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UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

BACKGROUND NOTE:

MACROECONOMIC POLICIES TO PROMOTE GROWTH AND JOB CREATION

UNCTAD contribution to the G20 Framework Working Group

8 March 2012

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Unemployment still is the main global challenge

The creation of 64 million jobs for the global economy is required, taking 2011 as a benchmark, in order to restore pre-crisis employment and absorb the new entrants to the labour market. In developed countries, the unemployment rate in 2011 was almost three percentage points above the pre-crisis level of 5.8 per cent. In developing countries, employment has recovered more rapidly, especially in Asia and Latin America. Nevertheless, major employment challenges persist even in these countries, as open unemployment rates remain high, often above 10 per cent in urban areas, and a high share of employed workers continues to be underemployed, poorly paid and obliged to accept vulnerable job conditions (United Nations *World Economic and Social Prospects*, 2012).

Rising and persistent unemployment in many countries has prompted a variety of explanations based on new and old ideas concerning rigidity and inflexibility of labour markets and the role of the welfare state in generating such “inflexibilities”. Most of this reasoning is based on neoclassical employment theory where the main explanation for high or rising unemployment are real wages exceeding the equilibrium level or where the growth of wages and salaries exceeds productivity growth. Too strong labour unions or too high legal minimum wages are considered as those institutional settings on labour markets that prevent wages from falling sufficiently to absorb an excess supply of labour.

However, in the light of recent experiences of some developed countries, like the United States, where wages have been lagging behind productivity for many years but unemployment rose sharply as an immediate result of the financial crisis these explanations sound somewhat outdated. Moreover, this kind of reasoning is based on a microeconomic concept that is unjustifiably transposed to the level of the overall economy. For prices to clear markets, the supply and demand functions have to be independent of each other. This is not the case for the labour market as a whole. The income situation of all households depends, directly or indirectly, on the value added all producers in an economy generate and the latter depends on the demand of households. If companies adjust their production downwards in reaction to a fall in household demand, which is triggered by a fall in wages in the first round, this adjustment itself will feed back into aggregate household income through lower total wage income.

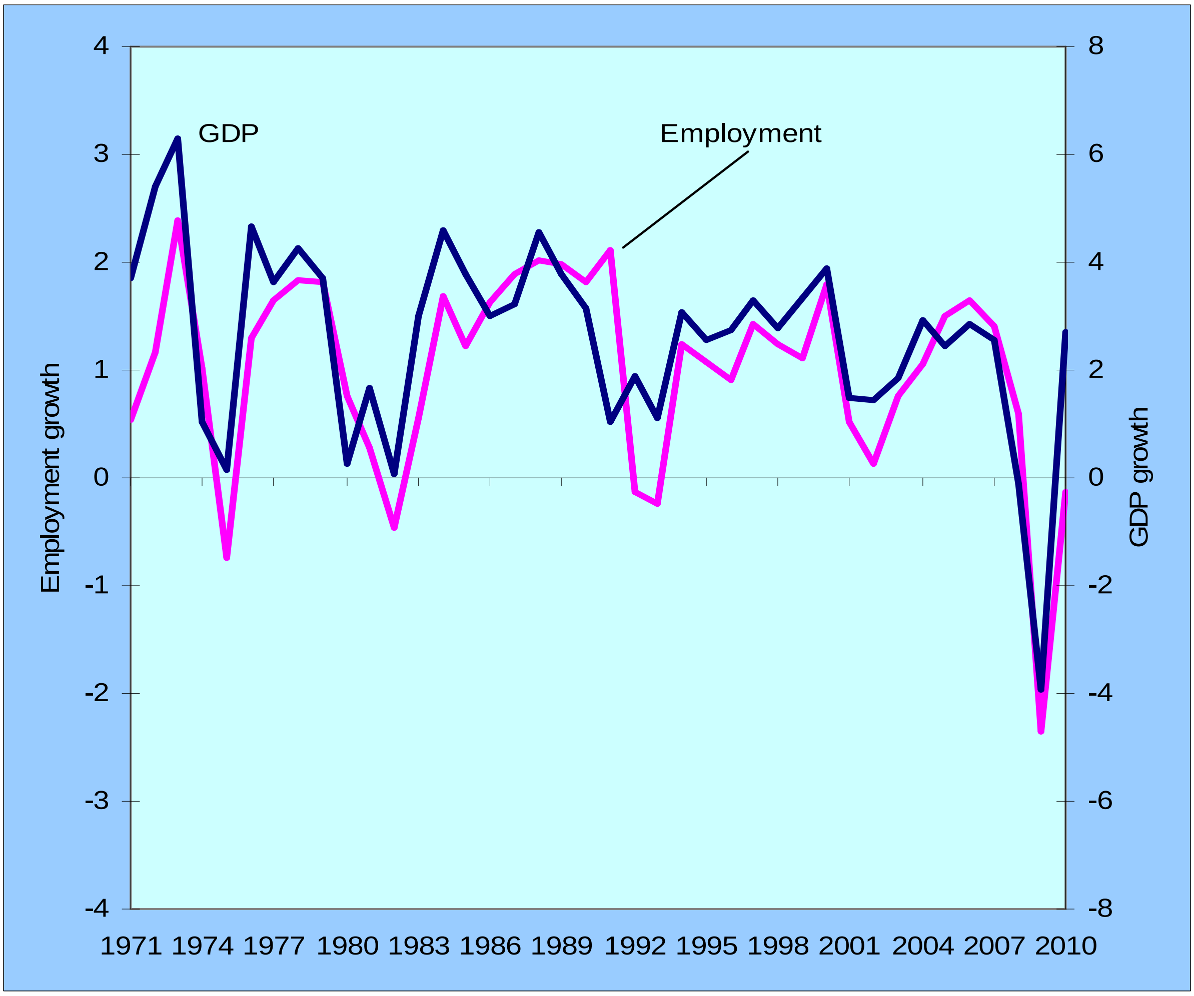
Macroeconomic trends are key to employment in advanced economies

As there is no simple supply-demand apparatus that could explain unemployment, it is obvious that employment has to be analysed in connection with output growth, instead of treating the labour market in isolation. Generally, in developed countries employment cycles are very closely associated with output growth cycles; employment growth in the United States (U.S.) and Europe, for example, is typically closely associated with growth of aggregate demand and output (chart 1). Both, the U.S. and Europe, have needed sustained recoveries to bring the unemployment rate down and a strong downswing, as in 2008 and 2009, has reduced employment despite wage flexibility and very low wage levels (wage shares) on both sides of the Atlantic Ocean. The fact that their macroeconomic environments have evolved quite differently in the past is due to different macroeconomic approaches rather than to different degrees of wage flexibility.

Chart 1

GROWTH OF EMPLOYMENT AND REAL GDP IN DEVELOPED COUNTRIES, 1971–2010

(Per cent)



Source: UNCTAD secretariat calculations, UN/DESA, National Accounts Main Aggregates database; ILO, LABORSTAT and Key Indicators of the Labour Market (KILM) databases; OECD Stat Extracts, Annual Labour Force Statistics and Main Economic Indicators databases.

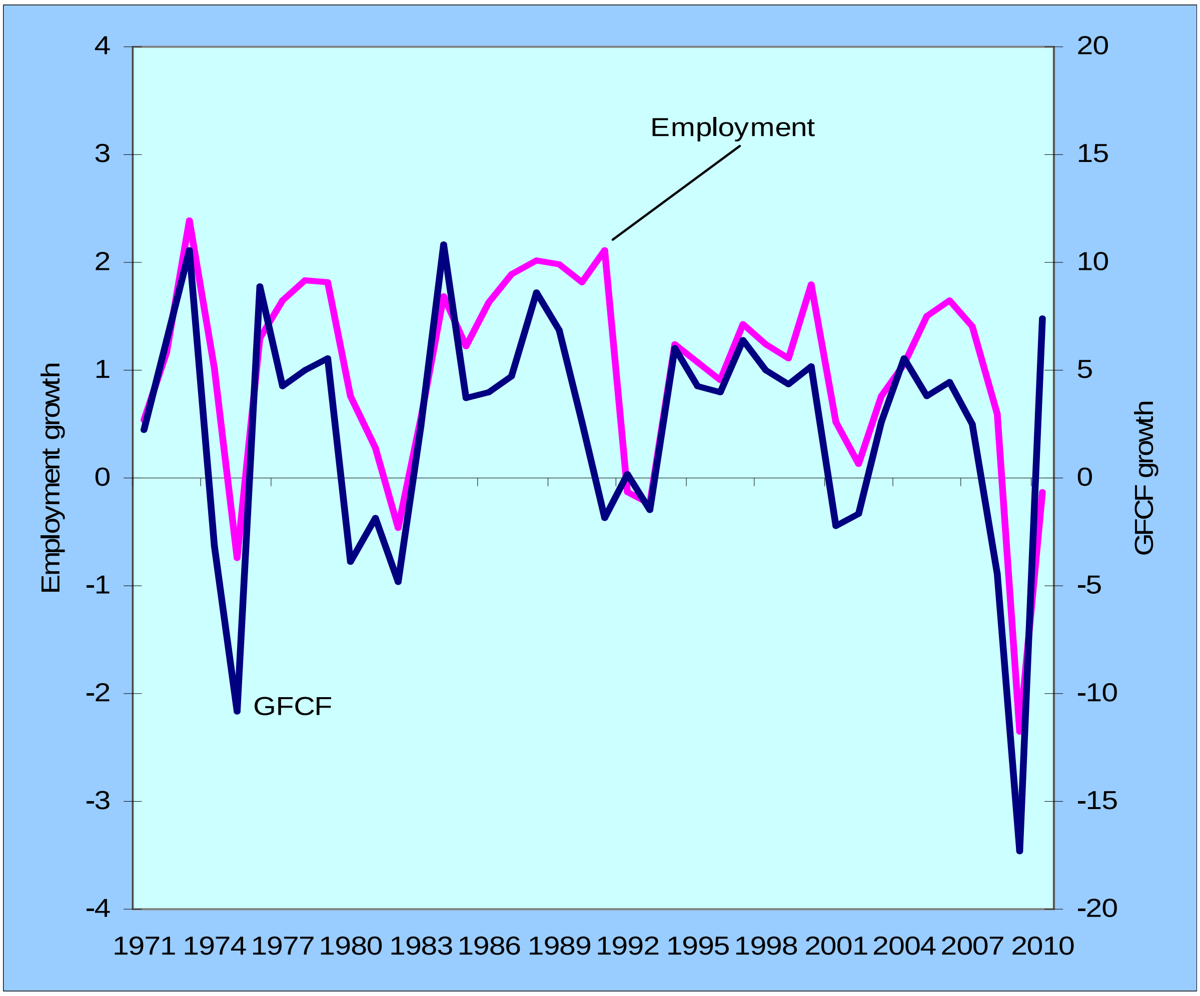
Note: Developed countries comprise: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Israel, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, the United Kingdom and the United States.

There is also a strong positive correlation between investment in fixed capital and employment creation in developed countries (chart 2). The evident explanation is that companies invest and disinvest in labour and capital at the same time, depending on the overall state of the economy. Consistent with this evidence is a view that regards capital and labour not as substitutes the use of which is the result of relative prices of the factors of production, but as complementary factors of production that are combined to achieve a certain output and independently of their relative prices. Clearly, the elasticity of employment in relation to growth differs from country to country, and from period to period, but the close link between growth, employment and investment challenges the belief that a significant number of new jobs can be created without a critical level of investment and output growth. Once it is recognized that it is not primarily the relative cost of labour but the pace of output growth that is the key determinant of the level of employment, it follows that investment in real productive capacity and the demand expansion that motivates such investment are the main drivers of both income growth and employment creation.

Chart 2

GROWTH OF EMPLOYMENT AND GROSS FIXED CAPITAL FORMATION (GFCF) IN DEVELOPED COUNTRIES, 1971–2010

(Per cent)



Source: See chart 1.
Note: See chart 1.

Whether or not aggregate demand rises sufficiently to create enough employment depends crucially on the distribution of the gains from productivity growth, which in turn is greatly influenced by policy choices. The policies generally adopted over the past 25 years have sought to keep wages low, and have served to translate productivity gains either into higher capital income or into lower output prices. But keeping wages low in order to generate higher profits is self-defeating: without rising purchasing power of wage earners, domestic demand will not grow sufficiently to enable owners of capital to fully employ their capacity and translate the productivity gains into profits. The only way to avoid this dilemma would be the hope to stimulate foreign demand through falling wages and an improved competitiveness, which would replace the faltering domestic demand. However, this creates a fallacy of composition. One country can be successful with such an approach but it cannot be a general solution. Such an employment creation would be at the expense of growth and employment generation in other countries and it cannot work if applied by many countries at the same time. Only real wages rising in line with productivity growth will generate the amount of domestic effective demand to nourish a virtuous cycle of growth, investment, productivity increases and employment over time.

Macroeconomic trends also matter in developing countries

Structural unemployment or underemployment is a prominent feature in most developing countries, and labour-market and social-security institutions are generally much less developed than in industrialized countries. These conditions lead to different behaviours of actors on both sides of the labour market. But in today's developed countries, the creation of such institutions was itself part of the process of structural transformation that accompanied industrialization, and the participation of labour in productivity growth was a necessary condition for advancing structural transformation and achieving higher standards of living. Between today's developing countries and the countries that industrialized and created labour-market and social-security institutions before the globalization of production and investment, the main differences are not in the macroeconomic processes but in the context of corporate decision-making on production and investment.

Prior to the globalization of production and investment, such decisions were taken primarily with reference to demand and competition in domestic markets, even when the rest of the world provided markets for some of the increasing production as well as outlets for some labour through migration. By contrast, in most developing countries today such decisions are taken primarily with reference to external demand and global competition. Moreover, these countries can import advanced technologies from the North. The problem of combining technological progress, investment and productivity growth with employment creation is more pronounced when labour-saving technology is introduced in an economy that produces neither capital goods nor the technologies embodied in them. Since this is a typical situation for developing countries, it is even more important for employment creation that productivity gains translate into higher demand for domestically produced goods and services.

In developing economies that are still highly dependent on the production and export of primary commodities, the link between growth and employment creation can be quite loose. This is because direct employment created in export-oriented activities is frequently small, especially in extractive industries; in addition, short-term growth is often influenced more strongly by movements in internationally determined prices for primary commodities than by an expansion in the volume of domestic output. Strong increases in commodity prices, as witnessed during the period 2002–2008, can lead to income growth without an increase in real output, and thus do not necessarily result in higher employment in the commodities sector. Transforming income gains resulting from commodity price increases into a sustained process of growth and employment creation would require ensuring that higher prices or productivity growth in the primary sector translate into greater domestic demand and/or more investment. . The role of the State is essential for capturing a significant part of that income and, through its larger current and capital expenditure, generates the conditions for higher productivity and decent employment in the rest of the economy.

The situation is different in those developing and emerging-market economies that have achieved a more diversified production structure. In some of these economies technological catching up has led to rapid growth in their tradable goods industries through an expansion of net exports. Productivity changes are often passed on in the form of lower prices, while keeping wages depressed, in order to maintain external competitiveness in the context of falling world market prices, or in the hope of increasing world market shares. To the extent that an economy depends entirely on external markets for growth, the scope for employment creation is circumscribed by limited demand expansion elsewhere or possibilities for increased market share.

Therefore, in developing countries, as in developed countries, the ability to achieve sustained growth of income and employment on the basis of productivity growth depends critically on how the resulting gains are distributed within the economy, how much additional wage income is spent for the consumption of domestically produced goods and services, and whether higher profits are used for investment in activities that simultaneously create more employment, including in some service sectors, such as the delivery of health and education.

The need for a new approach: incomes policy for wage-led growth

A successful strategy for growth and employment depends on investment in fixed capital. In a market economy with a dominant private sector, such investment is strongly influenced by the growth of demand for the goods and services that are produced with that capital, on the one hand, and on the conditions to finance such investment on the other. Public policies can support investment on both sides. The experience with the reform agendas of the 1980s and 1990s has shown that capital accumulation, productivity growth and job creation do not automatically result from a purely market-determined allocation of resources; successful strategies for economic growth, catching up and sustained improvements in welfare for all groups of the population require much more than integration into the international division of labour. Widening the scope of policy instruments beyond those that were deemed acceptable under the development paradigm of the past 30 years would not only allow the pursuit of additional goals, it would potentially also increase the number of combinations of instruments. In many cases this will be decisive in determining the success or failure of a strategy for growth and employment generation.

Supportive monetary, financial and fiscal policies are required to achieve a strong growth dynamic based on fixed capital formation that provides the additional employment opportunities required to absorb surplus labour. But the task of monetary, financial and fiscal policies to support employment growth can be greatly facilitated by the additional use of an incomes policy that builds on certain rules for determining mass incomes in a growing economy. If well-designed, an incomes policy can contribute to employment growth by enabling a steady expansion of domestic demand.

In order to attain a trajectory of sustained growth and employment generation, productivity gains need to be distributed in a way that allows labour income to grow at the same pace as productivity. As demand would grow at a similar rate as the supply potential, it would also serve as an inducement to additional fixed investment, and as a stimulus for industrial growth and the creation of jobs to absorb the surplus labour in the economy. In a market economy, the implementation of such an incomes policy requires an institutional framework adapted to the economic structure and the historical specificities of each country. Such an institutional framework is all the more important as an incomes policy can serve not only as an instrument for employment generation, but also as a means to control inflation. Wage growth based on the productivity rule could contribute to keeping inflation low by preventing unit labour costs and demand from increasing in excess of the supply potential.

Many developing countries have a history of very high inflation, or even hyperinflation, due to bouts of inflationary acceleration spilling over into nominal wage increases through indexation mechanisms. This has proved to be extremely costly, because for central banks to bring inflation down to their target level against permanent upward price pressures from the cost side, they are obliged to apply shocks to the economy time and again through interest rate hikes. This implies sacrificing real investment and employment for the sake of nominal stabilization. In some developing countries, a rule for growth of labour income along the path of average productivity growth in the economy may be of value for stabilizing the economy, on both the real and nominal side.

Such an anchoring of nominal wages to the productivity growth trend implies that the share of labour in total income remains unchanged. However, there may be situations when it is desirable to change a given distribution of income between capital and labour in an effort to redress inequities and national inequalities. In this case, more far-reaching adjustments of labour compensation and government measures to correct the market outcome should be part of a social compact.

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