countries with high youth unemployment rates are also the ones where employed youth report lowest job satisfaction. Low satisfaction indicates fear of losing a current job and the uncertainty surrounding the prospects for domestic labour markets.

…by contrast, the risk of social unrest is weakly related to the size of fiscal packages.

According to the EIU data on risk categories of social unrest (ranked 0 to 4, 0 being very low risk and 4 being very high risk), most countries fall in rank 2, which indicates medium risk of social unrest. On average, the size of the economic stimulus package announced by a country in this group is 2.8 per cent of GDP, which is more or less the same as for the low-risk countries (table 2.2). However, the average change in GDP between 2008 and 2009 was –4.8 per cent, the most severe decline among all of the groups. The average decline in employment was also the most severe, at 3.1 per cent.

For countries at high risk of social unrest – ranking 3 and 4 – the economic indicators provide a mixed picture. The declines in GDP and employment are not as severe in this group as for countries at medium risk of social unrest (ranking 2). However, it is important to note that the sample size is considerably smaller in the last two groups (ranking 3 and 4); rank 2 contains the largest sample of countries.

8. See Appendix A for details of the empirical methodology and results.

Table 2.2 Risk of unrest compared with economic indicators

Risk of social unrest, 2009 (rank)	Average values	
	Economic stimulus package (percentage of GDP)	GDP per capita (US$, 2009)
0	2.9	59,396
1	2.7	30,037
2	2.8	18,334
3	5.0	5,336
4	1.1	16,847

Note: Estimates based on a sample of 56 countries. EIU data are available for more than 150 countries, but the stimulus data are limited to 56 countries.

Source: IILS calculations.

Policy considerations

Available social indicators paint an unhealthy picture of the global social climate in the wake of the financial and economic crisis that erupted in 2008. In a number of countries, this has manifested into social unrest, as people have expressed dissatisfaction with the way their governments have handled the crisis by staging protests. Policy-makers should heed the warning signals and set in motion the right set of policies to improve the global social climate while paving the way for a sustainable recovery.

In particular, this chapter shows that lower unemployment combined with longer term efforts to reduce excessive income inequalities is the key to reducing the risks of social unrest – while also supporting the economic recovery itself (see Chapter 1). In particular, countries that have the highest rates of unemployment are most at risk of social unrest. It is therefore essential to move ahead with implementation of the Global Jobs Pact (bearing in mind the fiscal constraints analysed in Chapter 3). Countries with high levels of income inequality are also at risk of social unrest. Income inequality data for 2009 are not yet available, but past experience shows that income inequality tends to increase during times of crisis, and the primary source of this is the fall in earnings of people in the lower percentiles of income distribution. Effective labour market and social policies, which cushion the fall in earnings for low-income households, can mitigate the increase in income inequality and prevent the social climate from worsening further.

In the medium to long term, in order to tackle income inequality it is important to address distributional issues. Taxes and transfers can be powerful redistribution mechanisms, but for them to work, taxes have to be progressive and social transfers have to address the needs of people who are left out of economic gains. At the very least, social transfers should offset the reduction in taxes. During the period of economic expansion prior to the present crisis, low-income households were largely left out as wages failed to keep up with productivity (IILS, 2008). And now, during the crisis, it is low-income households that are facing the brunt of the crisis. This is key to understanding the risks facing social climate and designing policies to mitigate those risks.

Appendix A

Estimating the determinants of social unrest[9]

The dependent variable is social unrest, which is treated as an ordinal variable under the assumption that the levels of risk have a natural ordering (from "not likely" or 0 to "most likely" or 4), but the distances between adjacent levels are unknown. It is inappropriate to use ordinary least squares (OLS) for ordinal dependent variables because the OLS method assumes that the distances between categories are the same. For example, the distance between "very high risk" (4) and "high risk" (3) equals the distance between "medium risk" (2) and "low risk" (1). In most cases we cannot make that assumption, but that is what the OLS would do if used with ordinal variables. The appropriate model to be used in this case is called the ordered logit model (ordered logistic regression or proportional odds model), which is an extension of the logit model (logistic regression) for dichotomous dependent variables, allowing for more than two ordered responses. In this case, there are five ordered responses, from 0 to 4.

In the ordered logit model, there is an observed ordinal variable Y (risk of social unrest, from 0 to 4). Y, in turn, is a function of another variable, Y^*, which is not measured (called a latent variable). Unlike Y, Y^* is a continuous variable, and the value of Y^* determines the value of the observed ordinal variable Y. Y^* has various threshold points, and value of the observed variable Y depends on whether or not a particular threshold point has been crossed. For example, if $M = 5$:

$$Y_i = 0 \text{ if } Y^*_i \text{ is} \leq k_0$$
$$Y_i = 1 \text{ if } k_0 \leq Y^*_i \leq k_1$$
$$Y_i = 2 \text{ if } k_1 \leq Y^*_i \leq k_2$$
$$Y_i = 3 \text{ if } k_2 \leq Y^*_i \leq k_3$$
$$Y_i = 4 \text{ if } Y^*_i \geq k_3$$

One can think of Y as being a collapsed version of Y^*. For example, Y^* can take on an infinite range of values (continuous variable), which might then be collapsed into five categories of Y. In the population, the continuous latent variable Y^* is equal to:

$$Y^*_i = \sum_{k=0}^{K} \beta_k X_{ki} + \varepsilon_i = z_i + \varepsilon_i$$

Note that there is a random disturbance term, which in this case has a logistic distribution. This reflects the fact that relevant variables might be left out of the equation, or variables might not be perfectly measured. The ordered logit model estimates part of the above equation:

$$Z_i = \sum_{k=0}^{K} \beta_k X_{ki} = E_i(Y^*_i)$$

9. Methodology adapted from Menard (2002) and Murphy (1996).

Because of the random disturbance term, the unmeasured latent variable Y^* can be either higher or lower than Z. The K, βs and the $M - 1k$s are parameters that need to be estimated, and using the corresponding sample estimates we compute:

$$Z_i = \sum_{k=0}^{K} \beta_k X_{ki}$$

We then use the estimated $M - 1$ cutoff terms to estimate the probability that Y will take on a particular value. For example, when $M = 5$,

$$\Pr(Y = 0) = 1/[1 + \exp(Z_i - k_0)]$$
$$\Pr(Y = 1) = 1/[1 + \exp(Z_i - k_1)] - 1/[1 + \exp(Z_i - k_0)]$$
$$\Pr(Y = 2) = 1/[1 + \exp(Z_i - k_2)] - 1/[1 + \exp(Z_i - k_1)]$$
$$\Pr(Y = 3) = 1/[1 + \exp(Z_i - k_3)] - 1/[1 + \exp(Z_i - k_2)]$$
$$\Pr(Y = 4) = 1 - 1/[1 + \exp(Z_i - k_3)]$$

Hence, using the estimated value of Z and the assumed logistic distribution of the disturbance term, the ordered logit model can be used to estimate the probability that the unobserved variable Y^* falls within the various thresholds.

Ordered logistic regression results show that unemployment rate is positively associated with the risk of social unrest (see table A2.2). This means that increase in unemployment rate is likely to increase the risk of social unrest. Income inequality measured by the Gini coefficient is also positively associated with social unrest, which means that increase in inequality is likely to increase the risk of unrest. Conversely, increase in GDP growth rate is negatively associated with the risk of unrest, but the association is weak. Among the social indicators, increase in life satisfaction is negatively associated with the risk of social unrest. Likewise, higher confidence in government and higher trust among people are negatively associated with the risk of social unrest. Increased perception of unfairness, however, is positively associated with the risk of social unrest.

Table A2.1 Definition and sources of variables used in the regression analysis

Variable	Definition	Source
Risk of social unrest	Ordering of countries from 0 to 4, 0 being the very low risk and 4 being very high risk	Economist Intelligence Unit (2010)
Unemployment rate	Rate of unemployment in 2009	Central Intelligence Agency (2009)
GDP growth rate	Real GDP growth rate in 2009	Central Intelligence Agency (2009)
Gini coefficient	Commonly used measure of income inequality	Human Development Index (2007)
Fiscal stimulus	Fiscal stimulus as a percentage of GDP	International Institute for Labour Studies (IILS) (2009)
Life satisfaction	Survey question: How satisfied are you with your life, from 1 to 10? The values are averages for each country	World Values Survey (2007) Gallup World Poll Data (2009)
Confidence in government	Survey question: Do you have confidence in national government? Percentage of respondents that answered yes	Gallup World Poll Data (2009)
Perception of unfairness	Survey question: Can people get ahead by working hard in this country, or not? Percentage of respondents that answered no	Gallup World Poll Data (2009)
Trust	Survey question: Do you trust most people? Percentage of respondents that answered most people can be trusted	World Values Survey (2007)

Table A2.2 Ordered logistic regression results (dependent variable: risk of social unrest)

	1	2	3	4	5
Unemployment rate	0.127** (1.96)	0.030 (0.41)	–0.018 (0.21)	–0.079 (0.86)	0.059 (0.4)
GDP growth rate	0.043 (0.78)	–0.019 (0.31)	–0.046 (0.57)	–0.070 (0.82)	–0.71** (2.32)
Gini coefficient		0.079** (2.14)	0.107** (2.27)	0.085* (1.74)	
Fiscal stimulus			0.146 (1.04)		
Life satisfaction				–1.35*** (2.9)	–1.55 (1.29)
Confidence in government					–0.127* (1.86)
Perception of unfairness					–0.147** (1.91)
Trust					–0.163*** (2.5)
Chi square	4.16	7.39	7.99	14.96	20.78
N	56	53	35	30	20

Note: Absolute value of *t*-statistics in parenthesis. Significance levels: * significant at 10 per cent, ** significant at 5 per cent, *** significant at 1 per cent. For definition of variables, see Table A2.1.

Table A2.3 Predicted probabilities of risk of unrest

Country	Very low	Low	Medium	High
Brazil	0.090566	0.558311	0.343358	0.007766
Canada	0.728556	0.251762	0.019392	0.00029
Chile	0.009169	0.137393	0.775761	0.077677
Colombia	0.037738	0.383479	0.559298	0.019486
France	0.019381	0.248958	0.693722	0.037939
Germany	0.188585	0.623195	0.184878	0.003342
Italy	0.161859	0.619976	0.214146	0.00402
Japan	0.024736	0.295304	0.650147	0.029812
Mexico	0.00035	0.006102	0.303422	0.690126
Peru	3.18E-05	0.000559	0.038649	0.960761
Republic of Korea	0.031743	0.346509	0.598527	0.023221
Romania	0.00136	0.023288	0.611359	0.363992
Russian Federation	0.013984	0.194363	0.739561	0.052092
Slovenia	0.000863	0.014916	0.509948	0.474274
South Africa	0.010094	0.149025	0.769877	0.071004
Spain	0.003294	0.054492	0.751392	0.190822
Ukraine	2.86E-05	0.000503	0.034919	0.96455
United Kingdom	0.021452	0.267724	0.676493	0.034331
United States	0.511744	0.439356	0.048157	0.000743

Note: Based on regression 5 in table A2.2. "High" includes both "high" and "very high," hence only four categories of risk.

Source: IILS calculations.

Odd ratios are calculated based on regressions on table A2.2. These ratios are cumulative odds of belonging to a certain category or higher versus belonging to one of the lower categories. For example, estimates of odd ratios based on table A2.2 reveal that the odds of being at higher risk of social unrest rather than lower risk is the highest for countries with high unemployment.

Furthermore, ordered logistic regressions also allow the calculation of "predicted probabilities" of belonging to one risk category or the other based on the independent variables. Predicted probabilities of risk of social unrest based on this econometric exercise show that advanced economies, such as Canada, Germany, Italy and the United States, are at low or very low risk of unrest. Also included in this group is Brazil. Meanwhile, countries at high risk of unrest include Mexico, Peru and Ukraine. Most other countries, such as Chile, Colombia, Japan, Republic of Korea, Romania, Russian Federation, South Africa, Spain and the United Kingdom are at medium risk of unrest. The predicted probabilities roughly mimic the original EIU data on social unrest. The number of countries included table A2.3 is small because of the lack of availability of data across all indicators in the regression model in column 5 of table A2.2.

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3 Job recovery in times of constrained public finances*

Main findings

- In many G20 countries, fiscal positions have worsened significantly since the onset of the present financial crisis. This trend mainly reflects bailouts of the financial system, general spending increases and losses in tax revenues. Only less than 15 per cent of the increase in fiscal deficits can be ascribed to specific labour market programmes.
- Concerns have been raised regarding the sustainability of fiscal positions. Sovereign debt risk premia have increased, notably in certain European countries, triggering a wave of fiscal consolidation packages in many advanced economies. The announced size of these packages is substantial, often going beyond the initial stimulus that these countries had enacted at the onset of the crisis. Moreover, many of the cuts have concentrated on labour market programmes.
- Notwithstanding the necessity in some countries to return to safe fiscal positions, a rapid general move to fiscal consolidation would be counter productive. So far, there is no evidence that fiscal deficits have crowded out private demand. On the contrary, stimulus measures have proved effective in preventing a major depression and have helped to save or create jobs. In emerging economies, these effects are particularly strong, suggesting that even small increases in government spending on job-centred programmes have lasting positive effects on employment.
- It is crucial to support the economy now. Existing measures may lose effectiveness as public debt ratios increase further and the unemployed lose skills or get discouraged. Fiscal measures are all the more important because financial systems do not provide adequate credit to the real economy, as shown in Chapter 5.

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- Early exit from fiscal stimulus and lack of coordination of consolidation measures are likely to worsen both employment growth and the state of public finances. Given the current severe lack of aggregate demand, continued job-centred fiscal measures, if well designed, will pay off by themselves through faster job creation and thereby also lead to higher government revenues:
  - Aggregate demand spillovers through international trade from countries that front-load their consolidation packages will delay the global job recovery. In addition, it will lower policy effectiveness in those countries that continue with their stimulus packages.
  - Conversely, those countries that are pressured to implement consolidation packages due to the short-term unsustainability of their public finance positions need to be able to rely on an improved external position. At the current juncture, this means that those countries that still command fiscal space should use it, wich would also contribute to rebalance the global economy, an issue adressed in more detail in Chapter 4.
  - In summary, early and uncoordinated exit from stimulus measures could choke off the job recovery process, with adverse consequences for fiscal sustainability.

Introduction

Countries around the globe have started to consolidate their public finances. With public debt levels reaching triple-digit figures in many advanced countries, and large public deficits being seen even in emerging economies, concerns had been mounting fast as regards the long-term sustainability of these fiscal policies. As a consequence, policy-makers have come under increasing pressure to start phasing out stimulus measures amidst rising costs of public debt and fears of rapidly rising inflation rates. Discretionary measures are still sizeable, but political discontent is increasingly being felt as to sharing the final bill that is being presented to taxpayers. Indeed, increasing market pessimism regarding the state of public finances has pushed many governments to put forward consolidation packages that often take back more than what had initially been pumped into the economy as discretionary stimulus.

However, overly restrictive fiscal policies may further delay global employment recovery. Indeed, in June 2009 the International Labour Conference adopted the Global Jobs Pact (GJP) to support countries in designing effective labour market policy responses and to coordinate international efforts in that area. In that respect, this chapter documents that labour market spending takes the brunt of the consolidation packages, even though its role in the deterioration of public finances has only been limited. Such consolidation comes at an unfortunate moment as labour markets have only started –tepidly – to recover from the worst global recession in the past 80 years. Indeed, evidence points to an alternative policy option, whereby public spending can be reoriented towards employment creation which is based more broadly on job recovery, creating the conditions to put fiscal policies on a sustainable footing as well.

Against this background, the purpose of this chapter is: (a) to gauge the extent to which fiscal consolidation measures, as currently designed, may affect employment recovery prospects; and (b) to assess how a more careful exit strategy, which takes into account country-specific circumstances, may support the economy and

employment while still meeting fiscal goals over the medium term. This assessment has been carried out on the basis of estimations and model simulations for advanced G20 countries.[1]

The analysis presented here confirms that many labour market programmes are cost-effective. They foster job creation and mitigate job destruction at similar rates as generic public spending, but at a fraction of its costs. At the current juncture, this means that governments can improve both the state of their public finances and the labour market situation by reorienting part of their spending to these specific policies. Conversely, the costs of inaction or an early exit from labour market and stimulus measures can be substantial in terms of higher unemployment, more vulnerable employment and permanently depressed wage growth. Importantly, consolidation measures and early exit from fiscal stimulus will also manifest themselves in depressed job growth among trading partners, thereby further delaying the economic and employment recovery. This chapter therefore argues that rather than an exit, there should be a shift in policies towards a more dynamic use of active labour market measures that promise higher employment content for government spending.

The chapter is structured as follows. Section A discusses the shift to fiscal austerity measures that has occurred in a large number of countries. Section B examines the impact that this policy shift might have on both employment and fiscal outcomes. Section C discusses the optimal design of country-specific recovery packages in times of constrained public finances.

A. The shift to fiscal austerity

Fiscal deficits increased markedly after the crisis…

Between 2007 and 2010, net government lending – a measure of the fiscal stance – increased in almost all G20 countries, with the exceptions of Brazil, which managed to reduce its lending needs due to a very short-lived recession, and Saudi Arabia, which ran consistent surpluses thanks to a quick recovery of international oil prices over the period (figure 3.1). In the remaining G20 countries, public deficits increased by between 0.3 and 10.6 percentage points over the period, driven by automatic stabilizers, financial sector support and discretionary programmes, but also by shortfalls in tax revenues.[2]

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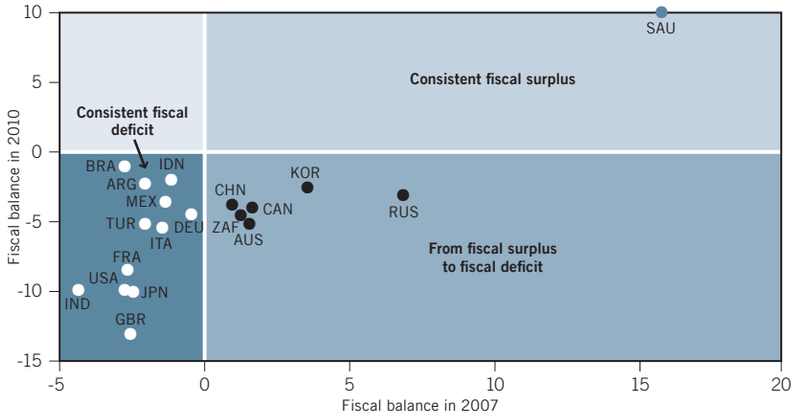
1. The chapter deliberately concentrates on public spending and revenue options in the current recovery process. More longer-term issues related to public investment and social security systems or the interaction of fiscal and monetary policies under different exchange rate regimes have not been taken up here even though their importance from a wider development-oriented perspective is acknowledged.

2. Automatic stabilizers refer to elements in the public budget balance that adjust automatically with cyclical conditions. For instance, tax revenues from corporate profits or personal income will decline as macroeconomic conditions worsen. Similarly, spending on social security and unemployment benefits will automatically increase with a rising number of jobless people. In contrast, discretionary measures refer to all those additional spending or tax measures that a government undertakes independently of the country's position in the business cycle. In the context of this chapter, the term mainly refers to additional spending programmes or tax cuts that have been implemented at the onset of the crisis.

Figure 3.1 Changes in the fiscal balance, 2007 vs. 2010



Note: The figure shows changes in the fiscal balance as measured by general government net lending as a share of GDP in 2007 and 2010. Fiscal balance in 2010 is forecast. The country sample includes: ARG: Argentina; AUS: Australia; BRA: Brazil; CAN: Canada; CHN: China; DEU: Germany; FRA: France; GBR: United Kingdom; IDN: Indonesia; IND: India; ITA: Italy; JPN: Japan; KOR: Republic of Korea; MEX: Mexico; RUS: Russian Federation; SAU: Saudi Arabia; TUR: Turkey; USA: United States; ZAF: South Africa.

Source: IMF (2010a).

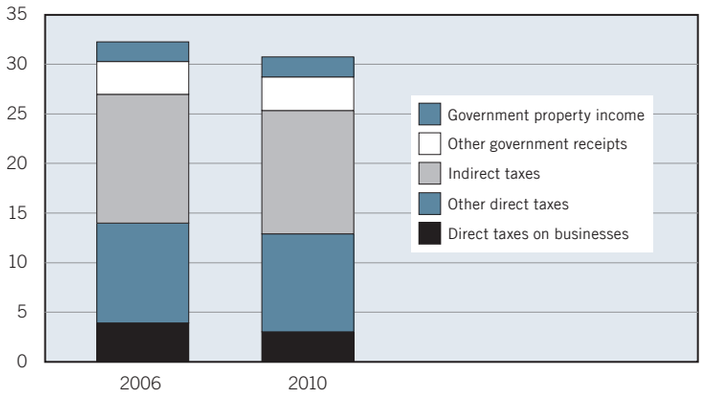
…partly related to shortfalls in government revenues…

Part of the increased government deficits can be explained by shortfalls in tax revenues (figure 3.2). Indeed, on average, advanced G20 governments lost almost 2 percentage points of total revenues (when measured as a share of GDP) due to substantially smaller corporate profits and reversals in income taxes. In certain cases, government revenues declined even up to 4 percentage points due to reduced direct taxation but also due to a deliberate effort to reduce tax rates to stimulate the economy (such as the temporary VAT decrease in the United Kingdom). Other sources of revenue, such as indirect taxation or income from government property, were also held up. So, some of the revenue losses may turn out to be permanent as they relate to tax cuts introduced during the crisis. In addition, the corporate profit taxation regimes in several countries allow for substantial accumulation of gain/loss over several years so as to smooth out tax payments. This means that current shortfalls in corporate profits are likely to create smaller tax payments over the next few years. Moreover, if the recovery turns out to be weaker than expected, then tax revenues would only gradually return to the previous high levels. Hence, in the current situation, and despite the fact that persistence in government revenues is typically lower than for public spending, loss in tax revenues is expected to contribute almost half of the projected increase in government debt in advanced G20 countries over the medium term (IMF, 2010a).

…and to financial sector support…

Fiscal support to safeguard the financial sector has been substantial, with direct support in the United Kingdom reaching up to 12 per cent of GDP (table 3.1). Not all of these support measures had an immediate impact on spending as some were in the form of guarantees, thereby creating contingent liabilities to the public sector that may or may not affect the fiscal balance in the future. In particular, the extension of deposit insurance and the increase in ceilings (up to blanket

Figure 3.2 Sources of government revenues in advanced G20 countries (percentage of GDP)



Note: The figure shows different sources of government revenues in advanced G20 countries, excluding contributions to social security and other parastatal institutions.

Source: OECD (2009a).

Table 3.1 Financial sector support in G20 countries (percentage of GDP)

	Direct support			
	Capital injection	Treasury purchase of assets and lending	Guarantees	Central bank interventions
Argentina	0.0	0.0	0.0	0.0
Australia	0.0	0.0	0.0	0.0
Brazil	0.0	0.8	0.5	0.0
Canada	0.0	9.1	0.0	0.0
China	0.0	0.0	0.0	0.0
France	1.3	0.2	16.9	0.0
Germany	3.4	0.0	17.2	0.0
India	0.0	0.0	0.0	0.0
Indonesia	0.0	0.0	0.0	0.0
Italy	1.3	0.0	0.0	2.7
Japan	2.5	4.1	7.2	0.0
Korea, Rep.	1.2	1.5	11.6	0.0
Mexico	0.0	0.0	0.0	0.0
Russian Federation	7.1	0.5	7.7	0.0
Saudi Arabia	0.0	0.0	0.0	0.0
South Africa	0.0	0.0	0.0	0.0
Turkey	0.0	0.0	0.0	0.0
United Kingdom	8.2	3.7	40.0	28.2
United States	5.1	2.3	7.5	12.1
G20 average	**2.6**	**1.4**	**6.4**	**4.6**
Advanced G20	3.8	2.4	10.9	7.7
Emerging G20	0.7	0.1	0.8	0.0

Note: Central bank interventions refer to asset swaps and purchase of financial assets (including treasuries) by the central bank. Only pledged amounts are reported in the table.

Source: IMF (2010a).

guarantees, such as in France and Germany) will only materialize if the situation worsens. Other measures, such as buying up toxic assets or bailing out failing banks, however, create huge up-front costs. These measures have proved to be essential in mitigating the crisis and preventing further damage to the real economy. At

the same time, they have contributed significantly to increasing public debt in advanced economies. Typically, the gross fiscal cost at the time these measures are enacted exceeds the net cost once the situation stabilizes and governments proceed in selling off these assets. For instance, during the Nordic crisis in the early 1990s, Norway and Sweden suffered fiscal losses similar to the ones currently observed to support their financial sectors. Most of these losses, however, were eventually covered by selling back the assets at a much higher price to the market, leaving the net fiscal cost at almost zero (Laeven and Valencia, 2008). Also, during the current crisis, evidence from Switzerland and the United States suggests that the final bill from financial sector support may be much lower than the present situation might lead us to fear, raising hopes that the direct cost of this crisis might actually be very low by historical standards (Schildbach, 2010).

…but much less on stimulus measures.

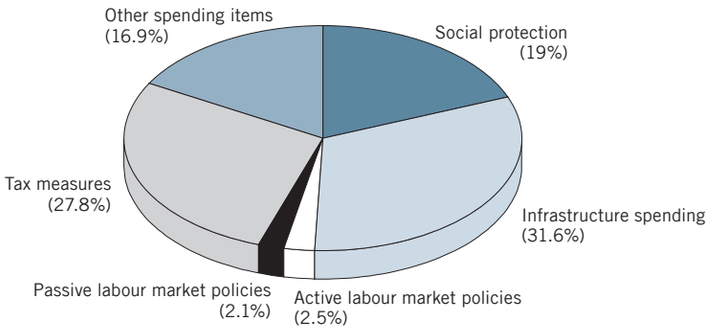
In comparison with the large efforts that governments have undertaken to safeguard the financial sector, labour market programmes have received much less attention and funding, representing less than 5 per cent of the total stimulus measures (figure 3.3). Indeed, most of the G20 countries have responded to the global economic crisis by relying on the automatic stabilizers built into their social security and tax system. Spending on unemployment benefits has increased tremendously as job losses have increased, and many governments have tried to increase resources for active labour market programmes. In addition, countries have provided additional stimulus through discretionary measures. The bulk of this extra spending is provided by only four countries – China, Germany, Japan and the United States – which account for about 78 per cent of the overall global stimulus measures announced and spend between 1.4 per cent and 2.1 per cent of their respective GDP. For most of the European countries the amounts are lower. In most developing economies the fiscal stimulus is less than 1 per cent of GDP.

With faltering employment, labour market spending has started to increase, sometimes substantially. In particular, passive labour market measures have expanded by around 20 per cent among OECD countries. On the active side, the rise in labour market spending has been more muted (at least regarding the GDP effect). However, given the size of the labour market challenge arising from substantially higher unemployment rates, further – and possibly permanent – spending increases can be expected here as well, particularly as the current downturn might also lead to a rise in long-term unemployment. Based on past experience regarding the evolution of labour market spending in reaction to unemployment developments, labour market spending is expected to increase by up to 1.5 percentage points of GDP in some OECD countries in 2010 (Charpe, 2010). In addition, countries may need to continue to stimulate employment creation, not only through labour market policies, but also through continuous support for aggregate demand, so as to guarantee that a sufficiently large number of vacancies are available for the rising number of job seekers.

Increasing public debt has raised concerns about fiscal sustainability…

As a result of automatic stabilizers and discretionary stimulus measures, strong increases in public debt levels are expected over the medium term (table 3.2). This has raised fears that credit conditions for private businesses are becoming more expensive in the longer term, to the extent that public and private bond

Figure 3.3 Composition of fiscal stimulus measures in G20 countries (percentage of total package size)



Source: IILS estimates based on OECD, 2009b; Andes and Castro, 2009; Robins et al., 2009; Reid, 2009; Meyer-Ohlendorf et al., 2009; Zhang, et al., 2009; ministry websites of various countries and other national sources.

issues compete for limited global savings. Crowding out of private investment may take place, in particular in emerging countries with less well developed domestic capital markets, which need to rely on international capital flows to finance their investment opportunities (Ağca and Celasun, 2009). As a consequence of such crowding out, an increase in public debt would limit the effectiveness of government spending, at least above a certain threshold. According to recent estimates by Reinhart and Rogoff (2009), this threshold – considered to be around 85–90 per cent of GDP – may already have been reached by some advanced G20 economies following the current recession, although increases in long-term interest rates have so far remained limited (see next section). In addition, in less advanced economies with smaller domestic capital markets and larger need for external financial investment for their public bonds, risk premia could go up and the maturity of new bond issues could shorten, making financing the budget deficit more expensive and more risky, and with consequences also for financing conditions in the private sector (Pettis, 2001).

However, a recent study has questioned both the association of debt and growth and the threshold limits (Irons and Bivens, 2010). In particular, their study shows that it is low growth that drives up public debt but not the reverse.[3] This may indicate that at least for those G20 countries that command over well developed domestic sovereign debt markets, more fiscal space for stimulus is available.

…and has pushed countries into fiscal consolidation.

Even though signs of crowding out are generally lacking, sovereign debt spreads have substantially increased during the first half of 2010 in certain countries, in particular in Europe (figure 3.4). This has raised serious doubts about the medium-term sustainability of some of the stimulus measures put in place at the beginning of the crisis. This can be related in part to long-standing fiscal sustainability problems in these countries prior to the crisis, which have been made more transparent by the vulnerabilities that the crisis has caused. It might also reflect an increase in risk aversion among (institutional) investors with the onset of the crisis, and a

3. In technical terms, this is done using Granger causality tests between time series of GDP growth rates and public debt ratios. In addition, their paper points to flaws in the measurement of debt used in the Reinhart-Rogoff analysis, which do not allow for a well-defined threshold for debt.

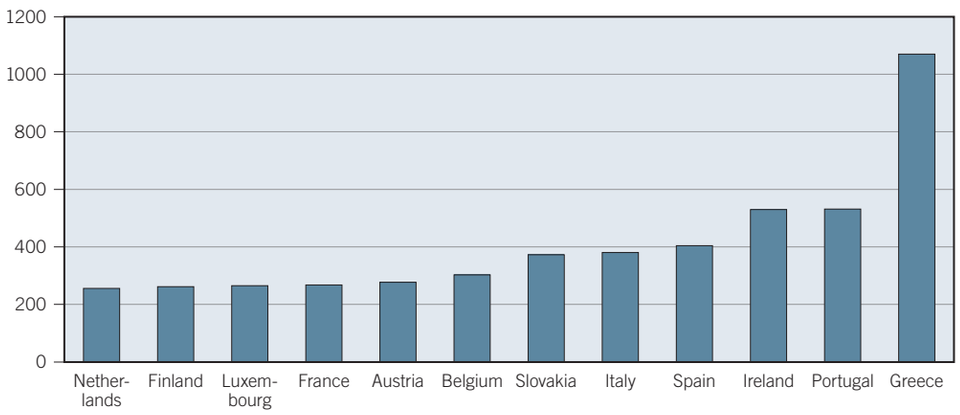
Table 3.2 Evolution of public debt and the fiscal balance in G20 countries (percentage of GDP)

Country	Public debt (in % of GDP)					Fiscal balance (in % of GDP)				
	2007	2009	2010	2014	2015	2007	2009	2010	2014	2015
Argentina	67.9	59.8	51.4	46.9	50.4	–2.1	–3.9	–3.5	–2.7	–2.2
Australia	9.4	15.5	19.8	22.1	20.9	1.4	–4.1	–5.0	–0.7	–0.2
Brazil	65.2	68.9	67.2	58.9	54.1	–2.7	–3.3	–1.5	–0.9	–0.7
Canada	65.0	82.5	83.3	74.2	71.2	1.6	–5.1	–5.2	–0.4	0.0
China	20.5	18.9	20.0	19.7	17.5	0.9	–3.0	–3.0	–2.2	–2.4
France	63.8	77.4	84.2	94.3	94.8	–2.7	–7.9	–8.2	–4.6	–4.1
Germany	65.0	72.5	76.7	82.0	81.5	0.2	–3.3	–5.7	–2.3	–1.7
India	79.2	80.8	79.0	70.3	67.3	–4.4	–10.5	–9.2	–4.7	–4.4
Indonesia	36.9	28.6	27.5	23.8	23.1	–1.2	–1.6	–2.0	–1.7	–1.6
Italy	103.4	115.8	118.6	123.9	124.7	–1.5	–5.3	–5.2	–4.7	–4.6
Japan	187.7	217.7	227.1	247.7	250.0	–2.4	–10.3	–9.8	–7.6	–7.3
Korea, Rep.	29.6	32.6	33.3	28.5	26.2	4.2	0.0	1.1	2.9	2.9
Mexico	38.2	44.9	44.5	42.4	42.4	–1.4	–4.7	–3.4	–2.7	–2.7
Russian Federation	8.5	9.0	8.1	10.0	13.0	6.8	–6.2	–2.9	–3.5	–4.2
Saudi-Arabia	18.5	16.3	12.8	7.3	6.4	15.7	–0.8	5.3	6.3	4.9
South Africa	28.3	31.5	34.7	36.8	35.7	1.2	–6.1	–6.1	–2.5	–1.2
Spain	36.1	55.2	66.9	89.8	94.4	1.9	–11.4	–10.4	–8.0	–7.7
Turkey	39.4	45.5	44.5	43.9	43.5	–1.7	–5.6	–3.4	–2.1	–1.9
United Kingdom	44.1	68.2	78.2	90.7	90.6	–2.7	–10.9	–11.4	–5.2	–4.3
United States	62.1	83.2	92.6	106.4	109.7	–2.7	–12.5	–11.0	–6.0	–6.5
G20 (weighted)	61.3	72.5	76.8	82.2	82.5	–0.9	–7.5	–6.8	–3.9	–3.9
All countries (unweighted)	53.4	61.2	63.5	66.0	65.9	0.4	–5.8	–5.0	–2.7	–2.5
Advanced countries (unweighted)	66.6	82.1	88.1	96.0	96.4	–0.3	–7.1	–7.1	–3.7	–3.4
Emerging countries (unweighted)	40.3	40.4	39.0	36.0	35.3	1.1	–4.6	–3.0	–1.7	–1.6
Advanced G20 (weighted)	77.9	96.9	104.4	115.5	117.1	–1.7	–9.4	–8.9	–4.9	–4.9
Emerging G20 (weighted)	37.3	37.4	37.0	34.3	32.7	0.3	–4.8	–3.7	–2.4	–2.5

Note: Averages are based on 2008 Purchasing Power Parity (PPP) GDP weights.

Source: IMF (2010a).

Figure 3.4 Average government bond spread over German government bonds in euro area (August 2010) (basis points)



Note: The figure shows the differences between long-term interest rates of government bonds in individual euro area countries and the rate of German treasury bonds. Differences are presented in basis points.

Source: IILS estimates based on www.ecb.europa.eu/stats/money/long/html/index.en.html (accessed 15 Sept. 2010).

sudden apprehension regarding the outlook for the real economy for some of these countries as the recovery started to set in. Most importantly, however, this can be related to the support measures for the financial sector that have transformed bank credit risk into sovereign risk, in particular for smaller countries with less developed domestic financial markets (Ejsing and Lemke, 2009).

The rapid increase in sovereign bond spreads, the deterioration of government bond ratings and the ensuing rise in the cost of public finance have pushed authorities in several countries to enact fiscal consolidation packages. Often, the announced packages are larger than the original discretionary stimulus measures (see table 3.3). In addition, most of the packages concentrate on easy to implement and quick measures, often related to increases in taxation or social security contributions and employment and wage cuts in the public sector. As will be argued in the next section, these measures are likely to make the recovery more

Table 3.3 Fiscal stimulus vs. consolidation packages for G20 countries and selected EU countries

	Amount of announced fiscal stimulus package (Billions)	Fiscal stimulus as % of GDP (2008)	Amount of fiscal consolidation (Billions)	Planned fiscal consolidation as % of GDP (2009)
Argentina	AR$32.18	3.1		
Australia	A$67.90	5.8		
Brazil	US$20	1.2		
Canada	C$51.61	3.2		
China	CNY4000	13.3		
Denmark		3.1	DKK24.5	1.5
Estonia			EEK20	9.0
France	€26	1.3	€100	5.1
Germany	€81	3.3	€80	3.3
Greece			€30	13.0
Hungary	HUF3200	12.0		1.6
India	Rp1860	3.5	Rp55	0.1
Indonesia	IDR69300	1.4	IDR9900	0.2
Ireland			€13.85	8.5
Italy			€24.9	1.6
Japan	JPY56800	11.2		
Latvia			LVL1	7.6
Lithuania			LTL5.3	5.6
Netherlands	€6	1.0	€16.5	2.7
Portugal	€2.18	1.3		3.4
Korea, Rep.	W67200	6.6		
Romania			€1.7	1.4
Russian Federation	RUB1576	3.8		
Slovenia	€0.86	2.3		4.0
South Africa	ZAR92.13	4.0		
Spain	€25.7	2.3		8.2
Turkey	TL57.87	6.1		
United Kingdom	£20	1.4	£128	9.0
United States	US$787	5.5		

Note: See table 3.4 for more details on the fiscal consolidation measures.

Source: IILS estimates based on National sources; OECD (2009b); IMF (2010b); Zhang et al (2009).

Table 3.4 Overview of fiscal consolidation programmes in G20 and EU countries

	Effective increase in taxation	Effective cuts in social security	Public sector cuts	Other spending cuts
Australia	×			
Canada			×	×
Denmark	×	×	×	×
Estonia	×	×		×
France	×	×		
Germany	×	×		×
Greece	×	×	×	×
Hungary	×		×	
India	X	×		
Indonesia	×			
Ireland	×	×	×	
Italy		×	×	
Latvia	×	×	×	
Lithuania	×	×	×	×
Netherlands		×	×	×
Portugal	×		×	×
Romania		×	×	
Slovenia				×
Spain	×	×	×	×
United Kingdom		×	×	×

Note: The table indicates planned or actually implemented consolidation measures in four main areas up to 2015. Tax measures include increases of excise taxes, personal and capital income taxes and taxes on financial services. Cuts in social security cover measures related to public pension, health care, education and unemployment benefit systems. Public sector cuts include wage cuts and/or reductions in public sector employment. Other spending cuts include cuts in infrastructure, military spending and foreign aid.

Source: IILS, based on National Sources.

protracted as they typically have the highest employment multiplier effects. Partly, this may be related to the institutional set-up, where many spending responsibilities have been given to lower level governance structures while revenue responsibilities remain with central government, a dangerous cocktail for successful fiscal consolidation. In addition, and to the extent that the recovery might be short-lived due to these consolidation efforts, the original goals of reduced public debt and lower deficits might not even be achieved. Finally, the uncoordinated nature in which these consolidation packages are currently being designed and implemented is likely to worsen their already harsh effects (Ernst and Charpe, 2009). In this respect, it is worrying to observe that – at least in the euro area – countries have started to put forward concrete proposals to reduce their outlays substantially in the course of this year, even though their fiscal room for manoeuvre is still available and despite the fact that it is public spending that has so far contributed to the avoidance of further job losses (ILO, 2010a and 2010b).

Notwithstanding the continuous need for further stimulus, the return to safe fiscal positions seems to be warranted from a longer-term perspective. Given the loss in revenues, however, this cannot be achieved solely through spending cuts or the return to higher growth rates, which would take too long to restore sustainable public finances given the depth of the crisis (Miyazaki, 2010). Also, an exclusive emphasis on spending cutbacks to restore soundness in public finances poses not only an economic but also an equity issue: indeed, corporations and middle- and high-income earners have seen their tax burdens decrease. In contrast, announced

consolidation packages are mainly targeting social security and labour market spending programmes, often at the expense of lower-income households or those that are experiencing high labour market risk (job loss, atypical work conditions; see table 3.4 for an overview of announced or implemented consolidation packages). In addition, public sector wage and employment cuts, which are included in many consolidation packages, have immediate negative labour market consequences. Such consolidation efforts may be appropriate in more tranquil times; however, under current circumstances, with large unused productive capacities, these measures are premature and are likely to worsen the labour market crisis (Almunia et al., 2010). In light of the discussion regarding the social dimensions of the crisis in Chapter 2, governments may, therefore, try to find a more balanced approach of returning to sound fiscal positions by also considering adjustments in tax revenues. In this regard, approaches such as (temporary) tax hikes on commodity exports and mining products, such as the recently announced Resource Super Profit Tax in Australia, might be considered more widely, especially in countries where the overall tax burden is low.

B. What do we know about the employment effects of fiscal policy in times of crisis?

First, so far, fiscal stimulus has not crowded out private demand…

So far, government spending programmes do not seem to have crowded out private consumption or investment. Indeed, in most countries, long-term interest rates (on government bonds) have continued to fall throughout the crisis (figure 3.5), in part due to the rapid easing of monetary policy. Only in certain countries, where concern over the long-term fiscal sustainability arose, there was a sizeable increase in long-term interest rates. However, the longer the recovery takes to materialize fully, the larger the spending purse remains open and the more likely it is that there will be an impact on (long-term) interest rates, thereby crowding out private spending. Such an effect might take time to materialize, and it partly depends on (shifting) perceptions of market participants regarding the speed and shape of the recovery. In addition, for long-term rates to increase rapidly, inflation expectations would need to shift substantially. At the current juncture, with the output gap still wide in many (advanced) economies and further deflationary pressure from a globally ageing workforce, the inflation outlook can be considered to be benign. Nevertheless, to the extent that long-term interest rates also include a risk premium to reflect uncertainties about the outlook, sudden shifts in perception and risk aversion can lead to public spending programmes having abrupt and non-linear effects on the private economy (Haugh et al., 2009).

…and has had a significant impact on employment, especially in emerging economies.

Government spending programmes appear to have been an essential ingredient in helping to avoid further job losses and allowing labour markets to recover from the crisis. In particular, in emerging and developing countries, the available fiscal space has been used to implement some, albeit small, countercyclical measures to stem the crisis. This is a welcome change in contrast to earlier episodes, where countries have

Figure 3.5 Changes in long-term interest rates vs. changes in fiscal balance, 2007–09 (percentage points)

Note: The figure shows (i) the change in fiscal balance between 2007 and 2009 measured by the difference in general government net lending as a percent of GDP and (ii) the change in nominal long-term interest rates on government bonds over the same period. The country sample includes: AUS: Australia; AUT: Austria; BEL: Belgium; CAN: Canada; CHE: Switzerland; CZE: Czech Republic; DEU: Germany; DNK: Denmark; ESP: Spain; FIN: Finland; FRA: France; GBR: United Kingdom; GRC: Greece; HUN: Hungary; IRL: Ireland; ISL: Iceland; ITA: Italy; JPN: Japan; KOR: Republic of Korea; LUX: Luxembourg; NLD: Netherlands; NOR: Norway; NZL: New Zealand; POL: Poland; PRT: Portugal; SVK: Slovakia; SWE: Sweden; USA: United States.

Source: IILS estimates based on IMF (2010a).

often suffered from procyclical fiscal tightening as limited fiscal space has forced them to rein in spending and raise taxes (often trade-related) in order to balance the books (see box 3.1 for a discussion of the experience of sub-Saharan Africa).

Going forward, however, no agreement exists regarding the extent to which additional public spending can boost employment creation. Most existing evaluations of the impact of government consumption on output and private consumption seem to suggest that both for advanced and emerging economies the effects of government spending can be sizeable, especially over the longer term. Several studies have documented such fiscal multipliers in advanced countries (Barro and Redlick, 2009; Blanchard and Perotti, 2002; Mountford and Uhlig, 2009; Perotti, 2005; Romer and Bernstein, 2009), but there are only a few estimates for emerging and developing countries (Davoodi et al., 2010; Ilzetzki and Vegh, 2008). Also, other country characteristics, such as the degree of trade openness and the existence of well-functioning (domestic) financial markets, appear to influence the effectiveness of fiscal policy. In particular, the latter feature has received some prominence in the actual debate because, in theory, simulated fiscal multipliers can be more than twice as large in situations where investors face a liquidity trap than under normal circumstances (Christiano et al., 2009; Woodford, 2010).[4] Finally, there is little or no evidence on the effect of a fiscal policy change on employment.

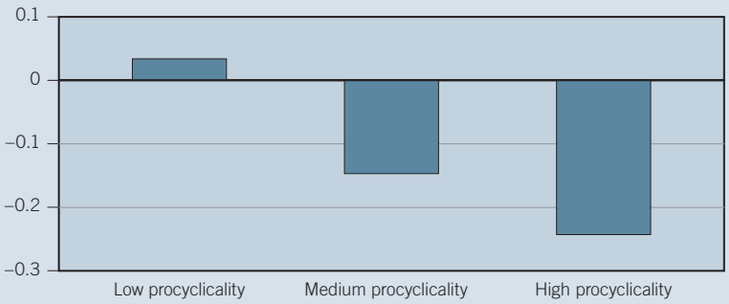
4. An economy is said to be in a liquidity trap when monetary policy no longer affects the real economy. This may happen either when monetary policy can no longer decrease interest rates due to the zero lower bound (i.e. nominal interest rates cannot, in principle, be set below zero) or when further decreases in interest rates and/or the expansion of money supply would only raise money holdings by private households and firms without affecting their consumption or investment decisions.

Box 3.1 The danger of procyclical fiscal policies for employment: The case of sub-Saharan Africa

The current difficulties of European governments with rapidly increasing public debt have triggered some debate on the potential benefits of procyclical tightening. Some observers have argued that the improvements in confidence and lower risk premia that result from public spending cuts could have the potential to overcompensate any direct adverse effects on aggregate demand caused by such a policy shift (Alesina and Ardagna, 2010). These insights may apply, however, only in specific circumstances and be less relevant in developing countries. This box discusses the large negative effect of procyclical public spending on employment creation in sub-Saharan African countries.

Sub-Saharan African countries have suffered in the past from highly procyclical government spending patterns (Fofack, 2010; Thornton, 2008). Limited fiscal space and the fact that much of government revenue are tightly linked to volatile income components, such as commodity trade and remittances, limit the capacity of many countries in the region to smoothen economic activity and job creation over the economic cycle. This has proved vastly damaging to sustainable employment creation (figure 3.6). Indeed, the increased volatility of economic activity that this procyclical stance for public spending had implied has destroyed on average more jobs than if there had been acyclical public spending (i.e. public finances that do not react to cyclical conditions). Such increased volatility holds back private investment and increases the risk premia, in particular for small and medium-sized enterprises, thereby heavily weighing on job creation. For instance, if the United Republic of Tanzania – a country with a relatively high degree of procyclical spending – had experienced the same low degree of spending procyclicality as Namibia, it could have added almost 170,000 jobs per year over the period 1991–2008, or 10 per cent of its current employment level.

Figure 3.6 Net employment creation in sub-Saharan Africa relative to degree of procyclicality of government spending, 1991–2008 (percentage growth per annum)



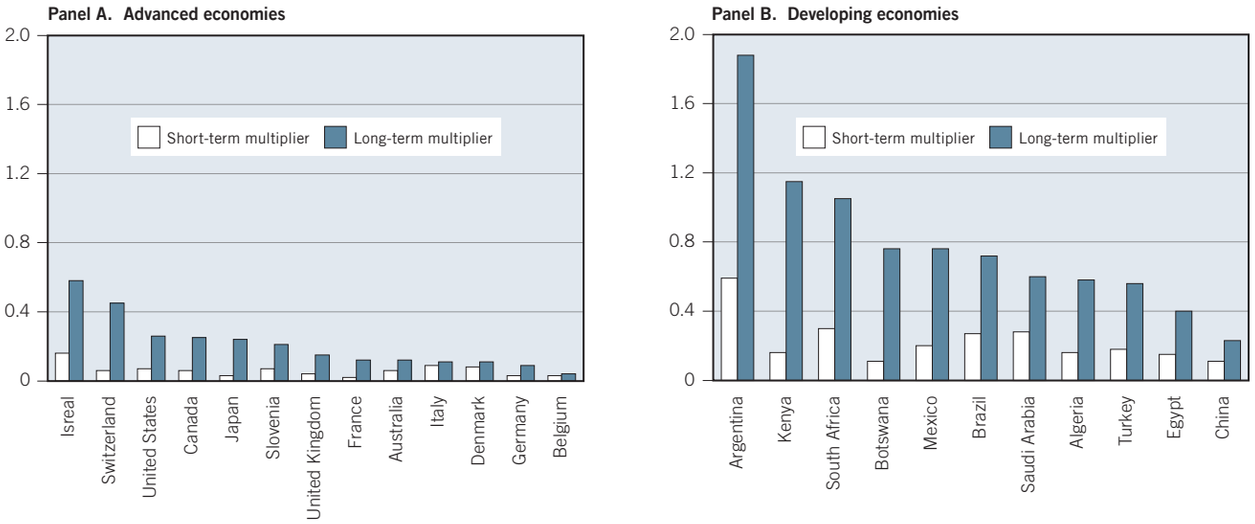
Note: Net employment growth is defined as the difference between employment growth and labour force growth (compound rates) between 1991 and 2008. Terciles have been constructed using unweighted averages of net employment growth. The degree of government spending procyclicality is measured with respect to GDP growth based on Thornton, 2008. The following countries are included: Benin, Botswana, Burkina Faso, Burundi, Cameroon, Central African Republic, Chad, Congo, Equatorial Guinea, Ethiopia, Gabon, Gambia, Ghana, Guinea-Bissau, Côte d'Ivoire, Kenya, Lesotho, Liberia, Madagascar, Malawi, Mali, Mauritania, Mauritius, Mozambique, Namibia, Niger, Nigeria, Rwanda, Senegal, Sierra Leone, Somalia, Swaziland, United Republic of Tanzania, Togo, Uganda, Zambia, Zimbabwe.

Source: IILS estimates based on Thornton (2008) and ILO Laborsta database.

In order to get a more precise understanding of the effects of government spending on employment, the multipliers for a selection of advanced and developing countries have been estimated.[5] The estimated multipliers are sizeable, in particular in the long term (figure 3.7). For instance, the estimated multiplier for

5. The estimates are carried out using structural vector autoregressive (SVAR) techniques, following the methodology developed by Ilzetzki and Vegh (2008); see Agu and Rani (2010) for a detailed discussion of this approach.

Figure 3.7 Estimated employment multiplier of government spending



Note: The figure shows estimated employment multipliers following increases in government spending both after one year (short term) and after five years (long term). The estimates cover the period 1980 to 2008 (on an annual basis). The employment multiplier is computed by dividing the "impulse response" by the average ratio of government consumption to GDP. For example, the employment multiplier for Argentina is 0.6, which would mean that an additional 1 per cent shock to government consumption will lead to an increase in employment of 0.6 per cent in the short term and an increase in employment of 1.9 per cent in the long term.

Source: IILS estimates based on IMF (2010a) and ILO Laborsta database.

the United States is 0.1 per cent in the short term and 0.3 per cent in the long term. Applying a 3 percentage point increase to the government spending to GDP ratio, as was recommended by international observers at the onset of the crisis, would have lifted employment by 0.8 per cent in the short term and 2.3 per cent in the long term. The actual stimulus packages have been much larger, reaching around 10 percentage points. Accordingly, this has prevented a further decline in employment of roughly 2.5 per cent and might lead to employment creation equivalent to 7.5 per cent of total employment over the long term, which should be sufficient to absorb a large proportion of the jobs lost so far. Figure 3.7 also demonstrates that employment responses to government consumption shocks in advanced countries appear to be considerably smaller than in developing countries. The impact multipliers were higher across all the developing countries than for developed countries. For instance, Argentina and South Africa had impact multipliers of 0.6 and 0.3, respectively, and their long-term multipliers were at least twice that of any of the developed countries. Among developing countries, China has the smallest short-term impact, slightly above the value for Italy. As regards the long-term effects, emerging economies also show substantially higher multipliers than advanced economies. This might partly be related to a higher responsiveness of labour supply to positive demand shocks in emerging economies, where informal economies are large. In addition, government spending output multipliers, which show a similar pattern across advanced and emerging economies, suggest that aggregate demand is the most constraining factor in these emerging economies, making them particularly receptive to additional public stimulus.

Second, some programmes have larger employment effects than others.

Which policies should countries implement? Does a generic approach exist, or is it necessary to identify concrete areas of policy intervention to guarantee success?

At the current juncture, with severely adverse macroeconomic conditions, the existing evidence on labour market programme effectiveness is only of limited help in selecting different policy options. Under more tranquil circumstances, some consensus had emerged in the past regarding the importance of certain policies, such as job search assistance and training programmes, for stimulating employment growth and bringing unemployed workers back to employment, even though there is almost no available cost–benefit evidence for these programmes.[6] There exists no evidence with regard to the effectiveness of these labour market policies taking macroeconomic and financial sector crisis conditions into account. These conditions must be taken into account, if countries want to select the right mix of policies as policy multipliers vary widely depending on the general macroeconomic environment. In this section, a novel approach is presented that aims to overcome – at least partially – this missing link between labour market policies and the aggregate state of the economy and employment. On the basis of a new database on unemployment dynamics, the macro- and microeconomic implications of fiscal and labour market policies are analysed. In particular, the analysis includes bidirectional effects between unemployment dynamics and fiscal variables to account for potential adverse effects from the costs of labour market policies at the macroeconomic level. This allows the fiscal implications of labour market policies to be taken into account explicitly and provides a more accurate picture of policy effectiveness under the current circumstances.[7]

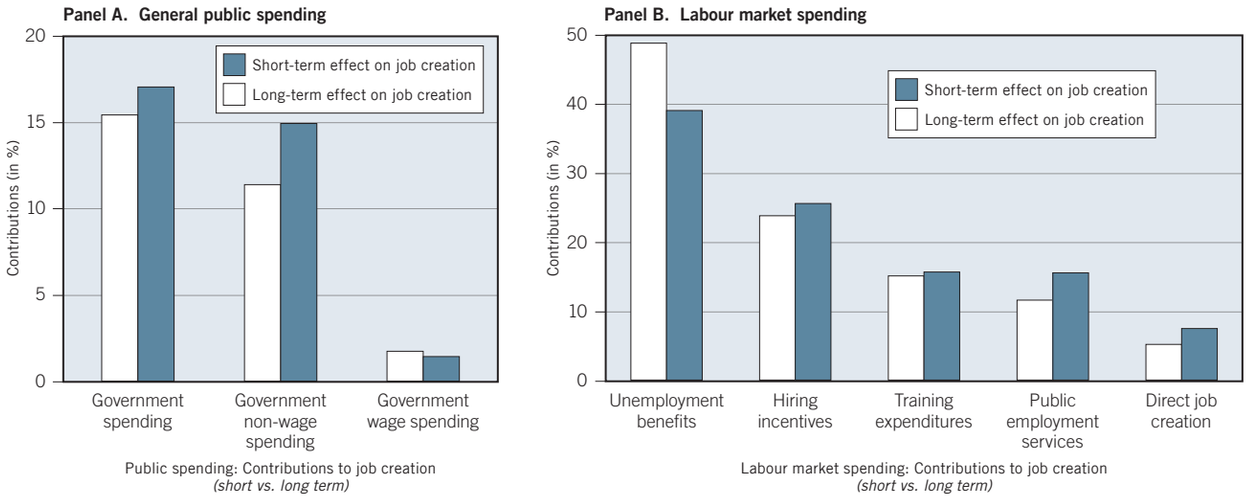
Countries face increasingly diverse challenges for their labour markets as a result of the crisis. Therefore, for the assessment of appropriate policy options, it is helpful to distinguish in more detail between different generic fiscal policies and specific labour market policies. In particular, this will allow assessment of the timing of when policies need to switch from income-support policies to those that facilitate long-term adjustment processes on the labour market. In this regard, total government consumption (excluding interest payments) is split into wage and non-wage government spending, the former being principally related to spending on public employment whereas the latter relates to policies directly relevant to supporting consumption in the private sector. Within this category also fall various labour market programmes, which have been further detailed in the analysis. A first distinction in these labour market programmes has been made between active and passive measures. The active measures comprises of direct job creation, hiring incentives, training programmes and spending on public employment services. The passive measures, on the other hand, comprise all those pertaining to income maintenance, at least temporarily.

On the basis of this analysis, general government spending seems to have a strong impact on job creation rates. In line with the above evidence on employment multipliers, the analysis presented here suggests that certain spending programmes have larger effects in the long than in the short run (see figure 3.8 panel A). On the other hand, public employment seems to have a more limited effect on job creation, even though it has played an important role in preventing employment from declining further at the beginning of the crisis.

The analysis also makes it possible to give a more detailed picture of various labour market programmes, including both passive and active measures

6. See Card et al. (2010) for a recent meta-analysis of existing studies in this area.
7. See www.ilo.org/inst and Ernst (2010) for a more detailed discussion of the empirical strategy, the estimation methodology and a summary of the estimation results. It should be noted that due to data restrictions the analysis in this section and the scenario simulations in the next section are limited to advanced G20 countries.

Figure 3.8 Estimated effects on job creation of different policy options in selected advanced economies



Note: The figure presents the contributions (in %) to job creation (measured by outflows out of unemployment) of different fiscal and labour market policies in a panel of 14 advanced economies. Contributions are measured relative to the total variance of cross-country job creation rates and are calculated with respect to the average spending shock across the country sample for each individual policy. Each bar corresponds to a single estimation of the employment effect of the respective policy, controlling for other policies affecting employment. Short-term effects are based on exogenous interest rates, long-term effects take into account the impact of an increase in government debt on real long-term interest rates. See www.ilo.org/inst and Ernst (2010) for detailed estimation results and methodology.

Source: IILS, based on Ernst (2010).

(see figure 3.8 panel B). Moreover, the particular macroeconomic focus and the detailed analysis of competing labour market programmes provide a more detailed understanding of the different policy trade-offs that countries are currently facing. In particular, direct job creation outside the public sector seems to come with high deadweight costs as it lowers job destructions substantially more than it increases job creation. In other words, the programmes often seem to benefit those already in a job or who would have been hired even in the absence of such policies. The absence of economically or statistically significant effects of direct job creation programmes on job creation is also confirmed when considering its effect over the long-term. Conversely, hiring subsidies seem to have the expected effect on job creation more than on job destruction, both in the short term and the long term.

Expenditures on training programmes and public employment services have the expected (positive) effects on job creation, confirming existing evidence in the literature. The estimated effects do not take into account the particular design of public employment services (PES) or training programmes in the countries of this sample. Some countries may actually find these policies have a much better effect on labour market flows when used in combination with appropriately designed unemployment benefits schemes. Nevertheless, it should be noted that these programmes often come with an increase in measured unemployment rates, an indication for the importance of programme design, in as much as the participation in certain programmes requires official inscription in the unemployment register.[8]

8. Partly, the rise in unemployment following an increase in expenditures on public employment services and training can be considered a statistical artefact: these measures particularly target inactive people to return to the labour market, causing measured unemployment rates to increase while inactivity rates decline.

As such, these programmes are not only an effective way of bringing unemployed workers back to employment, they also seem to constitute a useful instrument to activate those that currently have very limited ties with the labour market or have dropped out of the labour force altogether. The macroeconomic long-term effects of some of these policies, however, seem to be less significant than those in the short term, partly related to the high cost of these programmes, which weighs on public finances. In reality, these costs may be compensated by the individual long-term benefits regarding improved job matching rates and higher salaries; the estimates do not allow these to be taken properly into account.

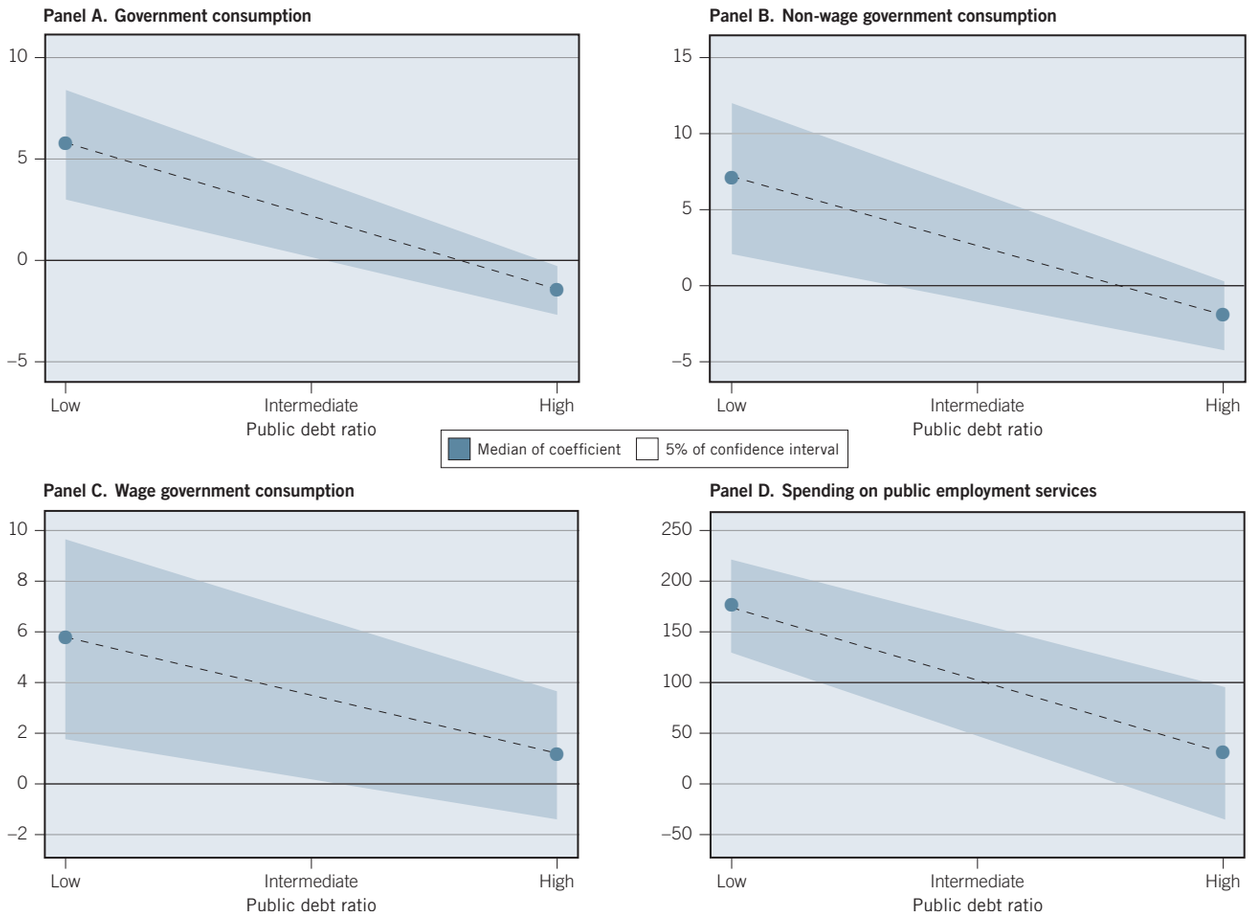
Finally, as regards the impact of unemployment benefits on labour market dynamics, these seem to produce the strongest effect among labour market policies in both the short term and the long term. In addition, such benefit systems – where they are in place – yield a positive contribution to job creation and help to reduce job destruction. This confirms the importance of such policies within the framework of stabilization policies. In contrast to fears expressed in the microeconomic literature, the results of the analysis presented here suggest that such benefit systems are acting in a stabilizing manner on labour market flows, thereby not overly distorting the process of job separation. Indeed, certain authors have suggested that the procyclical evolution of the tax wedge, due to benefit systems that need to balance their books, may increase the unemployment inflow rate, making labour market recovery more protracted (Den Haan, 2007). The above results do not suggest that this effect is particularly strong; rather – and in line with other studies, such as Acemoglu (2001) – the stabilizing impact on aggregate demand seems to dominate any possible deadweight costs from such systems.

Third, the employment impact of fiscal policy depends on country conditions, notably the level of public debt…

Differentiating the effectiveness of fiscal policy intervention depending on the initial level of public debt confirms concerns voiced earlier: for most spending types – including spending on labour market policies – the effectiveness declines and becomes insignificant (figure 3.9).[9] As public debt rises, private borrowers will find it increasingly difficult to finance their consumption and investment plans at reasonable rates, pushing up long-term interest rates. Certain private spending plans will be postponed, helping to support the savings rate, albeit in a procyclical way, and thereby slowing down the recovery (Afonso, 2008; Röhn, 2010). It should be noted that the results reported below suggest that these effects materialize independently of the immediate effect on aggregate demand: even those spending components which are likely to increase aggregate demand directly – such as spending on public sector wages – lose their effectiveness in supporting job creation. Conversely, coordination between fiscal and monetary policy is necessary for government outlays to have maximum impact on economic activity. When monetary policy-makers increase interest rates in reaction to additional government spending in an uncoordinated manner, the positive impact on activity will be smaller, or even absent, even in the short term. In part, the central bank reaction will depend on the cyclical situation: when the economy is running

9. Throughout this section, policy effectiveness is measured by the point estimate of the coefficient corresponding to the estimated impact of a particular policy on unemployment outflows. See Ernst (2010) for detailed results of the regressions.

Figure 3.9 Estimated employment effects of different spending policies, by level of the public debt ratio



Note: The figure shows coefficient estimates for the effect of various policy measures on job creation at various levels of public debt as a percent of GDP.

Source: See IILS web site: www.ilo.org/inst.

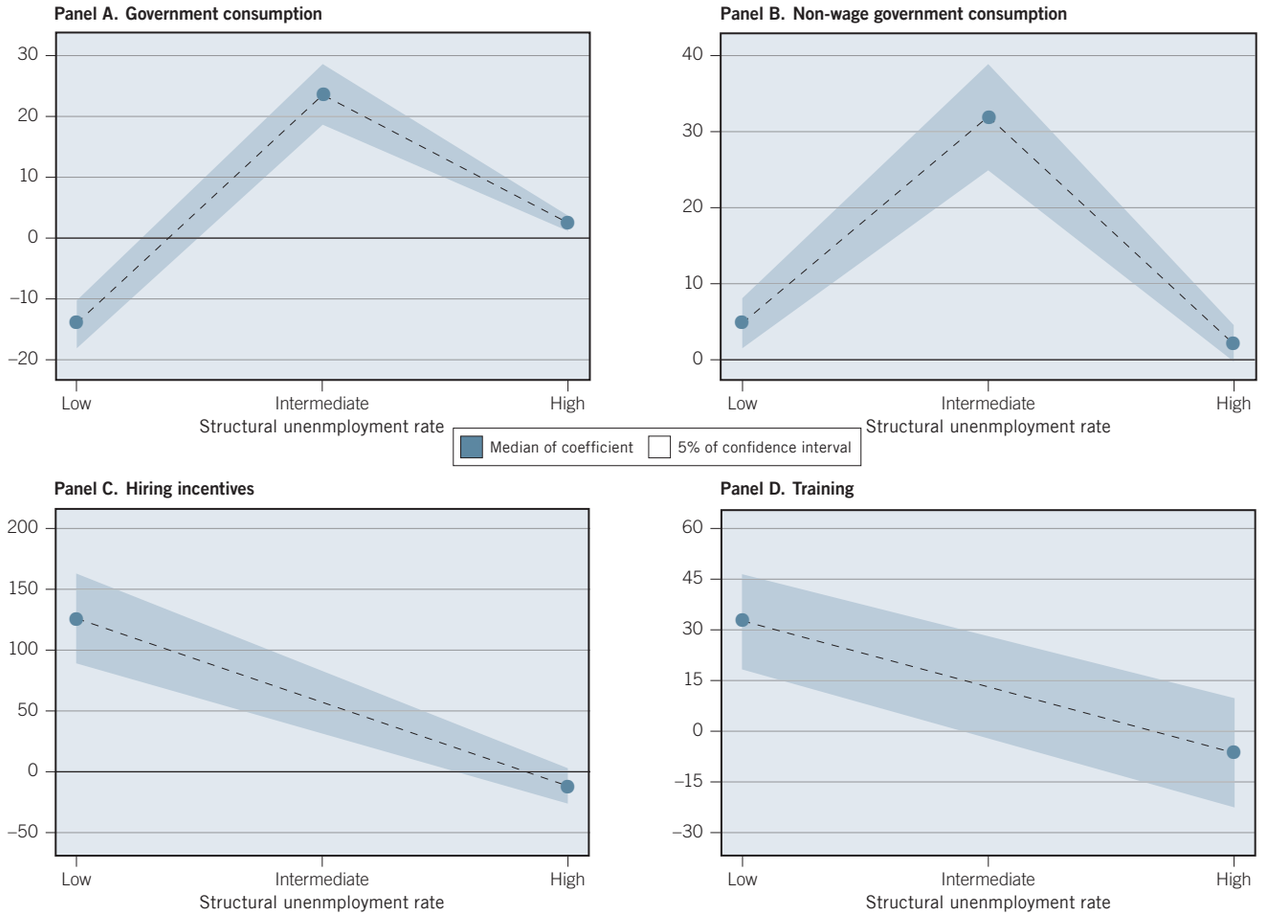
at or close to its potential, monetary policy-makers will be less inclined to guarantee the effectiveness of additional fiscal spending than at moments of large economic slack, such as in the current situation.

…structural unemployment…

Of particular concern coming out of the crisis will be the expected increase in long-term or structural unemployment.[10] Indeed, structural unemployment is rising among all OECD countries, with similar developments discernible also in some emerging countries, which will require labour market policies to reorient their efforts towards activation of those that are losing ties with the labour market or that have already left the labour force. In this regard, the estimates show that this will be no easy task. Indeed, general government consumption loses its

10. The notions of long-term and structural unemployment will be used interchangeably in this chapter as a way to characterize labour market segments that react only weakly or not at all to policy stimuli, such as automatic stabilizers or more targeted labour market measures. Typically, when structural unemployment is increasing, macroeconomic policies return to normalcy more rapidly to prevent inflationary pressures from building up.

Figure 3.10 Estimated effects of different spending policies by level of the structural unemployment rate



Note: The figure shows coefficient estimates for the effect of various policy measures on job creation at various levels of the structural unemployment rate.

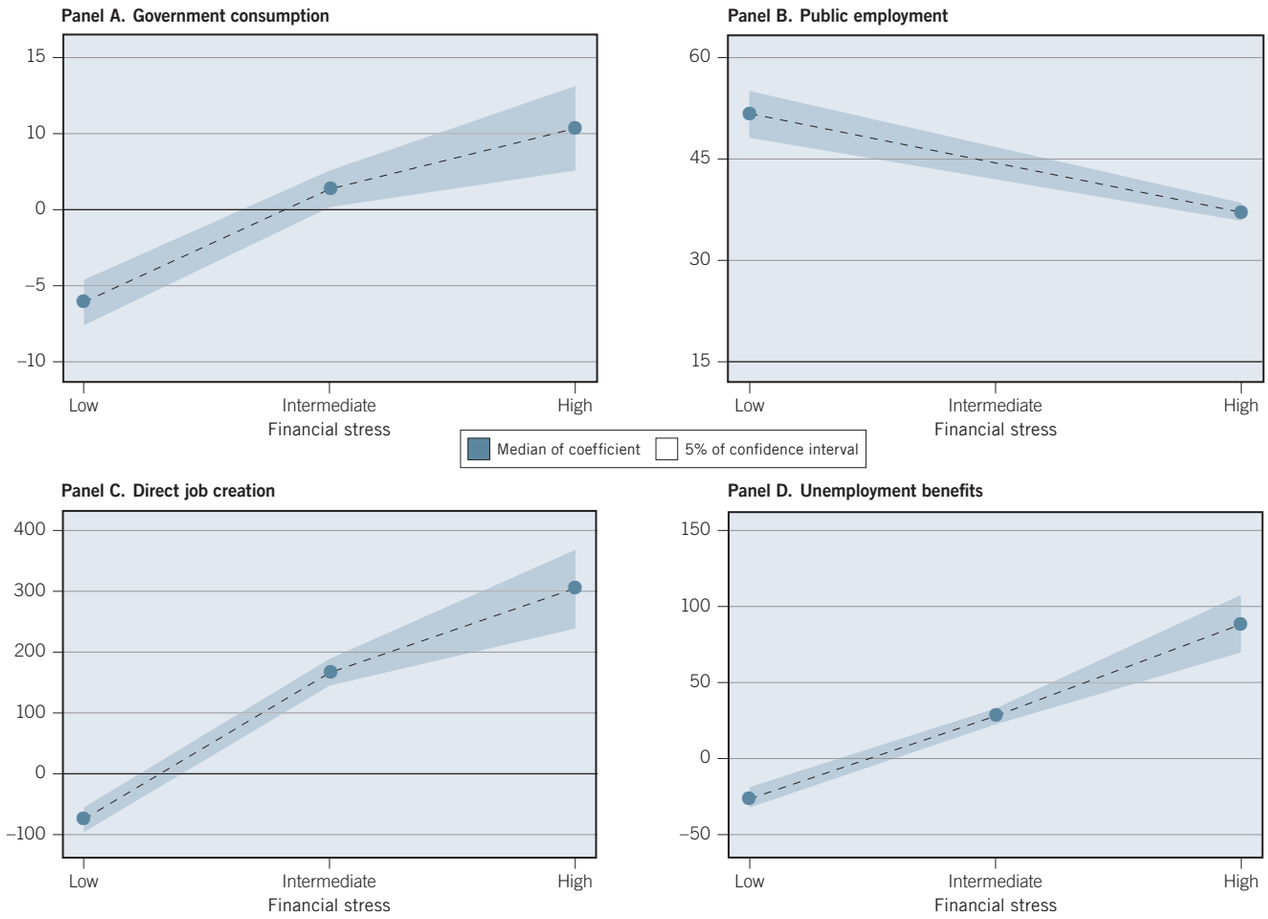
Source: See IILS web site: www.ilo.org/inst.

effectiveness with very high structural unemployment rates, irrespective of which spending component is analysed (see figure 3.10, panels A and B). Analysing labour market policies in more detail confirms this result: policies that are typically considered to be of great use when activating long-term unemployed – hiring incentives and training programmes – show strong signs of weakening effectiveness when structural unemployment rates increase (see figure 3.10, panels C and D).

…and financial market conditions.

Financial market stress is particularly relevant for understanding spending effectiveness in the current crisis (figure 3.11). Indeed, as mentioned above and discussed in detail in Chapter 5, several authors have suggested that financial market conditions can substantially alter the functioning of the real economy, leaving fiscal policy as the only effective tool for boosting production and employment creation. The results presented in figure 3.10 seem to support this view, in particular regarding general government spending, but also more specifically with respect to income support and direct job creation measures. Similar results are found for other active labour market spending programmes. It is notable,

Figure 3.11 Estimated effects of different spending policies, by degree of financial stress



Note: The figure shows coefficient estimates for the effect of various policy measures on job creation at various degrees of financial stress, as measured by Balakrishnan et al. (2009).

Source: See IILS web site: www.ilo.org/inst.

however, that this result does not seem to carry over for public sector employment creation, even though the above results suggest that under more normal economic circumstances, public employment creation can contribute to job creation. One explanation might be that the expansion of public employment during crisis would actually worsen the outlook for fiscal sustainability, thereby further increasing financial stress, with adverse spillovers into the real economy. This could also be one of the reasons why countries with consolidation programmes have targeted spending on this particular item as one area where public spending effectiveness is particularly low.

C. Fiscal austerity versus well-designed exit strategies

As the crisis continues, structural unemployment becomes more pervasive…

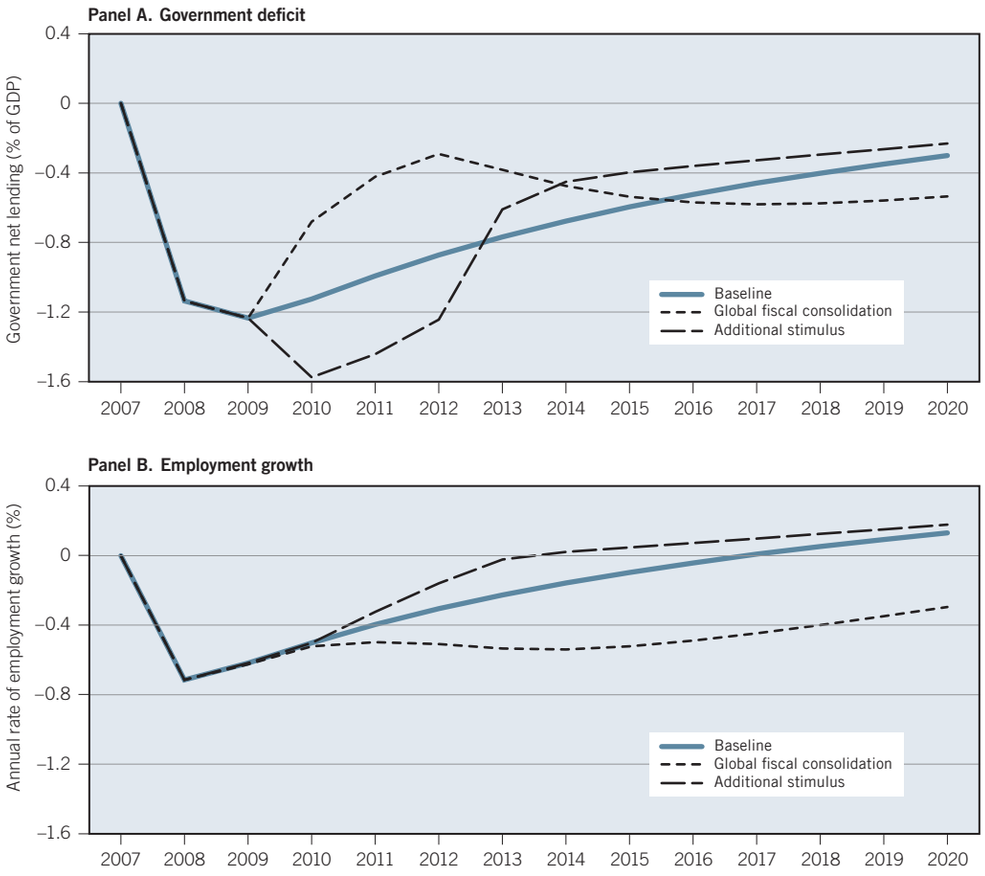
The fragile and muted nature of the recovery is likely to feed the structural unemployment rate. Indeed, after a financial sector crisis it typically takes a long time before growth returns to earlier rates. Partly, this is related to the fact that households and firms need to de-leverage before they can return to a stronger consumption and investment path (see also Chapter 5). As discussed in Chapter 1, this will cause the return of employment to pre-crisis levels to be only gradual. Indeed, in high-income economies, the adjustment period may be longer than six years, whereas upper-middle-income countries may have already returned to pre-crisis levels. Nevertheless, even in these countries the continuous growth in the size of the active population is putting additional pressure on labour markets. At any rate, the challenges that the crisis has created for labour markets will cause employment growth to remain at a lower rate than before the crisis for the foreseeable future. The flip side of these developments is that long-term challenges will arise on the labour market. Recent estimates of changes in structural unemployment rates across OECD countries indicate their likely increase – sometimes substantial – over the next two years, an important break with the past trend of falling structural unemployment rates in that region (OECD, 2010). Indeed, by 2011, structural unemployment rates are expected to rise by 3.5 percentage points for Spain and 0.5 percentage points for the OECD country average. As indicated by the analysis in the previous section, the growing structural problems in the labour market further complicate exit strategies by reducing the effectiveness of labour market and demand management policies.

In this context, what policy options do countries have, given the challenges for fiscal sustainability and labour markets as identified in this chapter? And how should they time and coordinate their policy interventions? At the current juncture, three scenarios for policy options can be distinguished for advanced G20 countries (figure 3.12). These scenarios provide some general lessons as regards both the timing and the cross-country coordination of policies. In particular, they demonstrate that there are some options to strengthen the labour market recovery. More importantly, there are policy choices that countries should refrain from if they want to avoid further deterioration of their employment situation.

The baseline scenario reflects the continuation of job-centred policies, as implemented with the onset of the crisis. These measures, though costly to the public purse in the short term, would in five years' time lead to fiscal deficits similar to those of an early exit strategy. In particular, by putting greater emphasis on labour market measures, they will be able to limit further increases in job destruction, avoid a downward spiral of wages and boost job creation.

In contrast, global fiscal consolidation from job-centred measures would significantly aggravate the employment outlook. Such a fiscal consolidation would improve fiscal balances only in the short term. However, it is crucial to note that this improvement would be short lived and would come at the cost of substantially worsened labour market dynamics. In particular, the analysis suggests that if restrictive measures were adopted now, employment in advanced G20 countries would be 4 per cent lower in five years' time (compared with the baseline). Shortly after early exit measures were adopted, fiscal deficits would deteriorate once again. This reflects the fact that (a) many workers would move out of the labour market, depriving the economy of valuable resources and reducing the tax

Figure 3.12 Exit scenarios from the crisis



Note: The figure shows three different exit scenarios from the crisis. Scenario 1 is at current policies; scenario 2 suggests a global fiscal consolidation, with global trade only expanding at half its pre-crisis rate (starting in 2010); and scenario three suggests an additional 3 per cent of GDP stimulus cut for 3 years (starting in 2010) and return to baseline public finances afterwards.

Source: See IILS web site: www.ilo.org/inst.

base, and (b) unemployment and labour market inactivity resulting from early exit measures have a strong bearing on public spending, as noted above. The adverse consequences of an early exit is particularly strong if fiscal consolidation were to be undertaken globally: as world trade in this situation would not recover to its earlier rate of expansion, a further dampening effect on aggregate demand and hence employment creation can be expected. In other words, uncoordinated fiscal contraction which disregards the situation of the global economy would produce a further drag on the recovery.

The simulated scenarios suggest that, in contrast to these consolidation measures, countries should use their available fiscal space to the full. Indeed, these countries could even consider a further increase in spending over the next three years in the order of 3 per cent of GDP. As the simulation scenario demonstrates, such additional spending would lead to a robust reaction of employment that is sufficiently strong to overcompensate the initial deterioration of public finances. Four years after the first additional spending measure has been set up, public deficits would actually be lower than under the baseline scenario. In light of the above discussion, such a scenario is only possible in those countries where some fiscal space remains and the labour market challenge continues to be one of lack in aggregate demand.

None of the three scenarios considers the structural challenges that arise from the crisis for labour markets. Changes in inactivity and necessary sectoral reallocation of resources and jobs, as described in Chapter 1, are not being properly reflected in these simulations and so policy measures need to be implemented along the lines suggested in the earlier discussion. However, to the extent that these measures also have some fiscal implications, the scenario simulations demonstrate that those measures that develop aggregate demand effects in the short term show superior labour market effects over the medium term, with the potential to improve the fiscal balance at the same time.

The analysis in this chapter suggests that policies will need to be decided on a country-specific basis as the recovery process takes divergent routes, notably due to differences in the level of public debt, the structural unemployment rate and the severity of financial stress. In particular, in light of the worsening situation as regards sovereign debt risk, not all countries that should continue stimulating their economy will be able to do so. In this regard, it is imperative that fiscal consolidation does not happen in an uncoordinated manner. In such a case, fiscal austerity is likely to turn out more severe than necessary. More generally, on the basis of the analysis and the simulations presented in this chapter, four principles can be put forward to inform the design of these policies:

- Countries will need to switch gradually from generic demand management policies to more targeted labour market and structural policies when recovering from the crisis, thereby using their remaining fiscal space most effectively. In particular, those labour market policies that contribute more to job creation than general/generic government spending could be given greater priority when reorienting public spending, following the guiding principles of the Global Jobs Pact, the ILO's key instrument for global policy coordination. Moreover, as the effectiveness of labour market policies is being less influenced by cyclical conditions than other public spending categories, they should be of priority when economies are recovering.

- Countries with low public debt – most notably some of the emerging G20 countries – will be able to support their economy longer and with smaller losses in policy effectiveness than countries with large public debt. This way they will support their own economy while also contributing to job recovery among those of their trading partners that benefit from less fiscal space. This issue and the contribution of such a policy on rebalancing the global economy will be discussed in depth in Chapter 4.

- It is crucial to tackle the rise of long-term unemployment and increase in informality quickly and decisively, even during the recovery phase. This may imply further support to aggregate demand to prevent an increase in long-term unemployment. Measures to limit job losses – such as part-time and work-sharing agreements – that have currently been put in place should be maintained until more normal cyclical conditions prevail. However, countries should prioritize measures that prevent a further increase in unemployment duration for those who have already lost their job.

- Fiscal space permitting, there is a strong case for maintaining well-designed, job-centred stimulus programmes in countries that continue to experience particularly high levels of financial market stress. In particular, labour market programmes can be of help here, with their lower fiscal costs and high policy effectiveness in an environment of high stress on financial markets.

In short, a majority of countries still have some room for fiscal manoeuvre, but are experiencing high long-term unemployment (such as Germany and Japan). These countries should use their available fiscal space and put more emphasis on active labour market policies, even beyond the forecast increases in spending on these programmes. Early action here is decisive in preventing structural unemployment from increasing too much or long-term unemployment becoming too persistent. Similarly, in countries like China where fiscal space is still available but lack of labour demand is the main contributor to unemployment rates, governments could use their room for manoeuvre and tackle joblessness head on. This will not only help to bring unemployment rates down, but will also prevent existing joblessness and informality from becoming structural. Finally, when fiscal space is no longer available, countries will need to concentrate on fiscal consolidation, as argued above, but should avoid cutting more effective labour market programmes. In particular, general spending cuts might not be the most appropriate policy. Rather, spending cuts or tax increases should take specific labour market challenges into account.

Policy considerations

The current global financial and economic crisis poses serious challenges for labour markets across the globe. Many countries are still to feel the full impact of the crisis on their labour markets but are already running out of fiscal space as public budgets have been stretched to safeguard the financial system. This chapter argues that despite these difficulties, several countries still have margins of adjustment to react to the labour market crisis. In particular, by reorienting current generic spending programmes more specifically towards labour market measures, they will be able to limit further increases in job destruction and help to boost job creation. Indeed, certain labour market measures – such as unemployment benefits and financial incentives for (private sector) job creation – have an effect on job creation that is comparable with unspecific government spending and may be better at preventing further job destruction. These measures should be favoured when considering reorientation of fiscal policies. At the current juncture, however, they only represent a very small share of the total stimulus that has been put in place, and have even come under scrutiny by certain governments in their consolidation efforts.

In addition, this chapter stresses the importance of international coordination, which has already helped to stem the first wave of the crisis. Such coordinated action should continue during the recovery stage to maximize policy effectiveness in stimulating global job creation. Indeed, countries that need to consolidate faster due to their deteriorating fiscal sustainability could still benefit from stronger world demand if all countries use their available fiscal space. For this, the Global Jobs Pact offers yardsticks to countries to facilitate the task of bringing into line their fiscal and labour market policies so as to maximize employment creation.

Finally, this chapter shows that once the appropriate measures have been decided they must be implemented quickly. The longer the labour market crisis continues, the higher the long-term unemployment will be and the more unemployed workers will get discouraged and leave the labour market. Moving ahead quickly is also important for maintaining policy effectiveness. Indeed, as public debt piles up, any measure will lose effectiveness, which further worsens the economic and fiscal outlook. In this respect, implementing the Global Jobs Pact quickly will ensure countries return to safer ground and support the labour market recovery.

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4 Rebalancing global growth: The role of an income-led strategy*

Main findings

- To ensure a sustainable recovery from the crisis, it is crucial to rebalance the composition of global growth. As seen in Chapter 3, the United States and other deficit countries must take steps to reduce recourse to debt as an engine for economic growth. This chapter addresses the flip side of the rebalancing story. It focuses on the challenge for surplus developing and emerging economies to reduce dependence upon export production by stimulating domestic sources of growth – notably through an "income-led" strategy, which includes a closer link between labour-incomes' growth and productivity gains, and strengthened social protection systems.
- During the years preceding the crisis, the share of wages in GDP declined by over 7 percentage points, on average, in surplus countries for which data are available. Meanwhile, the wage share stagnated during the same period in deficit countries. This means that real wages grew less than justified by productivity gains in surplus countries. Ensuring a better relation between wages and productivity growth in emerging surplus countries would help exploit domestic sources of growth in those countries while at the same time boosting the world economy and contributing to its rebalancing. The recent experience of Brazil provides an important illustration of how this can be achieved.
- Strengthened social protection systems also play a key role in rebalancing growth in emerging surplus countries, especially in Asia. Building up healthcare, education and pension systems could help encourage middle-class households to reduce precautionary savings and increase consumption. This would at the same time reinforce human capital and economic potential. Among poor

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and vulnerable households, a social protection floor involving elements such as income support and cash transfers not only translates readily into consumption, but also paves the way for higher investment in productive assets and creates new business opportunities. However, the design of social protection systems requires careful attention in order to avoid distortions in employment and investment decisions.

- Policy simulations carried out for the purposes of this chapter suggest that measures aimed at ensuring a closer link between wages and productivity, as well as strengthening and extending coverage of social protection systems in Asian surplus countries, including China, would be highly effective in boosting employment and growth prospects within Asia and across other regions. The effectiveness of income policies and social protection policies is further enhanced when they work in tandem. The policy simulations suggest that such income-led policies would be more effective for boosting global growth and job creation than targeting deficit reduction through fiscal consolidation.
- Currency appreciation in surplus countries is often considered to be a crucial policy measure for ensuring global rebalancing. Such measures, however, will tend to depress growth in surplus economies and not raise import demand significantly. For example, according to the policy simulations, a 20 per cent nominal depreciation of the US dollar vis-à-vis the Chinese yuan would produce only a relatively small reduction of the current account surplus of China while exerting upward pressure on unemployment in that country. Instead, an income-led strategy in Asian surplus countries (encompassing improved social security and nominal wage increases of 10 per cent – roughly what is needed to restore the wage–productivity linkages) would produce higher growth and lower unemployment in both the Asian region and other regions.

Introduction

Chapter 3 examined how growth can be rebalanced in debt-ridden countries. The purpose of this chapter is to explore how growth can be made more sustainable in surplus countries, with particular attention to the role of income and social protection policies in stimulating domestic aggregate demand in developing and emerging economies.[1]

The pre-crisis path of global growth based upon an excessive reliance on export-led growth in some countries and debt-driven demand in others is no longer sustainable (Torres, 2010). The current account surpluses accumulated particularly over the last decade by certain developing and emerging economies are mirrored by the growing spiral of debt-driven consumption and housing investment that has characterized economic growth in the United States and some European countries, such as the United Kingdom and Spain (IILS, 2008 and 2009; Rajan, 2010). The vulnerability of excessive dependence on external sources of demand was confirmed by the collapse in world trade that occurred over late 2008 and early 2009, triggered by the crisis of debt-driven growth in the North (Baldwin, 2009; Yi,

1. Hence, OECD surplus countries such as Germany and Japan are not addressed within the scope of this chapter.

2009). In addition to the trade surpluses, corporate and household savings are increasingly contributing to current account surpluses particularly in Asian surplus economies (Prasad, 2009).

To address these imbalances, global leaders and international organizations have called for policy measures that will attain a more balanced pattern of global growth in the post-crisis period (IMF, 2010; UN, 2010a and 2010b). Policy analysis and proposals include measures designed to strengthen domestic demand in surplus economies (G20, 2009 and 2010; UNCTAD, 2010; ILO, 2010a and 2010b; ILO and IMF, 2010).

This chapter is organized in two parts. Section A briefly discusses some of the main factors behind the need for a rebalancing of the export-led growth model. The discussion focuses particularly on the policy challenge to improve income and social protection systems as crucial elements in stimulating domestic demand in surplus countries. Section B then examines different policy options for reducing reliance on export-led growth while maintaining strong growth and employment dynamism in these economies.

A. Surplus economies: The challenge to rebalance sources of growth

The export-led model of growth helped promote development…

The export-led path of development has been a vital source of economic growth for many developing and emerging economies, particularly in Asia. Labour productivity has risen largely due to technological change, business investment and scale economies, as exporters tapped new mass markets which, in turn, fuelled new job growth (ILO, 2010e). Particularly among more recently industrializing countries, this export growth has been predominantly in price-sensitive, labour-intensive consumer goods and services. In these cases, output growth has not always translated into the creation of better-paid, stable or formal sector jobs. While demand for labour has created important new opportunities, it has often involved informal jobs, poor working conditions, hours and wages, particularly in the lower tiers of global supply chains (Barrientos, 2007; ILO, 2009a; OECD, 2009; ILO, 2010e; Posthuma and Nathan, 2010).

Over the past three decades, the share of low- and middle-income countries in world exports for goods rose from 16 per cent in 1986 to over 30 per cent in 2008 and from 13 per cent in 1986 to 20 per cent in 2007 for services (Milberg and Winkler, 2010). The export drive in China has been particularly pronounced, with exports growing from 3 per cent of GDP in 1970 to nearly 43 per cent in 2007, a trend mirrored in Argentina, India, Mexico and the Republic of Korea among others (ibid.).[2] Exports of goods and services as a share of GDP in Asia and Africa rose particularly over the 2000s, while Latin America experienced its strongest export growth over the 1990s. This export orientation has increased the reliance of developing countries on export revenues.

2. However, it must be borne in mind that export contribution to growth can be overestimated in countries such as China, where exports contain a large import quotient (see for example the CPB method: www.cpb.nl).

…but created excessive export dependency upon countries driven by debt-led demand.

The Asian region has long relied upon exports as a driver of growth. However, it was only after the Asian crisis that many countries in the region shored up greater foreign exchange reserves and larger current account surpluses as a buffer against future instability (ADB, 2009; Mendoza, 2010).[3] East Asian countries overall increased their current account surpluses from US$16.3 billion in 1997 to US$294 billion in 2006.[4] Meanwhile, Latin American countries turned their aggregate regional deficit of US$48 billion in 1997 into a surplus of US$48 billion by 2006.

As a counterpoint to strengthened external surpluses in developing and emerging economies, the growth path adopted in the United States and several other large advanced economies, including the United Kingdom and Spain, was driven by a rising spiral of debt-fuelled consumption and housing investment. As imbalances deepened, the United States became the world's consumer of last resort. With less than 5 per cent of the world's population, the United States came to consume over 20 per cent of world output. Conversely, with about 20 per cent of the world's population, China was consuming just 2–3 per cent of world output prior to the crisis. These diverging growth paths of surplus and deficit countries constitute a set of "fault lines" underlying the current crisis (Rajan, 2010).

Attaining sustained global growth will require rebalancing the composition of global sources of growth. For deficit countries, this means reducing debt-led demand and current account deficits, while also raising the saving rate and avoiding protectionist measures. Meanwhile, the challenge for surplus countries will be to stimulate domestic sources of growth.

Export-led growth will continue to be an important source of growth and job creation for many developing and emerging economies. Export-oriented growth can be compatible with balanced growth, but this requires a shift from the pre-crisis model that was dependent upon exports as the key engine of growth and the accumulation of massive current account surpluses (ADB, 2009; Chandrasekhar and Ghosh, 2010). Instead, the crucial policy challenge is to put in place measures to attain a sustainable balance between external and domestic sources of demand (Rodrik, 2008; ILO, 2010e).

The following discussion explores some of the factors behind two policy dimensions that will be crucial in stimulating domestic sources of growth in surplus countries: adjustments in wage shares; and a reduction of excessively high savings rates.

A more balanced model of global growth, which stimulates domestic demand in surplus countries, will need to address wage gaps…

Many surplus countries have built export competitiveness on a comparative advantage of low labour costs. Price competition has created pressure to control

3. It is estimated that two-thirds of global foreign exchange reserves are now in the hands of central banks in developing and emerging economies (OECD, 2010a).

4. This discussion focuses on the surplus economies; it does not address all developing and emerging economies, among which great heterogeneity exists. For example, no single pattern emerges for current account balances across Asian economies; there are both surplus and deficit countries. Rather, four broad types of behaviour have been identified: (a) middle-income countries that have raised current account surpluses since the Asian financial crisis; (b) high-income surplus countries and areas (Hong Kong, China; Singapore; and Taiwan, China); (c) low-income surplus economies (China); and low-income deficit economies (India and Viet Nam) (Adams and Park, 2009).

Figure 4.1 Change in wage share in trade surplus and deficit countries (1995–2000 and 2000–05)

Note: The figure shows changes in the share of wages in GDP, in percentage points, in (i) countries that had a trade deficit, on average, during 1995–2000 and 2000–05 and (ii) countries that had a trade surplus during the same periods. See Appendix A for the list of deficit and surplus countries.

Source: IILS estimates based on data from World Development Indicators, 2010, IILS, 2008 and UN System of National Accounts.

production costs, which often has involved strong wage moderation. Thus, productivity growth has not always translated into commensurate wage gains (Akyüz, 2010). Instead, rising income inequalities and lagging wage shares have characterized much of the process of global economic growth over the past two decades (ILO, 2008a and 2008b).

Declining wage shares bear a relationship with the trade balance for a set of 69 advanced, emerging and developing economies. Among the 37 deficit countries for which data are available, the share of wages in GDP stagnated during the period 2000–05. Significantly, the wage share declined over both periods in *surplus economies*. In particular, during 2000–05, the share of wages in GDP declined by over 7 percentage points, on average, in the 32 surplus economies for which data are available (figure 4.1). These findings suggest that the gains from export-led growth have not been shared equally between profits and wages in the majority of the countries examined.

This trend of declining wage shares underscores the policy challenge for the post-crisis period to follow a more balanced and socially inclusive approach. It has been possible for export-oriented growth to increase the absolute level of domestic consumption, even under conditions of declining wage shares, as seen in China. However, more balanced and inclusive growth in the future must involve greater attention to the role of incomes in stimulating domestic growth through the positive effect of increased earnings on domestic effective demand and household consumption levels. For example, rebalancing toward greater domestic-led consumption growth in Asia will rely largely upon its emerging middle class, which represents an enormous potential consumer market, but which remains fragile as the majority lies in the US$2 to US$4 range (ADB, 2010). Resources already exist to rectify this imbalance, at least among the surplus countries. The recent experience of Brazil suggests that, if carefully conducted, such a policy can be successful.

This pattern is under growing pressure to change. Wage pressures are rising in China, and also in other Asian export manufacturing economies, due to a combination of social, demographic and economic factors (box 4.1).

…strengthen social protection…

Social protection also has an important role to play in stabilizing consumption over the cycle and strengthening human capital. Low household consumption

Box 4.1 Wage pressures in Asia's global factories

Wage pressures have built up in Asian factories that fuelled the boom of export production. In mid-2010, industrial action in Cambodia halted production in ready-made garment factories, leading to intense discussions on changing the level of the existing minimum wage in this export-dependent sector. Industrial action at a number of factories in China has also led to pressure for wage adjustment.

Prior to the crisis, wage pressures were already manifest. In 2008, a record number of 762 strikes erupted throughout Vietnamese export factories, due primarily to double-digit inflation (particularly in food and oil prices). This social pressure contributed toward the setting of a new minimum monthly wage for workers in foreign-owned companies of US$52 in early 2010. In the case of China, a combination of structural factors is at play. These include tighter labour markets for skilled workers, demographic shifts, changes in labour relations, rising expectations among the industrial labour force (including migrant workers) in the coastal export zones and new labour regulations (Chan, 2010; OECD, 2010a). For example, the Labour Contract Law, which came into force on 1 January 2008, expanded employee rights and protections. Ambiguity over the legality of strike action by workers over wages was an important factor making recent labour disputes difficult to control.

and high precautionary savings among middle-class households in many surplus economies are explained largely by poor social protection systems and an underdeveloped financial system (Woo, 2008), which consequently create a private burden of expenditure on housing, education and healthcare (Chamon and Prasad, 2008). Weak domestic demand was further reinforced by industrialization policies that favoured output for exports at the expense of domestic consumption.

Throughout the 1990s and 2000s, household consumption as a share of GDP in East Asia fluctuated between 40 and 50 per cent of GDP. In China over the past decade, as economic growth and net exports rose at a substantial rate, household consumption declined from around 46 per cent of GDP in 2000 to below 36 per cent in 2008[5] (figure 4.2). In contrast, household consumption in the United States rose to around 70 per cent of GDP over the 2000s. For the OECD economies and Latin America, household consumption remained between 60 and 70 per cent over the period. High household consumption in Africa reflects low earnings and poverty that mean a large proportion of household income is spent on basic necessities.[6] Building up social protection, quality public healthcare and education and solid pension funds could encourage middle-class households to reduce precautionary savings. Social protection and education also can contribute to enhancing growth prospects by maintaining human capital.

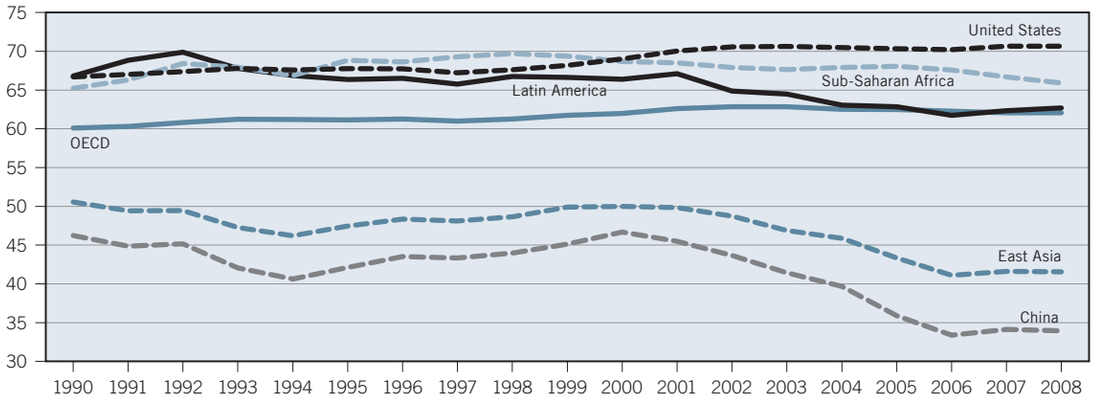
…and provide income support for poor and vulnerable households.

Strengthened social protection is equally important for raising consumption by poor and vulnerable households, which save little and have a high marginal propensity to consume. Greater social expenditure, such as income support and cash

5. Not only are household savings large in China, but the largest increase in savings in the build-up to the crisis came from the corporate sector (rising to 20 per cent of GDP) (OECD, 2010a).

6. Low savings rates in Africa have also been associated with the costs involved with formal financial markets, strategies for risk management as well as investments in household-level productive activities (Aryeetey and Udry, 2000).

Figure 4.2 Household consumption, 1990–2008 (percentage of GDP)



Source: World Development Indicators, 2010.

transfers, translates effectively into consumption. Such resources are often used for investment in productive assets, such as improvements in agriculture or the family dwelling, as well as urban micro- and small enterprises, which contribute to raising domestic output and job creation.

The ILO estimates that 80 per cent of the world population lacks adequate social protection coverage (ILO, 2010c and 2010d). Policy responses to the crisis involved various types of support to strengthen social protection mechanisms, revealing the recognition among policy-makers of the role of social protection as a socio-economic stabilizer, as well as its role in accelerating economic recovery. Looking toward post-crisis growth policies, an enhanced role of social protection and poverty reduction policies in developing countries is now seen as a necessary component to obtain sustainable global growth (Canuto, 2010). A broader, systemic approach that embeds social protection within development policy would be effective in unleashing greater domestic consumption, as well as addressing the new forms of vulnerability that have emerged as a result of engagement in the global economy (Cook and Kabeer, 2010; Prasad and Gerecke, 2010).

Attaining a growth model in surplus economies that maintains a better balance between export production and income-led domestic demand will necessarily involve raising the wage share to a more equitable level, in line with productivity gains. In addition, strengthened provision of social protection and other public social goods will play a crucial role in helping to reduce precautionary savings by the middle class, while providing income support to raise the disposable earnings of low-income and vulnerable groups.

This policy approach is in line with the Global Jobs Pact. The Pact emphasizes the macroeconomic interaction of employment policies, minimum wage mechanisms and social protection policies with fiscal and monetary policies as a central focus of strategies for stable, sustained and balanced growth (ILO, 2009b; ILO and IMF, 2010).

The next section explores different policy options for reducing reliance on export-led growth, while maintaining strong growth and employment dynamism.

B. Policy options for addressing global imbalances and recovery of growth

To address the imbalances described in the previous section, two types of policy responses have been advocated: (a) reducing growth led by private debt in deficit countries – mainly through tighter fiscal policy; and/or (b) boosting growth led by domestic demand in surplus countries, through some combination of currency adjustments, supportive wage and social protection policies and development of internal sources of growth. The employment impacts of tighter fiscal policy have been analysed in Chapter 3. The purpose of this section is to assess the employment effects of the second set of policy measures. This is done by examining three scenarios derived from a model of the world economy developed for this report (see Appendix B). Importantly, the model investigates the short-term effects of different policy options for rebalancing the world economy. It therefore does not consider the longer term impacts that policies may have on the structure of the economy. In addition, the model does not take into account the possible reaction of financial markets to policy changes. Despite these important caveats, the model helps illustrate the immediate post-crisis paths arising from different rebalancing policies. The main outcomes of these simulations are presented in table 4.1 and a detailed analysis can be found in Von Arnim (2010).

Currency changes yield conflicting employment effects and limited reductions in external deficits…

It is often argued that currency realignments will be sufficient for rebalancing economic growth. This would involve appreciation of the exchange rate in surplus countries vis-à-vis deficit countries. However, evidence suggests that currency realignments on their own are insufficient to achieve the transition to a balanced growth mode[7], not the least as the causes underlying current account surpluses and high savings rates are partly socio-structural in nature. Therefore, when undertaken, in combination with other policy measures, a credible realignment of exchange rates could be part of the rebalancing process (UNCTAD, 2010; Ma and Yi, 2010; OECD, 2010b; McKinnon and Schnabl, 2009).

As an illustration, the effects of an appreciation of the yuan against the US dollar have been estimated on the basis of the above-mentioned model. More specifically, the model is used to simulate the short-term effects of a 20 per cent nominal depreciation of the US dollar vis-à-vis the Chinese yuan. The size of this shock comes close to what is conventionally discussed. In this first policy scenario, Chinese exports become more expensive, while imports into China are more competitive. The result is a contraction of China's current account surplus of almost 7 per cent (Von Arnim, 2010), which is relatively small in view of the current size of the global imbalance. Importantly, relative to China's GDP, the current account surplus does not shrink noticeably. Moreover, domestic demand does not shift strongly enough towards non-Chinese products. The unemployment rate in China rises by more than 1.8 percentage points, and it remains broadly unchanged in the United States and other advanced economies.

7. Exchange rate appreciation of the yen in the mid-1980s failed to boost domestic demand and, instead, led to stock-market and real-estate bubbles and a shift of investment by Japanese companies to lower-wage Asian countries (Rajan, 2010).

Table 4.1 Changes in unemployment rates as a result of three policy options for rebalancing the world economy (in percentage points)

	World	Advanced economies	United States	Europe	Japan	Emerging& developing economies	Asia	Latin America	Africa	Brazil	Russian Federation	India	China	South Africa	Energy exporters
Yuan appreciation	**0.1**	**0.0**	0.1	–0.1	0.0	**0.4**	–0.3	0.1	0.0	–0.1	–0.1	–0.1	1.8	–0.2	–0.1
Asia rebalancing	**–0.3**	**–0.1**	–0.1	–0.1	–0.3	**–0.6**	–0.6	–0.2	–0.1	–0.1	–0.2	–0.2	–1.4	–0.1	–0.4
US deficit cut	**1.2**	**1.3**	3.1	0.3	0.6	**0.9**	0.8	2.2	0.2	0.3	0.5	0.4	0.7	0.3	1.2
Memorandum item: Unemployment rate, 2008	**6.2**	**6.1**	5.7	6.9	3.9	**6.4**	6.2	5.2	16.3	8.1	6.3	7.3	4.2	21.4	6.8

Note: The table provides differences in percentage points between estimated unemployment rates arising from each policy shock and actual unemployment rates. For example, a shock associated with Asian rebalancing would reduce the world unemployment rate by 0.3 percentage points (second figure in the first column). The three policy options considered in the Table are: (i) a 20 per cent nominal depreciation of the US dollar vis-à-vis the Chinese yuan (first row); (ii) improved social protection and a 10% wage increase in Asia (so-called "Asia rebalancing"; second row); and (iii) a 2 percentage-point cut in the US fiscal deficit relative to GDP (third row).

Source: IILS, based on Von Arnim (2010).

Over the longer term, a stronger positive effect can be expected from improved competitiveness in the US and other advanced economies. Likewise, the yuan appreciation may gradually boost the non-tradable sector of China, thereby dampening the negative impacts of output and employment associated with the currency appreciation. As mentioned, these longer-term effects cannot be captured in the model which is short term in nature. However, the immediate socio-economic implications associated with the currency appreciation make this a difficult option to pursue politically in China.

The weak impact of currency appreciation on growth patterns tends to corroborate the view of some authors that the root cause of global imbalances lies in national imbalances (ILO, 2008b). According to this view, savings and investment patterns dominate external borrowing requirements (Von Arnim, 2009).

…in contrast, boosting demand in surplus countries would support jobs and cut imbalances worldwide…

There is evidence that policy measures aimed at ensuring that labour income grows in line with productivity, in addition to strengthening and extending coverage of social protection systems, can be highly effective in boosting overall growth prospects (UNCTAD, 2010).[8] The effects of these policies are especially beneficial in emerging economies where higher income among low- and middle-income groups can lead to a virtuous cycle of greater consumption and investment, nurturing business opportunities and product innovation to meet new demand, and in turn leading to higher employment and income.

For instance, policies adopted by the Brazilian government prior to the crisis were aimed at addressing income inequalities, raising the minimum wage and

8. In the case of China, calculations suggest that the decline in disposable household income as a share of GDP is largely responsible for the relative decline of household consumption in aggregate demand (UNCTAD, 2010; Aziz and Cui, 2007).

strengthening the social protection system. This not only sustained consumption, but also stimulated business investment and the creation of new products that meet new demand – a key factor behind the successful crisis recovery of Brazil (Barbosa, 2010). Likewise, the impacts of the Chinese stimulus package appear to support the thesis that boosting domestic demand can support internal – hitherto unexploited – sources of economic growth and job creation.[9] The OECD attributes one-third of global growth in 2010 to China's double-digit expansion that was fuelled by monetary and fiscal stimulus (OECD, 2010a).

Policy instruments that can ensure appropriate rates of income growth include setting and adjusting regularly minimum wages (as discussed in box 4.2) in addition to broader measures to reinforce social dialogue and wage bargaining (ILO, 2008a).

Market forces themselves have exerted upward pressure on wages in some Asian countries. In cases where wage increases have been attained, these are often the result of company-level decisions, rather than arising from broad-based wage bargaining within a domestic industrial relations system.[10] Hence, in order to become a sustainable and regularly adjusted component of an income-led growth strategy, such wage adjustments must be structurally embedded within labour market institutions and agreed wage-setting mechanisms.

More generally, the effectiveness of wage policies and social protection policies is further enhanced when they work in tandem (ILO, 2010d). Thus, both income and social protection policies have an important role to play in post-crisis rebalancing, through their effect in distributing the benefits of growth more widely domestically and contributing to more sustainable and inclusive global growth.

To illustrate this, the second policy scenario simulates the effects of improved social security and higher wages in Asia on global rebalancing and recovery. The policy changes are implemented in the Asian surplus region, including China, as (a) a decrease in the net tax rate by 10 per cent (to capture higher social transfers) and a decrease in the propensity of wage earning households to save by 10 per cent (to capture reduced precautionary savings associated with strengthened social protection), and (b) an increase in nominal wages by 10 per cent. The results are clearly positive for employment in all regions (second row in table 4.1). Higher growth in Asia represents increased external demand for the rest of the world and leads to a cut in China's current account surplus relative to GDP (Von Arnim, 2010).[11]

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9. Chinese stimulus expenditures in 2009 accounted for the equivalent of 2.1 per cent and in 2010 totaled 2.3 per cent of the country's 2008 GDP (Prasad and Sorkin, 2009). Some studies forecast that the Chinese fiscal stimulus package had the potential to boost domestic demand sufficiently to raise internal job creation by as much as 17 to 20 million new jobs in non-farming sectors (He, Zhang and Zhang, 2009).

10. Some companies express concern that granting higher wages may affect their profits and the final retail price of their goods on global markets. In some cases, companies experiencing rising wage pressures have reportedly decided to shift all or part of production to lower-wage areas in China and other Asian countries, such as Bangladesh, India, Indonesia, the Philippines, Thailand and Viet Nam. These practices pose a challenge for ensuring a closer link between labour income and productivity, which if undertaken in the majority of the enterprises and sectors would be beneficial to Asian economies as a whole.

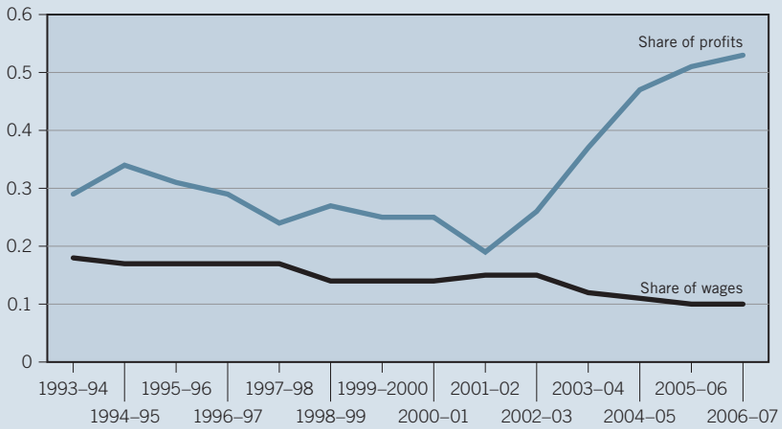
11. As shown in the detailed results (Von Arnim, 2010), the Asian aggregate region grows by 1 percentage point, but its aggregate external deficit increases slightly. That is largely due to the fairly strong in-region growth; the Asian deficit region's current account relative to GDP worsens by 0.5 percentage points, outweighing the Asian surplus region's reduction. Income inequality – as measured by the functional distribution of income – decreases. However, increases in the wage share should be interpreted carefully. Principally, wage share changes in this model are cyclical, and it is not necessarily obvious that they will last. Still, if higher real wages become structurally embedded institutionally, they can translate into improvements in the personal distribution of income, even if productivity growth catches up. Fiscal balances across Asia remain sound.

Box 4.2 Improving wage share through implementing and enforcing minimum wage legislation

Redistribution via increased wage share can contribute towards raising aggregate demand because the marginal propensity to consume out of wages is higher than the marginal propensity to invest out of profits (Lavoie, 2009; Stockhammer, Onaran and Ederer, 2007).

In India, for example, the share of profits in output has risen sharply since 2001–02, reducing wage share and depressing purchasing power (figure 4.3). An important mechanism through which wage share can be adjusted is minimum wage legislation. In India, the Minimum Wage Act of 1948 is an important piece of labour legislation. However, the minimum wage is set only "in certain employments or occupations" and therefore not all wage earners (especially casual wage earners) are covered. A major step towards improving the coverage was made when the Central Government introduced the concept of an indicative national minimum wage floor in 1996, currently set at 100 rupees or about US$2 per day. This was in response to the observation that high levels of poverty and inequality persist despite high rates of economic growth in recent years.

Figure 4.3 Declining wage share in India, 1993–2007



Source: Annual Survey of Industries, various years.

However, the national minimum wage floor is not binding on the States. If the existing minimum wage laws were adopted and implemented more effectively, it would help to increase purchasing power and improve domestic demand. Data simulations show that the effects of either making the national minimum wage floor compulsory or extending the coverage of State-level minimum wages would be considerable (Belser and Rani, 2010). Approximately 73 million out of 173 million wage earners throughout India do not receive minimum wages. About 30–40 per cent of these low-paid wage earners belong to poor families. Extending the minimum wage to all of them could lift their wages and would contribute to reducing both inequalities (9 per cent) and poverty incidence (8 per cent) in India. This example demonstrates the role of minimum wages as an effective redistributive tool.

Of course, an income-led strategy should go hand in hand with continued efforts to raise labour productivity and improve the responsiveness of enterprises to new demand (ILO, 2010e).[12] For example, China has been particularly effective in tapping foreign direct investment as a source of technology acquisition and productivity enhancement, in addition to domestic investments in science and

12. Towards this aim, policy measures in other domains are also necessary, such as ensuring availability of credit and provision of incentives to invest in technological change and upgrading installed capacity, including for smaller and medium-sized firms. Productive upgrading also calls for raising the quality and supply of training and skills development, to build requisite skills among the workforce. Industrial policies can focus attention where greatest potential exists to boost the sectoral composition of growth.

technology. This has played an important role in raising economic growth and labour productivity in China. Other countries wishing to follow an income-led growth path should at the same time make efforts to improve access to new technology and enhance productivity.

…which would clearly be better for employment than rebalancing world growth by reducing demand in deficit countries.

Evidence presented in Chapter 3 suggests that fiscal austerity measures tend to depress world growth. The third policy scenario confirms this, and it also shows that these measures would do little to reduce global imbalances, but would entail considerable cost in terms of higher unemployment (third row in table 4.1). For instance, a cut in US public borrowing as a share of GDP by 2 percentage points – which is the size of the cut that is often advocated – would lead to a sizeable contraction of GDP in the United States. According to the model, the US unemployment rate would increase by over 3 percentage points and the US external balance relative to GDP would improve by about 1 percentage point relative to GDP, mainly arising from falling imports (Von Arnim, 2010). The latter, in turn, would lead to a downturn in all the regions, especially in the US main trading partners – Canada and Latin America.

Policy considerations

There is widespread agreement that rebalancing of global growth will require policies in surplus economies to obtain a more sustainable balance between export-oriented production and domestic sources of growth. Raising labour income commensurate with gains in productivity has been shown in this chapter to be a necessary policy shift for surplus countries, and as such should be an integral component within a broader income-led growth strategy. Likewise, strengthened social protection systems (including well-designed policies for health care, education and pensions) can impact favourably upon reducing precautionary savings. Such policies would also exert a positive supply effect by boosting human capital and creating new business opportunities associated with the enlargement of the market to include low-income groups. Policy measures introduced during the crisis that involved income support and enhanced social protection provide positive lessons in this regard, as they have proved effective in sustaining both domestic demand and domestic sources of growth (ILO, 2010a and 2010d).

The driving question behind this chapter has concerned how domestic growth can be stimulated in surplus countries through policy measures that give primacy to income-led growth paths. What are the elements for this necessary policy shift?

The strengthening of mechanisms for wage setting, involving bargaining between employers and workers representatives, is crucial in this respect. Wage-setting mechanisms can help reduce wage inequalities, particularly as experienced in rapidly growing economies. Social dialogue and extension of collective bargaining coverage can ensure that wages are more responsive to productivity gains (ILO, 2008). Such policy mechanisms affect earnings in the formal economy, but can also be designed to influence wage patterns in the informal economy. Wage-setting in the public sector also can serve as a wage anchor.

Minimum wages are particularly important in setting a wage floor and redressing inequalities at the bottom of the wage scale, for categories of workers not covered by collective bargaining mechanisms, such as low-skilled workers, the self-employed, informal and vulnerable workers.[13] Minimum wage mechanisms work best when kept simple and manageable, with adjustments conducted on a regular basis. Credible enforcement mechanisms also help improve effective implementation of minimum wage legislation (ILO, 2008a). Various countries are implementing relevant policy responses in this regard. For example, in order to enhance the effectiveness of minimum wage policies, a series of reforms are being introduced in the Philippines and Viet Nam. In the case of China, new laws on wage regulations are being developed, particularly in response to increases in wage disputes and widening income inequality. Many other countries in Asia (e.g., Mongolia) are following suit through initiating various reforms in wage policies (ILO, 2010f).

Putting in place a stronger and more extensive system of social protection (including provision of basic services such as quality health and education and strengthened public and private pension systems) can promote the well-being of society. Social protection systems also contribute to the sustainability of economic growth by building human capital and thereby boosting future labour productivity. Social protection policies constitute important countercyclical policies that can help sustain aggregate demand in times of crisis. For poor and vulnerable households, mechanisms that introduce, strengthen and extend the social protection floor (such as income support and conditional cash transfers) can prevent extreme poverty and open new market opportunities, while also contributing to boost aggregate demand.

Since the 1990s, Latin American countries have made efforts to put in place an effective social security system (Maurizio, 2010; Mesa-Lago, 2008). This has helped exploit domestic sources of growth and has contributed to make Latin America more resilient to crises – as the relatively good performance of these countries in the wake of the 2008 crisis shows (Barbosa, 2010; Maurizio, 2010). Other recent social protection policy initiatives include the extension of pensions and minimum health insurance coverage to rural China. Also, China has launched social security reforms that have improved coverage of the social safety net (with the exception of unofficial migrants) (OECD, 2010a).

Wage adjustments and social protection policies alone are not a silver bullet. Nor can they be implemented in isolation. The policy agenda to attain more balanced growth will require greater coherence between different policy domains. This will involve policies to boost investment, technological development, labour productivity and human capital formation, along with income-led strategies as key components to lay down the structural conditions for sustainable growth.

13. In the formal sector, minimum wages should not be considered a substitute for collective bargaining, which can ensure more accurate wage adjustments.

Appendix A

List of deficit and surplus countries

1995–2000		2000–05	
Surplus	**Deficit**	**Surplus**	**Deficit**
Algeria	Argentina	Algeria	Australia
Armenia	Bahamas	Argentina	Bahamas
Australia	Belgium	Armenia	Bahrain*
Austria	Brazil	Austria	Bulgaria
Bahrain*	Bulgaria	Belarus*	Canada
Belarus*	Chile	Belgium	Colombia
Canada	Egypt	Brazil	Costa Rica
Colombia	France	Chile	Croatia
Costa Rica	Germany	Egypt	Cyprus
Croatia	Greece	Germany	Denmark
Cyprus	Hungary	Greece	Estonia
Denmark	Iceland	Hungary	Finland
Estonia	Italy	Kenya*	France
Finland	Jordan*	Kuwait*	Iceland
India*	Kenya*	Lesotho	India*
Ireland	Latvia	Luxembourg	Ireland
Japan	Luxembourg	Malta	Japan
Korea, Rep. of	Mexico	Mexico	Italy
Kuwait*	Mongolia	Mongolia	Jordan*
Lesotho	Netherlands	Namibia	Korea, Rep. of
Lithuania	Nicaragua	Netherlands	Latvia
Malta	Niger*	Paraguay	Lithuania
Namibia	Poland	Poland	New Zealand
New Zealand	Portugal	Portugal	Nicaragua
Nigeria*	Singapore	Saudi Arabia*	Niger*
Norway	Slovenia	Singapore	Nigeria*
Oman	Spain	Slovenia	Norway
Paraguay	Sri Lanka	Sri Lanka	Oman
Philippines	Sweden	Sweden	Philippines
Qatar	United Kingdom	Switzerland	Qatar
Romania	United States	Tunisia	Romania
Saudi Arabia*		Venezuela, Bolivarian Rep. of	South Africa
South Africa			Spain
Switzerland			Thailand
Thailand			Turkey
Tunisia			United Kingdom
Turkey			United States
Venezuela, Bolivarian Rep. of			

Note: Wage shares are calculated as the share of labour incomes in per cent of GDP, adjusted for the incidence of self-employment in total employment. * Wage shares not adjusted for the incidence of self-employment in total employment, owing to lack of data.

Appendix B

Assessing rebalancing policies: A modelling exercise

The model applied here allows investigation of a variety of scenarios. It falls within the general category of computable general equilibrium (CGE) models. A CGE model is based on a social accounting matrix, which depicts detailed data on relations of production and distribution between the main socio-economic agents in an economy. The model adds behavioural relationships to the accounting, with econometric evidence being used to calibrate relevant parameters. The model can then be used to simulate responses to assumed shocks and policies. For simplicity, and given the analysis in Chapter 5, the model does not cover the financial side of the economy.

The model covers 160 countries. It is aggregated into 16 countries and regions: the countries are the United States, Japan, Canada, and the BRICS (Brazil, Russian Federation, India, China and South Africa); the regions are Africa, Asia, the Eurozone, the rest of Europe, and Latin America and the Caribbean.[1] Additionally, countries with more than half of their exports concentrated in oil and gas products are grouped together. Further, Asia and the Eurozone are disaggregated into surplus and deficit regions.

The model covers product and labour markets in simple but comprehensive fashion. For example, consider price and quantity setting in both markets. Product markets feature a "macroeconomic firm" that uses domestic factors and imported intermediates from all other regions to produce domestic value added. The firm marks up on domestic labour costs; the supply price is then a weighted average of domestic factor and import cost. Foreign cost pass-through is limited by the cost structure. The size of the markup depends on the degree of competition in product markets. If the firm faces little competition and as a result has high pricing power, its markup rate is high. High markups, of course, imply high profit shares.

The level of aggregate demand for the firm's product is a function of expenditure levels, the multiplier and the real exchange rate. Expenditure levels – real private investment and real public expenditures – are exogenous in this model. The multiplier, however, increases with redistribution towards wage earners, due to their lower propensity to save. It also changes with prices: all else being equal, higher domestic prices imply a real appreciation and higher imports – which lowers the multiplier.

A fall in the real exchange rate – a real appreciation – has also a negative impact on the level of external demand. Therefore, expenditures, prices and distribution all affect value added of the domestic firm, which is of course equal to the country's household income.

The country's "macroeconomic household" has two elements: one that owns the firm and employs labour in it, and one that works in the firm and receives wages from it. The two bargain in labour markets over nominal wages, which are ultimately determined by the rate of unemployment. The lower the rate of unemployment, the higher the nominal wages, and vice versa. Neither owners nor workers know all prices at the time of wage bargaining, and the real wage deviates

1. The composite developing regions (Africa, Asia and Latin America) exclude the BRICS in the respective regions.

from the rate bargained. Further, labour productivity depends on demand conditions, due to labour hoarding as well as overhead labour. Labour hoarding refers to the fact that the firm retains skilled employees throughout a downturn because retraining new employees in the upturn would be costlier; overhead labour refers to the fact that firms usually have some back-office and managerial staff who are not easily expendable. The ratio of the real wage to labour productivity indicates the real unit labour cost, or, in other words, the wage share. The higher the workers' real wage relative to their productivity, the higher is the wage share – and the lower are the profit share and the markup.

The model data set includes: (a) national accounts data for GDP by expenditure and government revenue as well as private savings; (b) a bilateral trade matrix; (c) labour market data on labour force, employment and the relevant rates as well as the functional distribution of income (wage shares); and (d) a set of elasticities. Labour market data are summarized by the unemployment rate. The data set is based on population, labour force, employment and unemployment data from national statistics offices, regional development banks and ILO's LABORSTA and EAPEP databases. Reported unemployment rates are used where available, otherwise estimates based on the highest quality underlying data are used. All unemployment rates are for 2008, as are the rest of the data. See Von Arnim (2010) for a more complete discussion of the model and data issues.

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Reforming finance for more and better jobs

5

Main findings

- Despite massive support to financial institutions in the wake of the crisis, lending conditions remain tight for both households and enterprises – especially small ones – in the countries where the crisis originated. This situation is affecting investment and hiring decisions, delaying recovery.
- The chapter finds that tight lending conditions reflect two factors. First, some financial institutions need to repair their balance sheets and therefore are less able to provide credit to the real economy than would be the case in normal conditions. Second, only few of the reforms of the financial system which were announced by the G20 have been implemented. Reforms of the financial system need to address i) excessive market volatility, ii) lack of market transparency and of secure access to finance for actors in the real economy, and iii) irresponsible risk-taking on the part of financial actors. Such reforms need to be implemented at both domestic and international levels in order to avoid regulatory arbitrage across jurisdictions, which would weaken any reform efforts implemented unilaterally. The chapter shows that failure to improve regulation along these lines will affect job creation, while also complicating the achievement of balanced growth – which, as shown in Chapter 4, is crucial for a successful exit from the crisis.
- In particular, a tax on financial activities would help reduce excessive risk taking and promote incentives for the financial system to operate for the real economy. The revenues from such a tax could also be used as a buffer against future financial crises.
- Financial market reforms might lead to short-term adjustment problems. Over the longer term, however, properly regulated financial markets with an appropriate balance between domestic and international regulatory changes will

support both job creation and job stability. The chapter finds that, five years after implementation of reforms, employment would be almost 1 per cent higher in advanced economies than in the absence of reforms.

- The possible short-term adjustment costs of financial reforms, combined with strong resistance to announced measures by the financial industry, partly explain the slow action in this area. In addition, the economic recovery – modest as it may be – complicates the task for large-scale financial sector reforms as it relieves policy-makers and regulators of the sense of urgency. High levels of public debt and the outlook of more difficult financial sector conditions may also weaken the incentives to implement any regulation that could raise borrowing costs, including for governments (see Chapter 3). Finally, many reform proposals require at least some degree of international coordination in order to avoid regulatory arbitrage by financial actors. Therefore, for financial reform to benefit the real economy, further coordinated action is crucial. Indeed, failure to reform the international financial system will delay employment recovery.

Introduction [1]

The pressure on finance remains strong but so far reform progress has been limited. In July 2010, a resolution prepared by the Obama Administration to tighten control of the financial sector was passed by Congress. Meanwhile, the European Commission has prepared proposals for a banking activity tax to fund a stabilization pool and to strengthen oversight of financial market activities. Even international organizations such as the International Monetary Fund (IMF) are advocating stricter regulation of the financial industry. At the same time, however, political resistance to reform remains strong. The reform resolution did make it through the US Senate, but only after several attempts and in a heavily modified form, and the Toronto G20 meeting could not agree on any form of stricter regulation and resisted attempts to set up banking taxes to make the sector pay for the clean-up costs of the crisis. Even in Europe, where policy-makers typically are more favourable to regulation, reforms have touched only side issues such as legislation to limit or tax bonus pay. On major issues such as restrictions on certain financial instruments, however, coordination even at the European level has so far been unsuccessful.

The current international stalemate on financial regulation does not bode well for more ambitious reforms. A new framework that supports both financial stability and economic dynamism is, however, as necessary as ever before (Torres, 2010). Public debt is mounting fast, potentially drying up capital markets for private investors over the longer term, especially in emerging countries. Accommodative monetary policy is, for the moment, obscuring the true long-term cost of the crisis for the real economy. As soon as economic activity has recovered, however, interest rates will reflect heightened sovereign risk premia and the excessive build-up of public debt more widely (see Chapter 3). Financial actors will, therefore, be

1. The author acknowledges valuable research assistance by Ugochukwu Agu (IILS). He also would like to thank colleagues from the Institute, participants at the Forum de la Régulation, Paris, December 2009, and Sandra Lawson, Vice President at the Global Market Institute at Goldman Sachs for very insightful discussions.

called upon to mobilize new sources of savings across the globe and fit them into the international financial system to provide funds for the real economy. However, the state of the economy is still far from good. Labour markets around the world are in shambles and world trade has not yet fully recovered from the losses incurred in 2008–09.

A simple return to normalcy may, therefore, not be enough: confidence in the current regulatory framework has suffered. As a result precautionary savings are likely to go up, restricting a more dynamic recovery. But higher growth is essential if countries want to address their public debt crises and return income and employment to the levels observed prior to the Lehman Brothers bankruptcy. Keeping financial markets unreformed is not a viable option. Nevertheless, national regulators and policy-makers cannot agree on the best road to take.

This chapter offers a new view on the debates surrounding financial market reform. In particular, the chapter argues that even though they may be desirable, many of the currently discussed reform options may actually never see the light of day due to political resistance to change. This implies that policy-makers need to be prepared for different reform scenarios, depending on whether or not national and international regulatory efforts can be coordinated. In particular, the chapter argues that in between the two extremes of fully reformed and fully unreformed financial markets, two other scenarios might arise, whereby either only the domestic financial sector or only international capital flows undergo some regulatory reforms. These four scenarios are discussed from the point of view of their consequences for the real economy, in particular for the labour market.

A. A bumpy recovery for financial markets

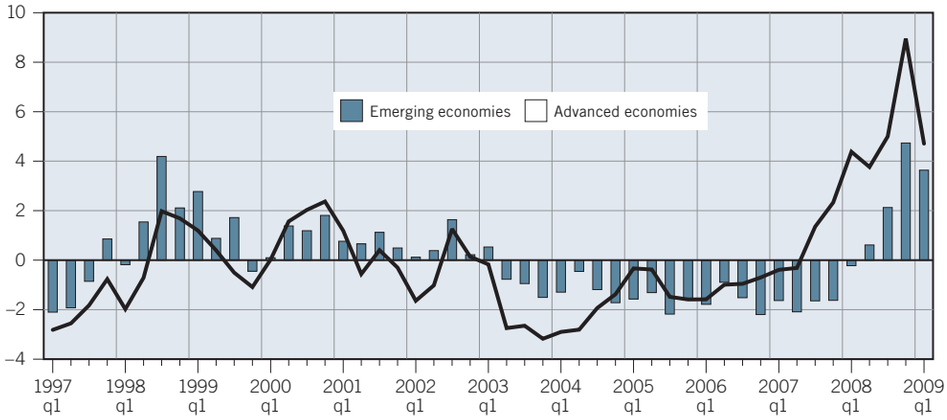
Financial stress has eased off after its heights in 2008…

Financial systems in advanced countries came close to a breakdown during the final quarter of 2008, following the bankruptcy of the US investment bank Lehman Brothers. Financial stress increased substantially as inter-bank lending dried up, leaving the banking sector with little to lend out to non-financial firms (see figure 5.1). The banking sector in many OECD countries saw a near collapse of their major banks as foul credits from the US sub-prime housing markets infected balance sheets of major international banks around the world (Monnin and Jokipii, 2010). Central banks such as the Federal Reserve and the European Central Bank were quick to react to this severing of liquidity conditions by extending their lending facilities, despite the environment of a general lack of trust among banks and the difficulties of evaluating certain financial products in the absence of properly functioning financial markets. Contagion effects due to the spillover of loss of confidence worsened financial stress in emerging markets as well, albeit not to the same extent.

…helping to improve lending standards in advanced countries…

As a result of these abnormal levels of financial sector stress, credit started to contract in advanced economies from the second half of 2009 onwards. While this trend has not yet been reversed, credit contraction has slowed down substantially since the beginning of 2010. Nevertheless, the deleveraging process is expected to

Figure 5.1 Financial stress, 1997–2009



Note: IMF Financial Stress Index data (weighted average over available countries, different indicators for advanced vs. emerging economies, 1997q1-2009q1). Higher values of the indicator stand for more stress in financial markets.

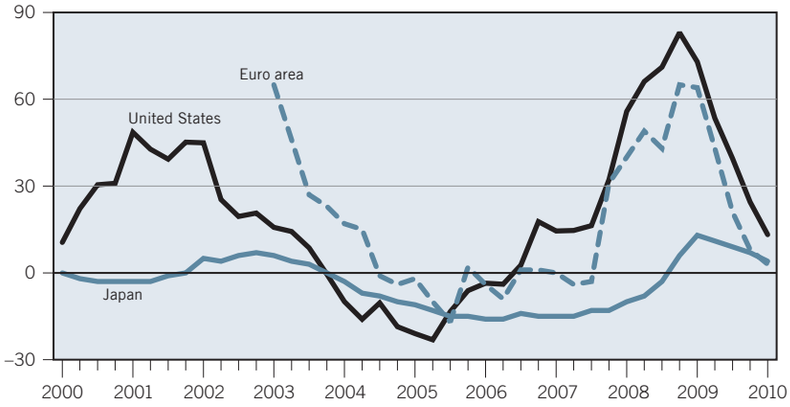
Source: Balakrishnan et al. (2009).

continue for some time to come as households and non-financial corporations will aim to reduce their levels of indebtedness. Moreover, credit developments are far from historical trends. In particular, when comparing the current recovery with the earlier cyclical downturn at the beginning of the 2000s, credit growth is lower by 5 to 10 percentage points, an indication of the depth of the impact of the crisis on the financial sector. This can partly be explained by the tightening of lending standards which can be expected to remain stricter than before the crisis due to the still highly volatile economic and financial outlook (see figure 5.2). Even after a return to more normal levels of bank lending standards, however, it will take up to nine months or longer before credit growth can be expected to resume. In addition, the high strains on international capital markets due in part to higher demand for funds from the public sector are likely to push up long-term interest rates in the coming years, even though this has not materialized yet (see also Chapter 3). This puts further pressure on the private sector to reduce its current high level of indebtedness.

…and securing a return of financial flows in emerging economies.

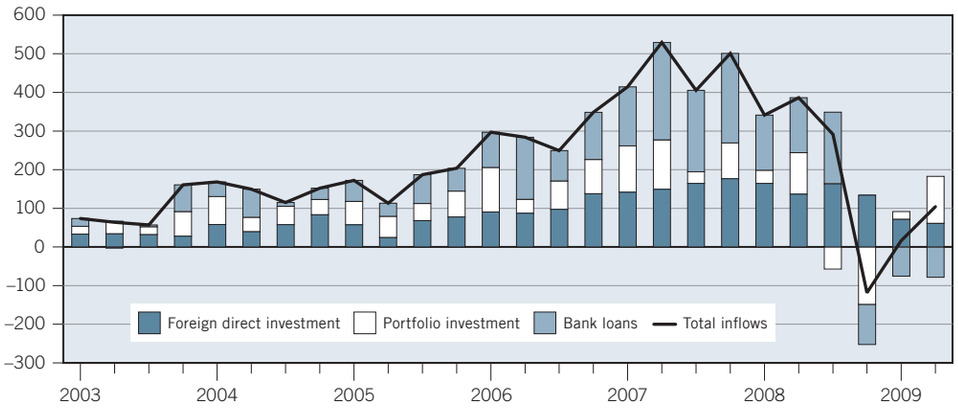
In emerging economies, credit conditions have not worsened to the same extent, partly due to the fact that their banking sectors were not as much interlinked with those main US banks that had been exposed to the subprime housing problems as their European counterparts. Rather, these countries have seen a rapid reduction in foreign direct investment and a massive outflow of short-term capital (see figure 5.3). With the onset of the crisis, a "flight to quality" set in that – somewhat surprisingly – attracted foreign investment back into the main financial centres in the developed economies from which the crisis emanated in the first place. International capital flows have since returned to emerging economies, but mainly in the form of short-term portfolio flows (principally as corporate bonds) and not so much via longer term foreign direct investment. This may potentially create a problem should these countries experience signs of overheating – as already seem to be the case for Brazil and China – as portfolio flows tend to experience large and rapid swings, which creates serious adverse conditions for the balance of payment stability of these countries. Moreover, bank loans with

Figure 5.2 Bank lending standards in advanced economies, 2000–2010



Source: IMF (2010).

Figure 5.3 Composition of capital inflows in emerging economies (billion US$)



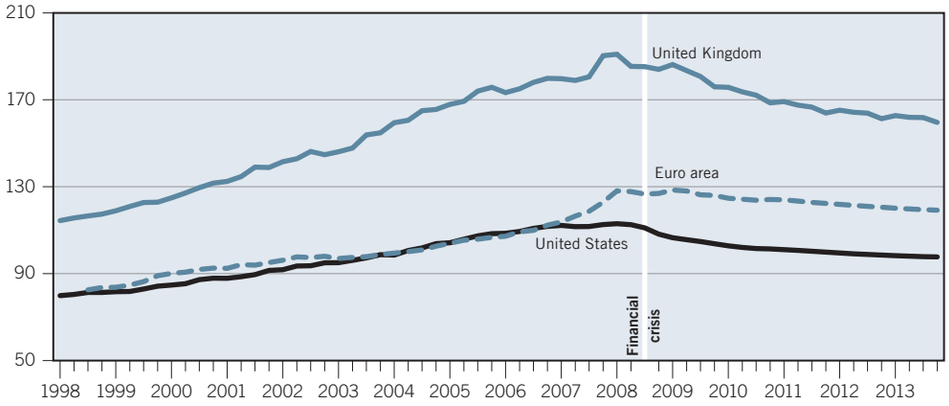
Source: IMF (2010).

their central role in providing liquidity to otherwise credit-constrained firms and households continue to weigh on financial conditions and worsen the risk outlook for these economies.

High leverage ratios decline only gradually…

Despite the rapid slowdown in credit growth with the onset of the crisis, leverage in the private sector remains high and is only expected to level off gradually (see figure 5.4). This return to more sustainable levels of private sector debt will constitute a substantial drag on economic growth for the foreseeable future. Credit growth and the availability of financial funds for investment and consumption – in particular among credit-constrained firms and households – are widely seen as important drivers of economic development (Beck et al., 2000; Demirgüç-Kunt and Levine, 2001). Credit growing less than GDP does not, therefore, bode well for a strong recovery as it forces non-financial firms to search for internal resources for growth, making them less reactive to market conditions and lowering their potential for expansion. Also, slow increases in credit will push investors into seeking alternative credit opportunities from outside those countries that undergo such a deleveraging process, further worsening financial conditions and lowering potential growth.

Figure 5.4 Bank credit to the private sector (percentage of GDP)



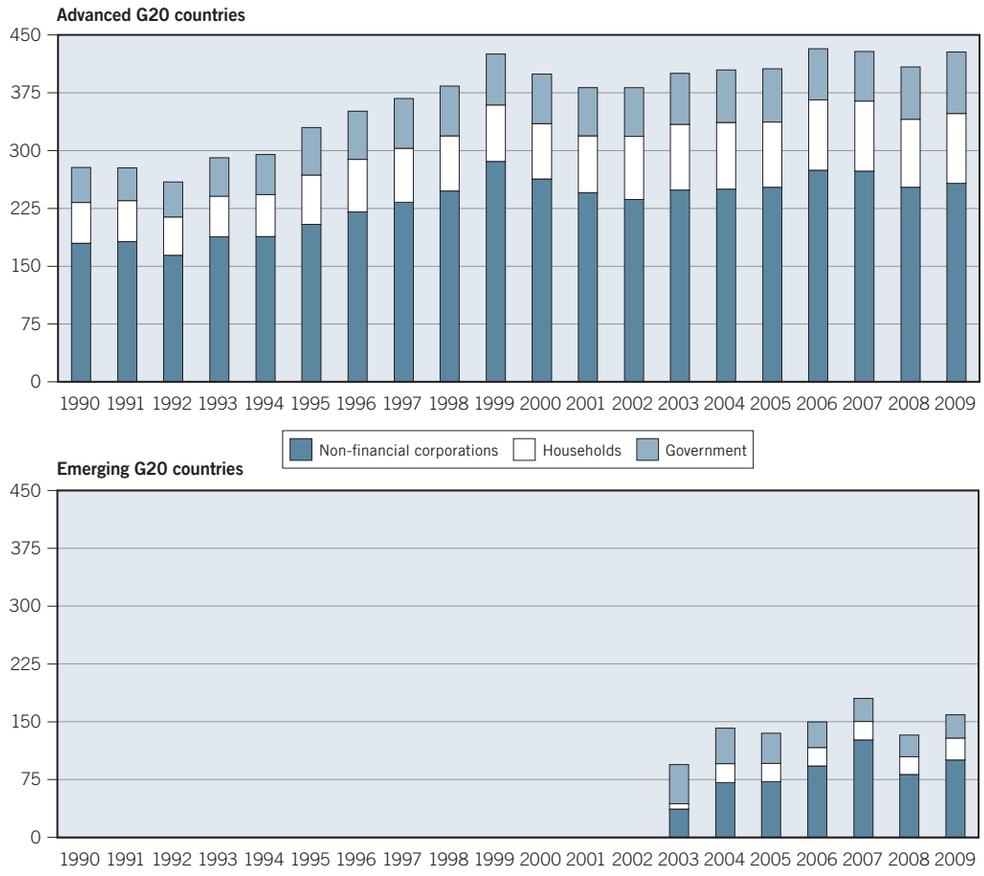
Source: IMF (2010).

…and liabilities weigh heavily on the corporate sector.

The deleveraging process strongly affects the corporate sector and hence investment and jobs. Indeed, high liability levels weigh particularly on balance sheets of non-financial firms (see figure 5.5). As interest rates are likely to increase over the medium term, this will accelerate the deleveraging process, further reducing the demand for new credit and depressing private investment and employment growth. This will have repercussions for the household sector as well. Indeed, the depressed state of the labour market will also trigger further deleveraging among households and depress private consumption. Suffering from both job loss and large amounts of (unpaid) debt, households are often enough forced to default on their credit. The interaction between a depressed labour market and more limited access to financial markets is likely to have a strong negative effect on the recovery that is caused by the financial market crisis. For instance, some observers fear that in those countries where households are suffering from depressed housing markets and therefore have lowered their personal wealth or are left with negative net equity, labour market participation decisions may be affected and geographical mobility – which would require selling the house – reduced. Similarly, non-financial firms that have a high level of leverage and a poor business outlook might prefer deleverage of their balance sheet instead of using retained earnings for new investment.

These financial market developments do not bode well for a strong recovery in jobs. Even though risk premia and market volatility have declined substantially from their crisis peaks, the deleveraging process will continue as long as the business outlook remains uncertain. Financial market reforms therefore need to restore confidence quickly, ensuring that market participants can rely on the safety of their financial investment. This will require market transparency improving and reducing incentives for excessive risk taking by financial managers. Also, financial sector regulators need to adapt their regulatory framework to improve the resilience of financial systems against shocks. Finally, as regards international capital flows, regulation (especially in emerging economies) needs to reflect the level of development of a country's domestic financial system in order to avoid rapidly changing external financing conditions. These could be caused by a high share of portfolio flows, which would damage a country's medium-term economic outlook

Figure 5.5 Composition of liabilities in G20 countries (percentage of GDP)



Note: The figure shows weighted averages of liabilities for advanced and emerging G20 countries by main economic sectors (non-financial corporations, households and governments) for available years.

Source: Economist Intelligence Unit.

as has been the case during the Asian crisis and recently in emerging European economies. In the following section, current reform options along these lines will be presented, aimed at restoring long-term financial market stability, a precondition for a vigorous recovery in jobs and the economy.

B. Reform options for long-term financial market stability

The crisis has triggered substantial discussion on financial sector reforms, and some first initiatives have already been implemented (see table 5.1). In each case, the favoured area of reform depends on the particular theory of the origins of the crisis put forward by the reform's proponents. As such, not all reforms are desirable or feasible. Most observers acknowledge, however, that financial market regulation needs to target three main areas: (a) safeguards need to be set up against systemic risk arising from banking activities; (b) the transparency of market operations needs to improve; and (c) excessive risk-taking by financial actors needs to be diminished. The following discussion shows, however, that none of the proposals currently on the table is the silver bullet that can resolve the crisis. More importantly, certain grand-scale reforms require diverse actors at different jurisdictional

Table 5.1 Planned or existing financial market regulation (G20 countries)

	Dealing with systemic risk		Increase market transparency		Lower risk-taking		
	Financial sector oversight	Regulation of credit growth	Market information	Regulation of OTC derivatives	Regulation of financial sector activities	Managerial compensation and bonus regulation	Financial transaction/ activities tax
Argentina	Market-based risk assessment	Cap on loan to deposit ratios			Planned lift of capital controls		UC[1]
Australia		N		UC[2]	N	N	N[3]
Brazil		Countercyclical adequacy rules			Capital controls (2% tax on inflows)		UC[1,4]
Canada		Cap on loan to value ratios in the mortgage market		UC[2]	N	N	N
China		Countercyclical adequacy rules			Capital controls	Reform of disclosure rules for executive compensation in SOFEs	Stock trading stamp duty (0.3%)
European Union	EU-wide financial market oversight; Extension of MiFiD; hedge fund certifications	Basel III recommendations	Centralized supervision of rating agencies	Standardization of products traded via CCPs	Restrictions on short-selling	Bonus linked to base compensation; max. 30% in cash	N
France		Moderate increase in regulatory capital planned	Creation of a public rating agency	UC[2]	N	Surtax on bonus pay; bonus pay to be spread out over several years	Banking activity tax to finance rescue fund
Germany	Increased competencies of financial regulator (BAFIN)	Moderate increase in regulatory capital planned		UC[2]	Ban on naked short selling[5]	N	Banking surtax to compensate for crisis costs
India		Countercyclical adequacy rules			Capital controls		Securities transaction tax (0.075%)
Indonesia					Capital controls		UC
Italy				UC[2]	N	Surtax on bonus compensation exceeding three times base salary	
Japan		N		UC[2]		Stricter disclosure rules for executive compensation	N[6]

Korea, Rep.		Countercyclical adequacy rules			Capital controls		
Mexico							
Russian Federation		Countercyclical adequacy rules			Ban on naked short selling		
Saudi Arabia					No short selling permitted		N
South Africa							N
Turkey		Adjustments to risk weights					
United Kingdom	Prudential Regulation Authority as part of Bank of England's financial stability oversight	UC[7]	Consumer protection agency (CPMA)	UC[2]	Temporary ban on short selling (in 2008)	Surtax on bonus pay	Stamp duty on stock market transactions (0.5%)
United States	Stricter banking oversight	Tightening of leverage ratio regulation; extension to shadow banking system	Consumer protection agency; legal accountability of rating agencies	Open-market trading planned[2]	No proprietary trading for deposit-taking institutions ("Volcker rule")	Temporary bonus limitation (2009)	N

Note: The table presents an overview of planned or existing measures to regulate the financial market. Basel III refers to a reinforcement of the existing Basel II prudential regulation framework that is currently being negotiated at the Basel Committee on Banking Supervision of the Bank for International Settlements, including increases in regulatory capital and limits on credit growth.

N = no planned/existing measures; UC = under consideration; OTC = over-the-counter; CCP = Central-counterparty; SOFE = State-owned financial enterprises; MiFiD = Markets in Financial Instruments Directive (EU Directive to harmonize regulation for financial investment services).

[1] The recently created Banco del Sur is expected to levy parts of its funds through a financial transaction cost. [2] Participation in the OTC Derivatives Regulators Forum. [3] Australia had a bank debit tax for cash withdrawals between 1982 and 2002/2005. [4] Brazil experimented with a financial transaction tax between 1993 and 2007. [5] Limited to certain asset classes (ten major German financial institutions; credit default swaps on euro area sovereign debt). [6] Securities transaction tax abolished in 1999. [7] Move to a cyclical-adjusted capital adequacy rule.

Source: National sources; Barth et al. (2001).

levels to coordinate, which so far has not been successful. The following section provides an overview of the most important strands of the debate, including a discussion of potential pros and cons.

Dealing with systemic risk

The crisis has exposed the weakness of the current regulatory framework for detecting and managing systemic threats to the financial sector. Indeed, a shock originating in a small housing subsector unravelled the entire global financial system. This puts into question the capacity of the current regulatory regime to help financial markets absorb such shocks. Prudential regulation and supervision has focused almost exclusively on analysing the stability of individual banks and financial actors without taking into account the wider implications of excessive credit growth. In order to address the shortcomings of the current framework, reform proposals have looked at two interdependent issues: the size of individual banks ("too big to fail") and their interconnectedness in the financial systems ("too interconnected to fail").

The size of a bank may cause problems both in the run-up to a crisis and during the clean-up of the crisis. If a bank becomes too large, there may be a risk that policy-makers and regulatory authorities will do everything possible to keep the bank afloat instead of proceeding towards a bankruptcy (albeit in an orderly manner). Such a policy, however, is likely to prolong the underlying imbalance, until the problems become too large and investors and depositors run away massively from such banks. During the clean-up phase, authorities will need to proceed with extreme caution in order to prevent spillovers, which would make the crisis exit and recovery more prolonged. Typically, market dominance will be regulated through competition regulation. It may well be, however, that a bank can reach a size that threatens the stability of the financial system well before it reaches a dominant market position. In addition to stricter anti-trust regulation, therefore, proponents of reform have suggested the introduction of a tax or capital surcharge ("regulatory capital") – which would if possible be countercyclical. Ideally, the rate of such a tax would increase with the size of the bank, thereby constituting an effective limit on the speed at which the financial firm can grow.

A related issue arises from the degree to which any particular bank is interconnected with other financial firms. Indeed, even though a bank may be large, if its operations across the financial sector and into the real economy are limited, its bankruptcy would cause only limited damage. In contrast, if a highly specialized but widely connected financial actor which is a counterparty to many deals goes bust, the damage will be widespread; this was the situation that arose when Lehman Brothers needed to file for bankruptcy in 2008. In practice, taking into account such interconnectedness would mean that regulators would care not only about the quality of a bank's balance sheet but also its interaction with other banks through its banking network. If necessary, the regulators could adjust, for instance, the regulatory capital requirements according to such a bank's contribution to systemic risk (Chan-Lau, 2010; Espinosa-Vega and Solé, 2010; IMF, 2010, ch. 2). A particular challenge arises in this case from the fact that most banks, especially larger ones, do not limit their activities to the national financial market but are interconnected across borders. A proper calculation of the contribution to systemic risk by each player in the market would, therefore, require taking its entire global activities and network connections into account. To the

extent that national regulators might not implement such regulation in identical ways, such stricter regulation would then simply lead to regulatory arbitrage and the shift of the most regulated activities to countries where regulation is less strict (Caprio, 2010).

Increasing market transparency

Lack of financial market transparency has been seen as one of the main reasons for overly optimistic investment decisions. In this respect, the market for customer-specific, specialized financial instruments has been singled out as being particularly opaque. The purpose of these products is to help investors hedge against certain types of market risk. Financial firms offer a variety of such products to their clients in a tailor-made manner, which are based on existing securities on the market but correspond more specifically to their needs than generic financial products.[2] The rapid growth of this market, however, has posed new challenges for financial market stability. Indeed, as most of the trades take place in an idiosyncratic manner, market opacity has increased, concealing the specific interconnections that exist between different market players and preventing easy liquidation of these products when investors need to restructure their portfolios. This has led to a further increase in systemic risk (IMF, 2010, ch. 3). In response, reform proposals suggest the standardization of products and the introduction of central counterparties, so-called "clearance houses", which would act as intermediaries in the market and help to settle trades across a large number of participants. This would eliminate part of the market opacity, and would prevent contagion effects should one of the market participants go bankrupt. However, not all financial products can be protected in this way as such a clearance system would require the standardization of products, which would take away some of the attraction that these products have for certain investors. More important, however, is the fact that clearance houses themselves would need to be insured against a possible bankruptcy, a rare but significant event. Given the large amounts of funds that are involved in such institutions, supervision and regulation would need to be tight as the repercussions in the case of failure would be many times greater than has been experienced during the current crisis.

Rating agencies have played an important role in disguising the true risks taken by financial investors. Many financial products that ended up as toxic waste on banks' balance sheets started out as being issued with the highest rating grade. For instance, Moody's – one of the three main international rating agencies – was forced to downgrade almost 700 securities during the summer of 2008, which partly explains the rapid deterioration of financial market stability that led to the bankruptcy of Lehman Brothers. The incredulity at the rapid deterioration in ratings was followed by the question of why the ratings proved to be so essential to the resilience of financial markets. To a large extent this is related to the fact that ratings are increasingly being used by regulators in assessing the soundness of individual financial firms (Booth, 2009, ch. 11). At the same time, the current business model of rating agencies relies on the issuing firm to pay for the rating service. Together, these two elements help to explain why ratings have been systematically biased towards being optimistic, and why they proved to be so important in

2. The market is termed "over-the-counter" (OTC) in reference to the fact that most of the products are highly customer-specific and not standardized.

generating the housing boom and bust. In reaction to these deficiencies, the European Commission has suggested the imposition of external oversight for rating agencies. Alternatively, some have suggested the introduction of a public rating agency to provide a more neutral view on certain assets (in particular, sovereign bonds). In addition, stimulating increased competition by lowering the currently high entry barriers to the rating business is mentioned as one way to strengthen incentives to produce the most accurate ratings possible.

Finally, the crisis has further revealed the persistent difficulties that certain categories of market participants experience when trying to get access to proper finance, such as in particular low-income households and small and medium-sized enterprises. Indeed, it is fair to say that part of the reason for the development of a high-risk subprime market segment is the fact that certain individuals and firms could not get proper finance otherwise, despite the fact that their participation in the financial market could have been welfare-enhancing (Rajan, 2010). In an environment of limited market transparency, unscrupulous bank or mortgage institution mangers benefited from lax(er) supervisory standards and an overall market opacity. This allowed them to offer mortgages to such households at unfavourable rates or against overly optimistic assumptions about future house price and income growth. As the crisis broke out, the banking sector reacted strongly in the other direction, putting up high ceilings to credit access and effectively drying up the subprime market. Hence, what started as a promising financial innovation to enhance financial inclusion ended up leaving many former homeowners bankrupt and a larger number of households and small enterprises facing even more difficult financing conditions than before the crisis. To remedy this situation, proposals have been put forward to enhance financial inclusion in order to improve the credit situation, in particular for small and medium-sized enterprises and certain categories of households. For instance, legislation recently passed in the United States includes enhanced financial consumer protection through a specialized agency. Similarly, the nine "Principles for Innovative Financial Inclusion" presented by the G20 Expert group on Financial Inclusions suggests that authorities should enhance innovative modes of access to financial services while at the same time strengthen consumer protection involving both governments and representatives from financial service providers and consumers.[3]

Lowering risk-taking

The shock that originated from the subprime housing market has also demonstrated the excessive inclination of market participants to take up risk. In particular, lax supervision of lending standards in the US subprime housing market and the international search for yield seem to have led financial firms to increase their risk appetite (Caballero et al., 2008a, 2008b and 2008c). To reduce the incentives to take up excessive risk, reform efforts have concentrated on capital controls, a ban or tax on certain forms of financial transaction, the regulation of banking activities and changes to the remuneration of financial managers.

A long-standing issue has been the introduction of a tax on international financial transactions ("Tobin tax") in order to eliminate or reduce short-term (currency) speculation. The G20 has taken it up, inviting the IMF in its

3. The principles are available at: http://canadainternational.gc.ca/g20/summit-sommet/2010/toronto-principles-toronto.aspx?lang=eng (accessed 6. Sep. 2010).

Box 5.1 Earlier experiences with financial transaction taxes in Latin America

Several Latin American countries have experimented with particular forms of a financial transaction tax. Indeed, Argentina, Brazil, Colombia, Ecuador, Peru and Bolivarian Republic of Venezuela all introduced different forms of bank debit tax at the end of the 1980s or early 1990s. Today, only Colombia still has such a tax in place. A common feature to all the schemes was that the tax was levied on withdrawals or transfers from bank accounts, mainly checking accounts, but also savings and term accounts. Certain schemes also covered transactions arising from trading in securities and derivative products.

The stated immediate objective of these schemes was revenue generation rather than stabilization of the financial sector, and often only on a temporary basis. Some of the schemes were introduced to generate earmarked funding for particular programmes, such as the Contribuição Provisória Sobre Movimentação Financeira ("CPMF") scheme in Brazil which was introduced to fund a new health-care programme. With the exception of Ecuador, however, none of the schemes generated sizeable amounts of fiscal revenues. In most cases, additional tax revenues generated by these taxes remained below 1 per cent of GDP (Coelho et al., 2001).

The potentially positive effects resulting from higher tax revenues and expansion of certain social programmes have to be set against observed direct effects on financial market development. In particular, all the schemes caused significant disintermediation, with more people carrying out their financial transactions on a cash-only basis to avoid paying the tax. In some cases, offshore facilities or holding accounts in neighbouring countries were used for tax evasion, reducing the transparency and stability of the domestic financial system. In Brazil, more complex financial products replaced the standard checking and saving accounts, thereby limiting the capacity of the CPMF scheme to raise revenue.

Pittsburgh meeting to assess the issue and make concrete suggestions on whether or not to implement such a tax against the background of earlier experiences in this area (see box 5.1). In addition, some countries proceeded to ban certain financial instruments, in particular short selling, or limited the inflow of foreign capital through capital controls. Alternatively, the IMF suggested the introduction of a financial activity tax, whereby an additional tax is levied on (excess) profits in the financial sector, with the specific purpose of limiting leverage and bank size. This idea is currently being considered by the Banco del Sur, a Latin American development bank that has recently been established. Ideally, such a tax would reflect the contribution of each individual financial firm to systemic stability. Eventually, the additional money levied from such a tax could be used to fill up a financial sector stabilization fund, which would provide liquidity in situations of financial stress without requiring the involvement of public finances. Such an additional tax seems indeed a valuable tool in limiting excessive credit growth and will allow policy makers to dispose of sufficient resources in case of a possible future crisis.

Other proposals have aimed more directly at regulating certain banking activities. In particular, the merger of commercial and investment banking activities in the United States has been seen as the root cause of heightened risk appetite of financial investors as it allowed the merged bank to use deposits (and deposit insurance) to pay for its own speculative activities (so called "proprietary trading" or "own-bank trading"). Paul Volcker, a former chairman of the US Federal Reserve, suggested that commercial banks should be banned from proprietary trading altogether ("Volcker rule"). Other proposals have focused on a stronger role for bond holders and depositors in limiting a bank's risk appetite. In particular, the idea of a forced debt–equity swap in case a bank goes bankrupt has the potential to

force bond holders to select their portfolio more carefully and only take up those bonds for which they are willing to hold the risk. Such conditional convertibles ("CoCos") also have the capacity to improve the equity base of a financial firm when certain assets turn out to be toxic, which should further contribute to stabilizing the banking system. Both the Volcker rule and the introduction of CoCos would constitute substantial interventions into banks' business models and have already met stiff resistance from financial market lobbyists. In addition, it seems that at least the CoCos are not entirely free from market manipulation as the conditions under which a conversion takes place requires complex technical analysis, which would potentially make the system more opaque (Goodhart, 2010).

Finally, performance-related incentives for managers have been said to have led to excessive risk-taking by certain financial firms. Indeed, most traders now receive only a small part of their remuneration in the form of a fixed salary. Most remuneration is paid out as a bonus depending on previous performance (in general the previous year) or in the form of stock options that can be exercised after a certain delay. In particular, the short-term, backward-looking nature of many bonus systems is pushing financial managers to focus too much on short-term gains rather than on long-term sustainable profits. In reaction to these issues, reform proposals have been enacted or implemented that aim to reduce the use of high-powered incentives through bonus systems. In particular, some authorities have made it mandatory for compensation packages to include a bonus-malus system, which smoothes out yearly gains and losses over an extended period of time and allows a bonus pay-out only if it corresponds to a "sustainable" gain in bank profits.

C. The future of finance: Four scenarios

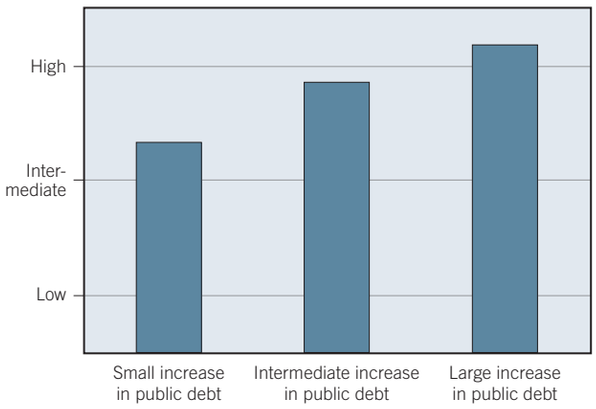
Financial sector reform will depend to a large extent on political forces shaped by the economic recovery described in the opening section. Indeed, resistance to change is high as banks and financial institutions fear for their business model or their independence. First attempts to regulate compensation schemes for financial managers or introduce additional taxes in this area have already triggered countervailing measures. Similarly, the international coordination necessary for certain proposals to be implemented successfully has often been resisted by national governments, in particular those that have fared well during the financial crisis. In the following section, this chapter takes a closer look at the political economy constraints that weigh on financial sector reform and analyse four possible scenarios for the future of finance and their consequences for the real economy.

Forces shaping financial regulation

There are two main areas in which policy-makers can impose financial market reforms: domestic markets and international capital flows. One of the difficulties for policy-makers is that it might be necessary to concentrate on only one of the two areas of intervention. Whichever area policy-makers choose for intervention, however, the financial sector reform process is shaped by three forces: the economic recovery, the high level of public debt and regulatory competition between jurisdictions:

Figure 5.6 Public debt and financial market reforms

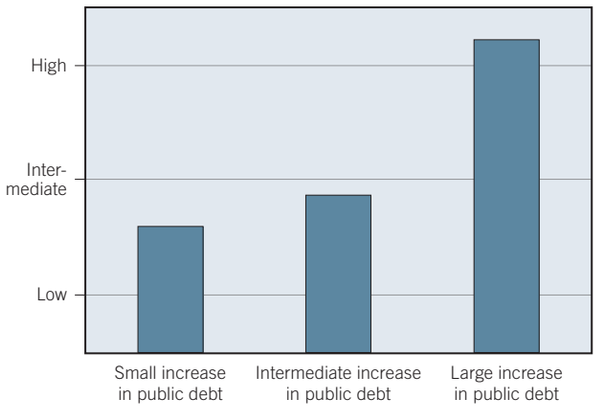
Panel A. Intensity of capital account liberalization in the OECD (vis-à-vis changes in public debt)



Note: The figure displays the ten-year variation of capital account openness vis-à-vis the (lagged) increase in public debt over the same period among OECD countries between 1970 and 2003.

Source: Chinn and Ito, 2008; OECD, 2009.

Panel B. Domestic financial sector reform intensity (vis-à-vis changes in public debt)



Note: The figure displays the intensity of reforms of the domestic financial sector vis-à-vis the (lagged) increase in public debt over the same period among OECD countries between 1970 and 2005.

Source: Abiad et al., 2008; OECD, 2009.

- The financial and economic recovery actually complicates the task of substantial regulatory reform of financial markets. The popular political pressure that has so far kept up might wear off as business activities resume (see also Chapter 2). The immediate sense of urgency will then recede, making policy-makers more lenient when putting forward an encompassing reform agenda. In addition, the crisis has somewhat limited the political influence of financial firms, but as the outlook improves, they will regain a stronger political voice. Finally, financial sector (re)regulation will take place in a substantially different macroeconomic environment. The risk appetite of investors has – so far – resumed only half-heartedly. Over the longer term, precautionary savings may go up as investors are re-evaluating their environment and considering investing in lower yielding but less risky assets.

- At the same time, countries and policy-makers are limited in their action by the high level of public debt that accumulated during the crisis. This will reduce their scope for action and hence the extent to which they can effectively introduce *any* kind of regulation without regard to the interests of capital owners and their own financiers. In the past, periods of rapid increase in public sector debt have often preceded periods of financial deregulation (see figure 5.6). In other words, even if it were possible to identify *ex ante* the optimal package of financial sector regulation, such a reform bundle is unlikely to be implemented as policy-makers rely heavily on financial markets to (re)finance their high and still increasingly debt levels.

- Finally, regulatory competition between jurisdictions prevents countries from implementing all of the measures deemed necessary for fear of losing out (financial sector) market share to competitors. As countries compete to attract financial firms through favourable regulatory conditions, overly stiff prudential regulation may hamper further growth of the financial sector. Highly qualified staff may consider moving to different locations with a more attractive tax and regulatory environment (for instance regarding bonus regulation). Similarly, financial firms may consider moving their activities to jurisdictions

Table 5.2 Exit scenarios from the crisis

	Domestic financial markets	
International capital flows	**UNREFORMED**	**TIGHTENED REGULATION**
UNREFORMED	Scenario I: A bumpy road ahead	Scenario III: A new compromise
TIGHTENED REGULATION	Scenario II: Brakes on globalization	Scenario IV: Major financial sector reform

Source: IILS.

where limitation on leverage and credit growth are less stringent, offering their services to clients abroad or arbitraging across different regulatory conditions through branching.

As a result of these dynamics and the different areas of policy interventions, four scenarios arise for the future of finance (see table 5.2). Essentially, reforms of the domestic financial market require different political resources and layers than those reforms targeted at international capital flows. Domestic reform can – if policy-makers wish to do so – be implemented swiftly and with little regard to what happens elsewhere. International capital flows, however, need some minimum form of international cooperation. A country might very well shelter itself to some extent from certain forms of capital flows through capital controls but only in the exceptional case of complete autarky will a country not see any foreign capital on its balance of payments. However, such relations with foreign capital markets always bring the risk of contagion from local financial crises, be it through confidence effects or more serious solvency risk. Opposing these two types of market intervention leaves us with four main scenarios, depending on whether and where countries are able to impose their policies. Notice that table 5.2 does not consider which type of regulation will be imposed. Rather it is assumed in these scenarios that whenever governments intervene, they do so in order to tighten up existing regulation and limit certain activities in the area of regulatory intervention. The differences between the scenarios then arise from the capacity of state regulators to intervene effectively.

Four scenarios for the future of finance

Scenario I. Bumpy road ahead

The first scenario assumes that States have suffered a sizeable drawback in their capacity to regulate the financial sector. Following rescue operations in the financial sector and stimulus measures to support aggregate demand, countries want to recover the fiscal space in order to be able to intervene in similar circumstances in the future. Also, a simultaneous increase in demand for funds from the fiscal authorities around the world will impact upon available liquidity on international financial markets and raise interest rates. In this scenario, therefore, the regulatory stance in financial markets is to support the future development of financial markets, rather than to restrain it. This may seem odd, given today's strong opposition of policy makers to any further financial market deregulation. However, under the influence of huge piles of public debt, policy-makers are likely to soften their current stance. Moreover, as the memory of the crisis starts to fade,

lobby groups for international investors will regain their strength and set course to consolidate the protection of foreign investment against excessive taxation or to facilitate the introduction of new financial instruments unknown today. And all this will inevitably lead to a deepening of financial market and greater international financial integration, whatever the critics believe. Other reforms currently on the table are likely to both strengthen financial market stability and improve the outlook for financial innovation, such as the introduction of clearing houses for certain financial products and further improvements to the international payment infrastructure.

Such a deepening of the financial market will have substantial consequences for the real economy. At the macroeconomic level, the liquidity-driven growth will return after a brief pause due to the crisis, and at the microeconomic level, the financial relationship will continue to be at arm's length – but even more so than in the past, and certainly in those countries that still rely heavily on more traditional banking relationships. Indeed, banking intermediation has taken a hit during the crisis and is likely to take longer to recover than direct market-based finance. As a reaction, governments may be tempted to facilitate direct access to market finance for smaller players, thereby further increasing pressure for high financial returns on these companies. It also means that investment banking is likely to return to centre stage and will tap into new markets that so far have remained underdeveloped. Taken together, under the scenario of unreformed financial markets, financial pressures on the real economy will be maintained or may even grow. Such a generalization of cost-efficiency objectives will be only consistent with pre-crisis rates of operational profits (and the underlying rate of trend productivity growth) if leverage by firms continues to increase and corporate debt continues to grow.

Despite a return to pre-crisis financial market conditions, the outlook for future macroeconomic expansion and job creation would, nevertheless, look gloomier in this scenario than prior to the crisis. Indeed, with government debt levels in advanced G20 economies being almost 40 percentage points higher than before the crisis (see Chapter 3), necessary funds for investment will become hard to get at. This is particularly true for emerging economies which have been the main driver of the global recovery so far. In addition, when financial markets remain unreformed, market sentiment and household confidence might very well be less secure than before the crisis, implying there is also an increase in precautionary savings in those countries that traditionally have been considered the consumer hub of the world. As a consequence, consumption growth might decline in those countries as well, putting further downward pressure on global growth. Finally, with financial pressure mounting further, social frictions and slow wage growth may become more widespread than before the crisis, with further adverse effects on macroeconomic dynamics. In other words, growth can only be restored if macroeconomic policies can provide a credible exit from high debt rates while at the same time restoring confidence of market participants and households in a more sustainable future growth pattern, an equation that will be difficult to balance.

Scenario II. Brakes on globalization

The second scenario sees the substantial increase in the fiscal effort of economies, especially the advanced economies, as the first step for the return of a strong State: the advance of "state capitalism" (Bremmer, 2009 and 2010). As pressure

for financial reform remains strong, its consequences may be felt even beyond the financial sector. Indeed, some observers have noted that the probability for a general re-regulation of the capitalist system has substantially increased (Zingales, 2009). The already visible tendency for a global shift in (financial) wealth and the intensive search for a scapegoat may actually trigger protectionist reflexes among leaders in advanced economies (Cohen and DeLong, 2010). In particular, governments may be tempted to react to popular agitation by cutting back on some of the liberal advancements that have been introduced over the past 20 years. In fact, governments have already started to use their new-found powers to start raising barriers to international trade, although only timidly for now. Several programmes have targeted fiscal stimulus mainly towards domestic production (e.g. "Buy America") and certain tariffs were increased to the extent that multilateral agreements allow. Other countries have started implementing measures to curb exports in certain areas to gain competitive advantages in others.[4] At the same time, all attempts to revive a new multilateral trade agreement – the Doha round – have remained unsuccessful so far. Thus, there is a strong and persistent risk that the massive decrease in international trade observed following the financial crisis will not be overcome soon and a sustained decline in international trade may arise. At the time of writing, world trade had not yet recovered fully to the peak level observed in mid-2008, more than two years ago. Similarly, pressure to protect domestic firms in advanced countries against an increased inflow of funds from sovereign wealth funds has been mounting and threatens to impose stronger restrictions on international investment in the future. This will have significant consequences for trade and the ability of multinational enterprises to organize their production around the world.

Moreover, persistent difficulties in obtaining funds to facilitate trade and the continuing lack of trust among trading partners regarding prefinancing of exports could lead to at least a partial shift of global production chains moving production platforms back closer to final consumers. Partly, this may also be triggered by other policies such as those related to climate change, which will be used as a pretext to impose tariffs related to energy use or carbon emissions. In general, there are good reasons to believe that in future, the producers will prefer to be closer again to their final customers in order to better respond to their needs, but using standard components (referred to as "glocalization", see Dziemba et al., 2009). In particular, the need for an increasing service component and the possibility of offering an integrated product–service solution will push certain producers back closer to their final clients.

Finally, putting the brakes on globalization will also limit the perceived benefits of the export-led growth model. Emerging markets are likely to seek new, domestic sources of growth. Due to their larger size, some – for instance Indonesia – have already begun to promote and stimulate private consumption at the expense of an overly strong dependence on exports. Others will find a solution by joining existing free trade agreements or being ready to give up a non-negligible potential for growth. However, in view of the importance of international trade to global growth (Freund, 2009), such a return of protectionism is likely to damage the growth potential of those countries that remain heavily dependent on exports. For large, relatively closed countries and regions – such as the United States – there might be a potential for reorienting part of their imports towards

4. See, for instance, recent concerns expressed by the World Trade Organization regarding export barriers for some raw materials in China (WTO, 2010).

domestic production. Clearly, such a readjustment is likely to reduce the potential for growth and leave traces on the labour market, at least temporarily (Artus and Pastré, 2009, ch. 6). At the same time, the stronger capacity of the State to mobilize resources in order to return to more sustainable public finances might limit further crowding out of private investment. Similarly, as the global economy rebalances and the outlook for more stable growth brightens up, precautionary savings might be reduced. Both sources of domestic growth could help to some extent make up for the loss of potential growth benefits from trade.

Scenario III. A new compromise

In the third scenario States will prove powerful enough to forge a new compromise but lack the capacity to coordinate to limit or reduce financial globalization. Governments will be able to influence the evolution and dynamics of their domestic banking sector, but international financial flows – and hence the prospects for global growth – will continue to be influenced by considerations of financial return and investment opportunities in the global economy. Governments might even follow a few examples that are considered to be best practice in the field, such as the regulation of the mortgage market in Canada or the variations in regulatory capital over the business cycle that Spanish banks had to implement. On the other hand, and partly because of the lack of re-regulation of international capital flows, they are unlikely to go very far with domestic banking sector regulation or to adopt untested policies, such as a forced restructuring of the banking industry or the imposition of limits on the growth of financial firms in order to limit the size of the financial industry relative to the rest of the economy.

Financial market actors will not be able to avoid stricter regulation of national markets completely; they will be forced to show better appreciation of risk with the objective of improving and stabilizing financial funds. At the same time, financial flows will continue to benefit from free international movement, allowing the global economy to continue its previous expansion. In particular, current proposals regarding a tax on international financial exchanges will not pass the initial stage of a simple political feasibility study. Similarly, the idea of strengthening the role of some international actors – notably the IMF – in managing the international financial system will be rejected, particularly by developing countries. Indeed, these countries would see such an expansion as another takeover attempt on the part of industrialized countries and with the sole purpose of preventing or slowing the shift of economic power and international politics. At the same time, the lack of international coordination in forcing a common solution to re-regulate the financial system means that regulatory arbitrage continues to take place. This might greatly undermine the stability of the global financial system or even create an incentive for (some) national governments to show excess zeal in regulating their domestic markets, with adverse consequences for growth at home.

Nevertheless, from the perspective of macroeconomic stabilization, this scenario will probably be considered the most capable of combining the stabilization of short-term savings with the keeping in place of previous growth mechanisms. At the same time, certain socio-economic trends observed in recent decades will change only very slowly and under the direction of a proactive policy: international capital flows will continue to put downward pressure on the wage share, thus limiting the ability of States to promote more balanced growth. Moreover,

short-term financial returns will continue to dominate the distribution of international capital flows and hence the potential growth of certain countries and regions. As a consequence, restructuring of national economies towards more sustainable social and ecological growth patterns is likely to take longer under such a scenario, at least when compared with scenario II. Also, global imbalances are unlikely to dissipate soon, only the prospect of another crisis has been pushed back again thanks to strengthened prudential regulation at home. However, the extent to which such re-regulation of financial markets would be able to weather future financial innovations remains unresolved under this scenario.

Scenario IV. Major financial sector reform

The last scenario assumes that policy-makers and regulators manage a general and profound overhaul of both the domestic and international financial architecture. This implies that governments recover some of the autonomy that they have lost during the financial crisis. At the same time, such a scenario could lead to a general restructuring of the economy as governments are likely to use their newly found capacity to intervene to satisfy other policy objectives as well. In particular, the often heralded emergence of a greener economy could then be placed high on the agenda of policy-makers. More generally, such a reorientation of economic activity to other, more productive sectors – housing turned out not to be much of a driver for total factor productivity as recent estimates have made clear (Jorgenson et al. 2008) – could further widen policy space if it can promote additional resources, for instance, those that help in fiscal consolidation and economic recovery. Hence, similar to scenario II, governments will again play a greater role in defining the economic strategy of the country without necessarily compromising the objectives of other economic and financial actors.

At the same time, a policy shift towards a new sectoral portfolio will most likely be accompanied by a weakening – at least temporarily – of the potential growth rate. Indeed, the structural change implied by such a scenario poses serious challenges in the form of large and long-lasting transition costs. The painful experiences of EU countries after the two oil shocks during the 1970s and the ensuing sectoral restructuring show that the effects of structural adjustment may be felt for several years, or even decades. Adjustment costs will be higher where there are rigid labour and product markets, which prevent an otherwise rapid transition of jobs and workers from one sector to another. Also, such adjustment will not happen without significant frictions: structural unemployment will rise on a permanent basis and the growth rate of labour productivity and real wages will fall. This may cause additional adverse effects, including through a weakening of aggregate demand. At the same time, revenue raised from taxes intended to reorient the economy towards new sectors will probably not be fully used to finance new jobs, for the simple reason that public finances have already taken a large hit during the crisis.

Clearly, while this may be the least likely scenario, it is also the most far-reaching from the perspective of real economy consequences. Financial returns are likely to decline for some time due to the strict limits that new regulation will impose. Moreover, disregarding active government intervention, the new financial environment will redefine comparative advantages, which entails transition costs and will reduce growth prospects. Certain international linkages and vertical production chains will get undone and a similar or even stronger tendency

towards glocalization as described for scenario II will emerge and diminish the role of world trade. Over the longer term, however, a substantially increased financial stability due to the smaller likelihood of international (financial) spillovers and a more tightly regulated banking system may provide some support to investment and job creation.

Consequences for labour market developments

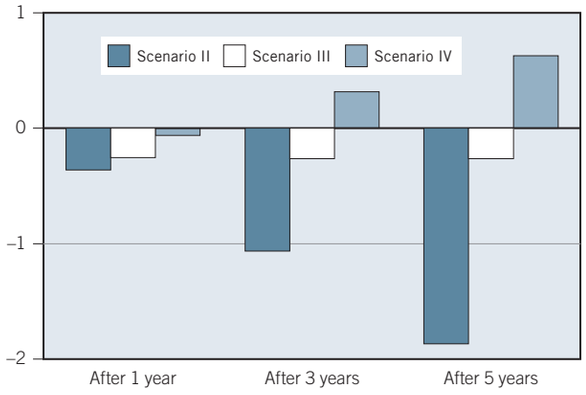
The discussion of the four scenarios highlights three key factors that will determine the implications of financial sector developments on the real economy. First, the extent to which new or modified regulation is implemented will have implications as to whether financial markets show more or less stress and volatility.[5] Second and related to the previous factor, financial market regulation influences the cost of capital as well as the development of stock market valuations. Third, regarding the international situation, changes in the international financial architecture may impact on both international capital and trade flows. In order to improve understanding of the implications of the four different scenarios for labour markets, this section presents a quantitative investigation into the relationship between certain key macroeconomic variables that are part of these scenarios and labour market dynamics. In particular, a recently developed analytical framework to identify the determinants of labour flow dynamics was used for this investigation (Ernst, 2010). This framework makes it possible to link both economic and financial variables to the rate at which new jobs are created and old jobs are destroyed and thereby get a more precise estimate of the impact that each of the four scenarios will have on employment dynamics. Based on the scenarios developed in the preceding section we will put forward some likely paths that various variables will take under these different specifications.

On the basis of the different assumptions that these four scenarios make regarding the evolution of economic and regulatory variables, an estimation has been carried out as to the likely impacts on employment dynamics in an archetypical advanced G20 country.[6] In the baseline scenario it was assumed that – starting in 2010 – the real value of outstanding shares would increase permanently by 10 per cent, that trade growth would continue at 10 per cent per annum and that capital flows would also increase by 10 per cent per annum. No further financial market regulation regarding securities or the banking sector would be introduced. At the same time, this scenario assumes a unit increase in global financial stress as measured by the indicator produced by Balakrishnan et al. (2009). The quantitative scenario assumes an impact of financial market stress not only on employment creation but also on labour supply (through a discouraged worker effect). In particular, according to the underlying estimates, labour force growth is permanently depressed by 1 percentage point if there is a unit increase in the financial market stress indicator. Despite this additional financial market stress,

5. In the following simulations, only the direct impact of financial market volatility on incentives for job creation is considered. Other, indirect influences of financial volatility, for instance through a devaluation of pension wealth or a reduction in capital gains, have not been retained. Considering them in the context of the empirical model used here is likely to reinforce the results presented in this section.

6. The scenarios are based on estimated elasticities of job creation and destruction rates with respect to various financial market variables; see Ernst (2010) for a detailed discussion of the methodology and results.

Figure 5.7 Comparisons of employment levels (scenarios II–IV vs. baseline scenario I) (percentage difference in employment levels with respect to scenario I)



Source: IILS.

employment growth continues to recover, thanks to strong growth in trade and share prices. After a peak in 2015 it will gradually return to its long-term trend rate at around 1.7 per cent, in line with labour force growth in this region (no change in demographics have been assumed for these simulations).

In comparison, the three other scenarios assume – each to a different degree – a further tightening of either regulation of securities or the banking sector, whereby scenarios IV makes the strictest assumptions about the evolution of these indicators (figure 5.7). Trade is expected to decline in scenarios II and IV whereas financial market stress (and the real value of outstanding shares) declines only in scenario III and IV, thanks to the introduction of tighter domestic regulation. As figure 5.7 demonstrates, for all three reform scenarios the effects on employment are negative in the short-term as expected, although the effects are certainly much less than has been predicted by others elsewhere (IIF, 2010). However, already after three years, some improvements can be seen under scenario IV, in particular due to the decrease in financial sector volatility. Under scenario II, where this effect is weakest, the adverse effects from reduced dynamics in world trade and financial market activity will keep the employment growth rate permanently below the baseline rate (unreformed financial markets), and employment levels will diverge. Under scenario III, where some re-regulation of international financial markets is attempted, the initial reduction in jobs will not be recovered, but over the longer term employment recovers to similar levels of expansion as in the baseline scenarios. When policy-makers show more ambition, in particular as regards domestic re-regulation and the supervisory framework of the banking sector, even stronger positive effects for employment creation can be expected, and employment will expand permanently faster than in the baseline scenario. In other words, the increase in costs resulting from stricter regulation of the banking sector can be considered to be moderate in comparison with the benefits arising from reduced financial market volatility, a point also made by Kashyap et al. (2010) as well as by the Financial Stability Board (BIS, 2010a) and the Basel Committee on Banking Supervision (BIS, 2010b). This means that financial market regulation may not only bring positive effects for financial sector stability but could at the same time improve the medium-term outlook for labour markets, a potential benefit that policy-makers should not easily dismiss.

Policy considerations

A full recovery of financial markets, which will be necessary to sustain vigorous job growth over the medium term, requires major financial sector reforms. The currently observed reduction in financial sector stress is unlikely to allow financial markets to return to pre-crisis trends. What is needed is an improved regulatory framework that reduces incentives for excessive risk taking, enhances market transparency and strengthens the sector's resilience against systemic shocks. However, several proposals for financial reforms by individual countries and the G20 country group have so far met with sometimes fierce opposition, in particular by sector lobbyists. The resistance to change has even increased recently, as the global economy started to recover somewhat, relieving policy-makers of the sense of urgency.

Financial market reforms – in particular as regards the supervisory framework of the banking sector – can bring about substantial benefits for labour market dynamics, especially over the medium term. While some adverse effects might be expected from tighter regulation, employment creation can strongly benefit from the reduced volatility that a more elaborate framework for securities, banking supervision and capital controls can bring. In this regard, policy-makers should use the reform momentum to strengthen capital adequacy rules, as suggested by the current negotiations of the Basel III framework, in order to reduce disproportionate leverage and excessive incentives for risk taking within the banking sector. Also, more systemic stability can be brought into the financial system by moving to a centralized clearance system for most if not all structured products. Implementing these proposals can greatly reduce the still very high levels of uncertainty among market participants, which will help reduce volatility and lower risk premia for corporations and households, thereby stimulating output and employment growth. Benefits of financial sector reforms for the real economy are greatest when they are implemented in a coordinated fashion, reforming both domestic financial markets and the international financial system.

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