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BACKGROUND NOTE:

INCOMES POLICIES AS TOOLS TO PROMOTE STRONG, SUSTAINABLE AND BALANCED GROWTH

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BACKGROUND NOTE:

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Over the past year, the instruments available to policymakers for supporting economic recovery seem to have been limited, especially in developed economies. On the one hand, there was little scope for monetary policy to provide additional stimulus, as interest rates were already at historic lows. The only possible monetary stimulus seemed to be quantitative easing, which several central banks were reluctant to implement, and which, given the ongoing deleveraging process, proved to be of little help in reviving credit to boost domestic demand. On the other hand, higher public-debt-to-GDP ratios have convinced many governments that they should shift to fiscal tightening.

However, there is much larger space for macroeconomic policies, especially for proactive fiscal policies, than is perceived by policymakers (as discussed *TDR 2011*, chapter III). Moreover, there are other policy tools that have been largely overlooked, but which could play a strategic role in dealing with the present challenges, such as incomes policies.

I. The role of wages in economic growth

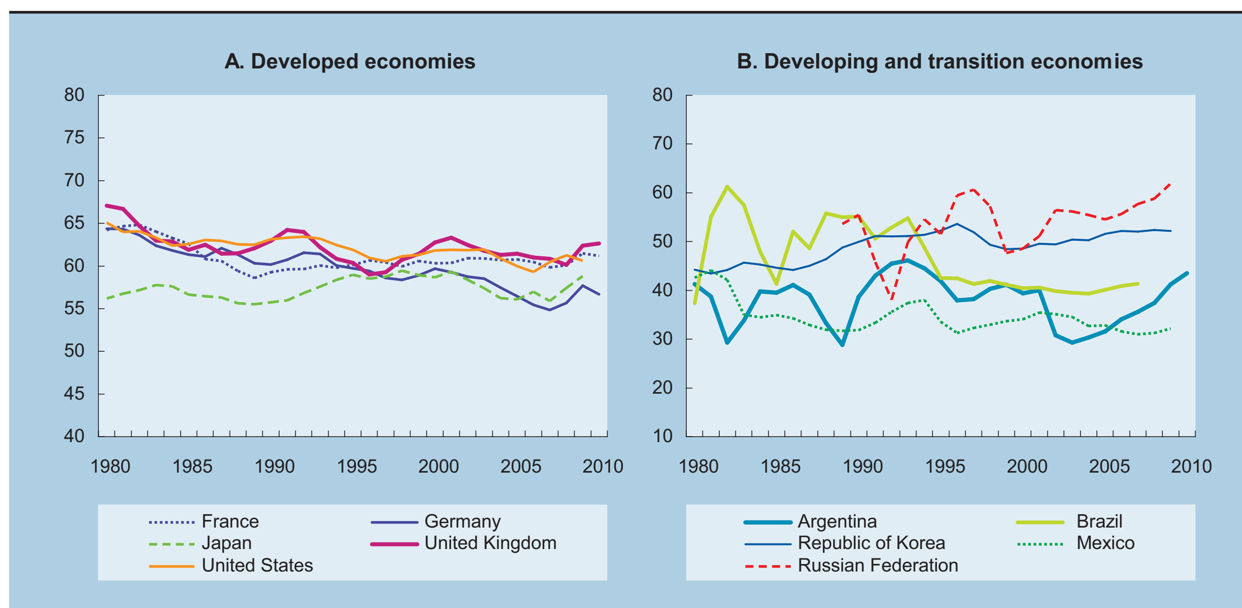
In the period of intensified globalization from the early 1980s until the global crisis, the share of national income accruing to labour declined in most developed and developing countries. If real wage growth fails to keep pace with productivity growth, there is a lasting and insurmountable constraint on the expansion of domestic demand and employment creation (*TDR 2010*, chapter V). To offset insufficient domestic demand, one kind of national response has been an overreliance on external demand. Another kind of response has taken the form of compensatory stimulation of domestic demand through credit easing and increasing asset prices. However, neither of these responses offers sustainable outcomes. These are important lessons to be learned from the global crisis. Over and above the risks inherent in premature fiscal consolidation, there is a heightened threat that deflationary policies may accentuate downward pressures on labour incomes as a result of the slump in the labour market. Such policies ignore the vital role of consumer spending in contributing to a sustainable global recovery.

From the perspective of a single country, strengthening the international competitiveness of producers may seem to justify relative wage compression. However, the simultaneous pursuit of export-led growth strategies by many countries has systemic

Chart 1

SHARE OF WAGES IN NATIONAL INCOME, SELECTED ECONOMIES, 1980–2010

(Per cent)



Source: UNCTAD secretariat calculations, based on OECD, *Main Economic Indicators* database; and Lindenboim, Kennedy and Graña, 2011.

implications: a race to the bottom with regard to wages will produce no winners and will only cause deflationary pressures. With widespread weakness in consumer demand, fixed investment will not increase either, despite lower labour costs. Global deflationary tendencies and the drag on global demand resulting from wage compression in many developed countries would need to be countered by some form of policy-engineered higher spending somewhere in the world economy. In the pre-crisis era, widespread resort to export-led growth strategies was made possible mainly by fast-growing imports in the United States, leading to increasing external deficits and financial fragility in that economy. Subsequent crises, with private sector deleveraging and increasing public debt, clearly showed the deficiencies of this approach. Rethinking fiscal policy and avoiding premature consolidation is one issue; halting and reversing unsustainable distributional trends is another.

Trends in income distribution since the 1980s confirm that inequalities within many developed economies have increased as globalization has accelerated (European Commission, 2007; IMF, 2007a and b; OECD, 2008). In particular, wage shares have declined slowly but steadily over the past 30 years, with short reversals during periods of recession (particularly in 2008-2009), when profits tend to fall more than wages. After such episodes, however, the declining trend has resumed (chart 1.A). This trend is creating hazardous headwinds in the current recovery. As wages have decoupled from productivity growth, wage-earners can no longer afford to purchase the growing output, and the resultant stagnating domestic demand is causing further downward pressure on prices and wages, thus threatening a deflationary spiral.

In most developing and transition economies, the share of wages has behaved differently. That share is generally between 35 and 50 per cent of GDP[1] – compared with approximately 60 per cent of GDP in developed economies – and it tends to oscillate significantly, owing mainly to sudden changes in real wages. In many of these economies, the share of wages in national income tended to fall between

[1] This is partly due to a lower share of wage-earners in the total labour force in developing economies, especially in Africa and Asia (*TDR 2010*).

Table 1

REAL WAGE GROWTH, SELECTED REGIONS AND ECONOMIES, 2001–2010

(Annual change, in per cent)

	2001–2005	*2006*	*2007*	*2008*	*2009*	*2010[a]*
Developed economies	**0.5**	**0.9**	**0.8**	**-0.5**	**0.6**	**0.1**
Germany	-0.9	0.0	1.1	1.2	-0.5	1.7
Japan	-0.4	1.6	-1.0	-1.1	-2.9	1.4
United Kingdom	2.8	2.6	3.9	-1.5	-2.2	-1.8
Unites States	-0.3	-0.1	0.5	0.1	2.8	-0.7
Developing and transition economies						
Africa	**1.3**	**2.8**	**1.4**	**0.5**	**2.4**	**..**
South Africa	0.3	5.1	0.2	2.3	3.2	5.2
Asia	**7.8**	**7.6**	**7.2**	**7.1**	**8.0**	**..**
China	12.6	12.9	13.1	11.7	12.8	..
India	2.6	0.4	-0.6	8.3	..	..
Republic of Korea	4.4	3.4	-1.8	-1.5	-3.3	1.2
Latin America and the Caribbean	**0.4**	**4.2**	**3.3**	**1.9**	**2.2**	**2.5**
Brazil	-2.6	3.5	1.5	2.1	1.3	2.4
Chile	1.6	1.9	2.8	-0.2	4.8	2.1
Mexico	0.9	1.4	1.0	2.2	0.8	-0.6
Eastern Europe and Central Asia	**15.1**	**13.4**	**17.0**	**10.6**	**-2.2**	**..**
Russian Federation	15.1	13.3	17.3	11.5	-3.5	2.6

Source: UNCTAD secretariat calculations, based on ILO, 2011; *EC-AMECO* database; ECLAC, 2010; Economist Intelligence Unit; and national sources.

a Preliminary.

the 1980s and early 2000s, but has started to recover since the mid-2000s, though it has not yet reached the levels of the 1990s (chart 1.B). The positive evolution of wages and the role played by incomes policies, particularly transfer programmes to the poor, may be the main factors behind the present "two speed recovery".

In developed countries, real wages grew on average at less than 1 per cent per annum before the crisis, which is below the rate of productivity gains; they then declined during the crisis, and tended to recover very slowly in 2010. Arguably, the early move to a more contractionary fiscal policy and the relatively high levels of idle capacity and unemployment imply that the pressures for higher wages could remain subdued, thereby reducing the chances of a wage-led recovery. In contrast, since the early 2000s, in all developing regions and in the CIS, real wages have been growing, in some instances quite rapidly (table 1). In some countries, this may represent a recovery from the steep reductions in the 1990s or early 2000s, and in others it is more than a mere recovery, as wages follow the same path as productivity gains. Even during the difficult years of 2008 and 2009, real wages did not fall in most developing countries, as had generally been the case in previous crises. This suggests that to some extent recovery in developing countries was driven by an increase in domestic demand, and that real wage growth has been an integral part of the economic revival.

Examining the evolution of total wage income, which depends on employment and real wages, is essential for understanding the risks of wage deflation. A fall in real wages, rather than leading to an increase in the demand for labour, will affect demand by inducing a fall in consumption (Keynes, 1936). Generally, there is a very close relationship between the rate of change of total wage income and that of final consumer spending. In this respect, Japan's "lost decades" provide a stark warning of the growing challenge at the global level today. Failure to halt downward pressures on prices and domestic demand left the Japanese economy excessively dependent on exports, resulting in persistent deflation and stagnation for two decades. As wage-earners' real

Chart 2

TOTAL WAGE BILL AND PRIVATE CONSUMPTION AT CONSTANT PRICES, SELECTED COUNTRIES, 1996–2010

(Annual percentage changes)

Source: UNCTAD secretariat calculations, based on IMF, *World Economic Outlook* database; and *International Financial Statistics* database; and Lindenboim, Kennedy and Graña, 2011.

income stopped growing, so did private consumption (chart 2). Germany seems to be going the way of Japan owing to deliberate wage compression since the mid-1990s, with vastly destabilizing consequences in the euro area. In the United States, even though consumption was mainly driven by a credit and property boom until the inevitable bursting of the bubble, there is also a strong relationship between the wage bill and private consumption. Wage compression in that country was magnified by regressive tax policies and a strong tendency for households in the upper 1 per cent of the income distribution to appropriate more and more of the total income (Piketty and Saez, 2007).

At the current juncture, in view of the unemployment legacies of the crisis, downward pressures on wages in developed economies risk strangling any incipient recovery of private consumption, which is the necessary basis for a sustainable and balanced recovery. The widely shared agenda of structural reform that aims at improving labour market flexibility would only reinforce the bargaining power of employers in labour markets in developed economies.

In contrast, the rise of the wage bill after periods of decline in several developing and transition economies in the 1980s and 1990s boosted private consumption. For instance, the decline in wages in the Republic of Korea and the Russian Federation after the crises of the late 1990s was followed by a significant upturn, which was not reversed by the Great Recession. Similarly, in Mexico wages recovered to some extent, but the economic influence of the United States may explain the negative rate of growth of the wage bill during the latest crisis.

The rise in real wages and the wage bill in developing countries, in addition to the real appreciation of exchange rates, indicate that the recovery in those countries depends increasingly on the expansion of domestic markets rather than on exports to developed countries. Nevertheless, developed countries remain important export destinations, and subdued growth in those countries, combined with upward pressures on developing countries' currencies, risks reigniting or reinforcing pressures for relative wage compression in developing countries as well. So far, this has not occurred, but the slowdown in global industrial production in the second quarter of 2011 increases that risk. Indeed, a macroeconomic policy mix in developed economies featuring fiscal austerity, tighter monetary policies and wage compression could create new global vulnerabilities, which may also affect developing countries. The global recovery would be ill-served by merely shifting fragility from the North to the South instead of directly addressing the fragilities at their source.

II. Incomes policy and inflation control

Growth-friendly macroeconomic policies, of which a proactive incomes policy is a key element, can also help to contain inflation, since investment and productivity growth create the capacities needed to meet the desired steady expansion of domestic demand. An incomes policy based on clear rules for determining wage income in a growing economy can greatly facilitate policymakers' task, and support capital formation and sustainable development. Such a policy, which aims at achieving wage growth in line with productivity growth (plus an inflation target), paves the way for a steady expansion of domestic demand as a basis for expanding investment while containing cost-push risks to price stability.

Wages are the most important determinant of the overall cost of production in a modern, vertically integrated market economy. An incomes policy is therefore also an instrument of inflation control. Wage growth based on the above-mentioned principle would contribute to keeping inflation within the government's target by preventing an overshooting of unit labour costs and maintaining a steady increase in demand. While incomes policy could focus on inflation control, monetary policy could concentrate on securing low-cost finance for investment in real productive capacity, which would create new employment opportunities. In several countries where real wages and the wage share fell due to prolonged

economic stagnation and deteriorating labour conditions – as in Latin America and Africa in the 1980s and 1990s – real wages could be allowed to rise faster than productivity for some time in order to restore the desired income distribution pattern. Such a change in income distribution would probably need negotiations among the social partners and the government in order to avoid a wage-price spiral, and it is likely to be facilitated by economic recovery and subsequent improvements in the labour market.

By achieving a rate of wage growth that corresponds approximately to the rate of productivity growth, augmented by a target rate of inflation, it would be possible to control inflation expectations. The problem in the euro area is that these macroeconomic considerations have not been taken into account in some of the member countries (as discussed in *TDR 2011*, chapter VI).

In view of the slow recovery in developed countries, the risk of demand inflation in these countries is minimal. The United States and Europe are experiencing enormous labour market slack, despite the fact that real wages are barely growing. Weak employment growth and stagnant wages, resulting in slow growth of disposable income, are hindering a sustainable domestic-demand-led recovery and are increasing the risk of an excessive reliance on exports for growth. In certain peripheral euro-area countries in particular, debt deflation is an additional acute threat. Fears that the increase in the monetary base in major economies will lead to an acceleration of inflation fail to take into account the context of deflationary forces in which these developments have been occurring. These forces include the ongoing deleveraging processes under way in the still weak financial systems and households of the respective developed economies.[2]

In this context, increases in food and energy prices may cause higher headline inflation in the short run. However, this should not pose a threat of sustained inflation, because the increase in the overall price level is only temporary, and a "second round" of price increases triggered by a wage-price spiral that could make the inflation hike permanent is highly improbable. Furthermore, anti-inflationary policies involving monetary tightening would also be ineffective, to the extent to which the increase in food and energy prices did not result mainly from higher demand for these goods, but rather from the speculative activities of financial investors (see *TDR 2011*, chapter V). Even if restrictive monetary policies could trigger a severe world recession, causing commodity prices to plunge, as they did in the second half of 2008, the remedy would be worse than the illness.

In spite of that, the European Central Bank (ECB) has continued to take its cue from headline inflation, embarking on monetary tightening in April 2011. The Italian central bank governor and recently appointed head of the ECB, Mario Draghi, warned, as early as November 2010, that a "clear and present danger" of overheating justified a "greater need to proceed with monetary policy normalisation" to prevent inflation from being imported from emerging market economies (cited in Wiesmann, 2011). However, faster wage growth in China does not pose any imminent threat of global inflation;[3] rather, it is an important element in rebalancing the Chinese economy towards increasing private consumption. And rebalancing the Chinese economy not only pre-empts the deflationary threat potentially posed by an unravelling of China's fast-track catching up; it also contributes positively to the rebalancing of global demand. Indeed, rising wages amount to a real appreciation of the yuan. Moreover, inflation in China is being driven by rising prices of food, energy and industrial raw materials. However, more generally, rising headline inflation in developing economies is less an issue of overheating than a reflection of the fact that food and energy prices have a much greater weight in the consumer price indices of poorer countries than of developed countries (*TDR 2008*, and *TDR 2011*, chapter V).

More serious concerns arise from asset price inflation, strong credit growth and the widening of

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[2] Borio and Disyatat (2009) assess the use of unconventional monetary policies during the crisis, and discuss the issue of excessive bank reserves as a source of inflation. Tang and Upper (2010) investigate non-financial private sector deleveraging in the aftermath of systemic banking crisis.

[3] The pre-crisis debate on the relationship between globalization and inflation remains inconclusive (see, for instance, Ball, 2006; and Borio and Filardo, 2007).

current-account deficits observed in some developing countries (e.g. Brazil, India, South Africa and Turkey, among the G-20 members). In the case of Brazil, the central bank raised the interest rate, which was already high in real terms, and the fiscal stance was also tightened. The Russian central bank took similar action. In both cases, it seems that core inflation beyond food and energy prices had also increased. However, that does not necessarily mean that contractionary monetary policy should be the instrument of choice to curb the rise in domestic prices. Price management and supply-side policies that increase the provision of goods and services, along with social pacts that link the rise of real wages to a rise in productivity, might be used to contain cost pressures when an economy still has spare capacity.

III. The European crisis and the need for proactive incomes policies

The lack of proactive and coordinated incomes policies is one of the main causes of present tensions in Europe, particularly within the euro area. Since the launching of the Economic and Monetary Union (EMU), serious imbalances have been building up as a result of diverging national wage trends. In a monetary union, national wage trends are the main determinant of the real exchange rate among its member economies. To avoid dislocations in intra-regional competitiveness positions, national wage trends need to follow an implicit norm that is the sum of national productivity growth and the agreed union-wide inflation rate (defined by the ECB as "below but close to 2 per cent"). Countries in the periphery that are experiencing severe public-debt crises today departed from this norm somewhat in the upward direction, whereas Germany, the economy with the largest trade surplus within the euro area, also missed that implicit norm, but in a downward direction. As a result, over time Germany experienced cumulative competitiveness gains vis-à-vis its European partners, especially vis-à-vis the countries in the periphery (*TDRs 2006* and *2010*; Flassbeck, 2007; Bibow, 2006). If inflation rates differ among countries with their own national currencies, they always have the possibility to compensate for inflation differentials by means of exchange rate adjustments. However, this solution is not possible within the EMU, which makes the resolution of the crisis even more difficult than that of comparable crises in a number of emerging market economies over the past 30 years.

Widening current-account imbalances inside the euro area occurred partly as a result of lending flows, which in some cases caused property bubbles. The bursting of those bubbles resulted in private debt overhangs that first triggered banking crises and eventually turned into today's sovereign debt crises. As a result, banks in the surplus countries became heavily exposed to debtors in the deficit countries.

With the reappearance of severe debt market stress in a number of countries in the second quarter of 2011, most governments are convinced that fiscal austerity is needed for debt sustainability, and that wage compression and labour market reform will restore competitiveness. Reflecting a dogmatic rejection of government intervention, the euro-area authorities only reluctantly considered fiscal stimulus measures. Initially slow to act, they were then the first to call for an early exit from global stimulus, even before recovery had properly taken root. In the event, the euro area has proved the laggard in the global recovery and is now a hotspot of economic instability. Today's financial and economic instabilities arise from an unresolved debt crisis that has its origins in private debt, and which the euro area's policy-making mechanism seems ill-equipped to handle. The area's policy response remains single-mindedly focused on fiscal retrenchment and on "strengthening" the so-called Stability and Growth Pact that was established to govern and asymmetrically discipline member countries' fiscal policies.

Apart from a perceived lack of fiscal discipline, today's crisis in the euro area is widely seen as evidence of a lack of labour market flexibility. But neither fiscal profligacy nor insufficiently flexible

labour markets can explain the crisis. Rather, the area's policy regime lacks suitable coordinating mechanisms that would assure stable domestic demand growth while preventing intraregional divergences and imbalances. In concrete terms, excessive wage increases in the economies now in crisis, on the one hand, and stagnating unit labour costs in Germany on the other, have allowed the accumulation of current-account surpluses in the latter at the expense of other countries in the area. By further weakening economic growth, the policies proposed by the euro-area authorities may not succeed in improving debt sustainability either (see *TDR 2011*, chapter III).

Austerity measures in the deficit countries may reduce intra-area current-account imbalances through income compression, but they may also worsen the underlying solvency problem through debt deflation (especially if emergency liquidity is provided at penalty rates). If the debtor countries receive sufficient official financing at reasonable rates (as decided by the European Council on 21 July 2011), they may avoid or postpone default, but this will not resolve the underlying problem of their lack of competitiveness and growth. Owing to erroneous regional policy responses, the crisis countries in the euro area are today labouring under extremely difficult conditions: their GDP growth is flat or even negative, while their market interest rates on public debt are prohibitively high. Seen globally, however, these local conditions are highly exceptional. While their budget deficits are generally high and their public debt ratios are rising, inflation remains low. Thus the current predicament in Europe should be resolved by promoting growth and reducing intraregional imbalances. The European experience holds important lessons for the rest of the world, in particular that austerity without regard for regional domestic demand growth may backfire badly. Well-coordinated monetary policies and debt management aimed at keeping borrowing costs in check regionwide is therefore of the utmost importance.

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