INTERNATIONAL LABOUR OFFICE

GB.291/ESP/1
291st Session

Governing Body

Geneva, November 2004

Committee on Employment and Social Policy

ESP

FIRST ITEM ON THE AGENDA

Macroeconomic policy for growth and employment

Contents[2-251]

Paragraphs

1. Background

1. This paper reviews the debate over the effects on stability, growth and employment of macroeconomic policies. It looks at how macroeconomic policies are linked to the strategic goals of the ILO and to shaping the social dimension of globalization and ends with some proposals for further work of the Office on these issues.

2. During the Governing Body session in March 2003, the Committee discussed and endorsed the Global Employment Agenda (GEA) [1] as an important component of policies to promote decent work. During the same session, the Committee urged the Office to review and elaborate the ten core elements that were contained in the GEA. The present paper is part of this review process.

3. The theme of macroeconomic policies and employment has been discussed in the ILO forums on a number of occasions. [2] It has assumed a renewed urgency in view of increasing concern about the social effects of liberalization and globalization, and a long-term slowing of the rate of growth of global output and employment. The promotion of freely chosen, productive and remunerative employment, based on respect for fundamental principles and rights at work, is crucial to the realization of decent work for all. Success in employment generation is intrinsically linked to trade and fiscal, monetary and exchange rate policies, and is recognized in the Philadelphia Declaration (1944), which urged the ILO to review economic and financial policies and voice its views on the effects these could have on employment and the world of work. The World Commission on the Social Dimension of Globalization has called upon all multilateral organizations to achieve a better common understanding of the interaction between economic and social policies. [3] Such a common search is likely to ensure greater policy coherence and better outcomes that would "connect with people's priorities". [4]

4. The design of macroeconomic policy frameworks is a central question on the political agenda of most countries. Success or failure affects economic and social progress. The issue evokes sharp, sometimes ideological, debates, even though many economists would accept that the causal chain between policy changes and employment outcomes is complex and difficult to predict or explain. Members of the Committee, during a preliminary review of the core elements of the GEA (March 2003), [5] themselves expressed divergent views on what constituted an appropriate macroeconomic policy for employment. However, disagreements lie less on the objectives of policy, than over which instruments and levers of macroeconomic reform are most appropriate. Given that the choice of policy tools

[1] GB.289/ESP/2.

[2] Resolution adopted by the International Labour Conference at its 83rd Session (June 1996), ILO, Geneva; *Conclusions of the international consultation on the follow-up to the World Summit for Social Development*, Nov. 1999; *Working out of poverty* (Report of the Director-General), ILO, Geneva 2003.

[3] See ILO: *A fair globalization: Creating opportunities for all*, Report of the World Commission on the Social Dimension of Globalization, Geneva, 2004.

[4] cf. ILO: *A fair globalization: The role of the ILO*, Report of the Director-General on the World Commission on the Social Dimension of Globalization, Geneva, ILO, 2004.

[5] GB.286/ESP/1(Rev.).

entails trade-offs between competing objectives, it is not surprising that macroeconomic debates are often conflictual.

5. This paper does not expect to resolve such conflicts. Rather its aim is to situate the ILO's concerns about ensuring a supportive macroeconomic environment for employment generation in the current discussions about the balance between financial stability, structural adjustment, growth in incomes and employment, and a more equitable pattern of development both within and between countries. It finds that there is a growing acceptance of the need for rethinking of the balance of macroeconomic policies although a new dispensation has not yet fully emerged to replace the so-called "Washington Consensus". ILO engagement in the discussions over a new balance in the construction of macroeconomic frameworks could thus be timely. It also finds that the process of national policy-making itself can affect success with packages that command the broad support of employers and unions having a good track record.

2. Macroeconomic policy objectives

6. The role of macroeconomics and the objectives of macroeconomic policies have been subjected to intense scrutiny and debate, both in the academic world and among policy-planners since the foundation of the ILO.[6] The post-Second World War democracies in the industrialized world largely accepted the obligation to sustain a full employment society. They relied to a considerable extent on macroeconomic policies that sought to minimize fluctuations in economic activity, through counter-cyclical, demand-management instruments.[7] The high-growth, near full-employment period, often dubbed as the "golden era", between 1950 and 1973 came to a halt in worldwide inflation and global recession at least in part as a consequence of the two oil price shocks of the 1970s. The objective of macroeconomic policy came to be defined more by the imperatives of inflation control and economic stability. This in turn led to a concentration on the control of fiscal deficits and the money supply as determining influences on the level of prices. This shift in the industrialized economies towards stabilization and adjustment was subsequently reflected in major macroeconomic reforms in the developing world, conducted largely under the supervision of the IMF and the World Bank. The policy package was dubbed the "Washington Consensus".[8]

[6] See G.M. Meier and J.E. Stiglitz: *Frontiers of development economics: The future in perspective*, World Bank and Oxford University Press, 2001; J. Tobin: *Full employment and growth: Further Keynesian essays on policy*, Edward Elgar, 1996; A. MacEwan: *Neoliberalism or democracy*, London and New York: Zed Books 1999; H.J. Bruton: *On the search for well-being*, University of Michigan Press, Ann Arbor, 2001 (paperback); S. Fischer: "The role of macroeconomic factors in growth", in *Journal of Monetary Economics,* No. 32, 1993.

[7] I. Islam: *Avoiding the stabilization trap: Towards a macroeconomic policy framework for growth, employment and poverty reduction*, Employment Paper 2003/53, Geneva, ILO, 2003.

[8] cf. J. Williamson: "The Washington consensus revisited", in L. Emmerij (ed.), *Economic and social development into the XXIst Century,* John Hopkins University Press, Baltimore, 1997.

Box 1

Elements of the "Washington Consensus"

- Fiscal discipline
- Redirection of public expenditure toward fields offering both high economic returns and the potential to improve income distribution, such as primary health care, primary education and infrastructure
- Tax reform (to lower marginal rates and broaden the tax base)
- Interest rate liberalization
- A competitive exchange rate
- Trade liberalization
- Liberalization of foreign direct investment inflows
- Privatization
- Deregulation (in the sense of abolishing barriers to entry and exit)
- Secure property rights

Source: J. Williamson: "What should the Bank think about the Washington Consensus?", background paper to the World Bank's *World Development Report 2000*, Washington, Institute for International Economics, 1999, p. 2.

7. Compared with early periods, the growth rates of per capita global output in the 1990s represent a significant slowdown. Low economic growth in many developing countries has given rise to either an increasing incidence or a disappointingly slow decline in poverty and unemployment. [9] The decline in growth of global output over the past two decades may not have been as steep as during the 1930s, but its prolonged tenure calls for a rethink of the adequacy of macroeconomic policies. The market will continue to play a dominant role, not least because it provides "a rational system of economic calculations" [10] but the real problem lies elsewhere. Removing market distortions and supply constraints may ensure a balance between aggregate supply and aggregative demand, but such equilibrium could easily coexist with substantial unemployment. [11] A growth strategy with a focus on reducing unemployment is likely to require consideration of a range of other policies, including demand-management, alongside price stability and market opening measures.

8. The choice of macroeconomic regime is complex, and not simply guided by demand or supply constraints. Country-specific structures and institutions play an enormous role in its implementation and effectiveness. It is rarely a matter of "free markets" or "big government". During the past two decades, many developing countries have, as a condition for financial support for stabilization programmes, cut fiscal deficits and reduced the size of government and public expenditure. Prolonged austerity has however squeezed public spending to the extent that the essential roles and functions of government, including the regulation of the market, are in jeopardy in many countries. There is also growing consensus that the process by which development policies are designed is important to their success. The idea of country ownership implies that the degree of societal commitment to policy goals and means is itself an influence on their successful

[9] ILO: *A fair globalization: Creating opportunities for all*, op. cit. This slowdown in global per capita GDP growth is largely due to the declining growth trends in OECD countries over the past few decades. It may be noted that a few countries, especially in Asia, including China and India, and among the transition countries, have posted satisfactory growth rates.

[10] A.R. Khan and M. Muqtada, eds.: *Employment expansion and macroeconomic stability under increasing globalization*, McMillan Press Ltd., London and St. Martin's Press, New York, 1997.

[11] cf. Tobin, 1996, op. cit.

implementation. In this process, unions and business associations play a key role in many countries as the main actors in the world of work.

3. Stabilization and structural adjustment policies

9. Since the early 1980s and until the latter half of the 1990s, the IMF and the World Bank have influenced the design and formulation of macroeconomic policies throughout the developing world, and made their lending policies conditional on the implementation of stabilization and structural adjustment policies (SAPs). This position derives from the contention that, if prices are stable and the exchange rate realistic, a country, all things being equal, would be less likely to face balance of payments difficulties. [12] This in turn was based on the conviction that sound monetary policy was crucial to the functioning of the price system and that an efficient allocation of resources would be rendered through freely operating markets. It was argued that “getting prices right” policies would lead to prices reflecting real costs of production, and would enable businesses to determine rationally their investment strategies. These policies – the control of inflation through the levers of monetary policy, a strict fiscal and current account discipline and a reduction in the role of the State and regulations in controlling markets – were thus believed to be the foundation for sustainable growth.

10. Few would contest that a precondition for economic growth is an enabling economic and political environment that encourages both domestic and foreign investment, and facilitates longer term capital accumulation and enterprise development. The need to keep prices reasonably stable is also not a matter of dispute. Voluminous literature, analytical and empirical, has evolved to establish credibility on why stability matters, and how stability is attained. The results of these findings, however, have been less straightforward, especially when stabilization failed to yield adequate and sustained growth. In fact, a recent World Bank research suggests that the “policy reform approach to economic growth exaggerated the gains from improved resource allocation, and proved to be theoretically unsupported and contradicted by the empirical evidence”. [13] For its part, the International Monetary Fund acknowledges that stabilization defies simple policy prescriptions:

> The IMF’s management of the Argentine crisis reveals several weaknesses in its decision-making process … Too much attention was given to determining – inconclusively – which alternative policy framework should be recommended to the authorities, while little effort was made to determine what practical steps the IMF should take if the chosen strategy failed. [14]

[12] See A. Krueger: *Policy lessons from development experience since the Second World War*, paper presented at the first ADB Conference on Development Economics, Manila, 1992; B. Balassa: *Development strategies in semi-industrializing economies*, John Hopkins University Press, Baltimore, 1982; J. Bhagwati and T.N. Srinivasan: “Trade policy and development”, in R. Dornbusch and J.A. Frankel (eds.) *Economic adjustment and reform in low-income countries*, IMF, Washington, 1999; for a critique, and alternative view, see A. Amsden: *Asia’s next giant: South Korea and late industrialization*, Oxford University Press, 1989; R. Wade: *Governing the market: Economic theory and the role of the government in East Asian industrialization*, Princeton University Press, 1990.

[13] World Bank: *The growth experience: What have we learned from the 1990s?*, May 2004 (draft).

[14] S. Takaqi et al.: *The IMF and Argentina, 1991-2001*, Washington, IMF, 2004, p. 5.

11. Furthermore, a study by the IMF states that: "notwithstanding the theoretical appeal of the arguments that high inflation is damaging to growth, the empirical support for this relationship has been mixed". [15] Such studies and results, although useful pointers, still keep begging the question: at the country level, what is the cut-off point for inflation, beyond which unhealthy effects would be initiated? Extreme cases of hyperinflation episodes, as occasionally observed in some Latin American and Eastern European countries, are not necessarily being referred to here. It is also important to consider the contention that mild inflation, especially in developing countries, can often be conducive to resource mobilization and utilization of capacity.

12. Studies carried out by the ILO bring the following observations: [16]

– nearly 20 years of stabilization policy measures, largely under strict conditionalities, have generally produced substantial price discipline and stability;

– not only has growth been inadequate (relative to labour force growth rates and unemployment, for example), it has also remained highly volatile in all but a handful of countries;

– although causal relationships are found between growth and the stability variables these are not always robust. In fact, budget deficits sometimes show a positive relationship with growth, implying that some focused public expenditure may contribute positively to growth;

– results from panel data show that the level of investment (investment-GDP ratio) as a single variable explains growth far better and more significantly than all the three stability variables taken together. It may be noted, however, that despite declining inflation and budget deficits, investment has failed to pick up significantly.

13. The ILO's work on stabilization and structural adjustment at global and country levels has examined their effects on growth, employment, income, labour markets and institutions. [17] The basic findings and messages which emerged are that growth in output and employment have been disappointing for the vast majority of the workers whose jobs and income have remained or become highly insecure, and industrial relations systems have come under stress.

14. Several other assessments are now also available on the varied experience of stabilization and its economic and social impacts. By most accounts, the essential issue appears to be not *why* stabilize, but *how* to manage stabilization. Stabilization measures also carry risks and costs. Hence, prudent management of stabilization requires a thorough *consensus* on when and how benefits would outweigh economic and social costs, and how the latter can be mitigated to contain a decline in income and employment entitlement of the poor, and

[15] H. Bredenkamp and S. Schadler (eds.): *Economic adjustment and reforms in low-income countries*, Washington DC, IMF, 1999.

[16] See, for example, M. Muqtada: *Macroeconomic stability, growth and employment – Issues and considerations beyond the Washington Consensus*, Employment Paper 2003/48, Geneva, ILO, 2003; I. Islam, op. cit.

[17] See, for example, R. van der Hoeven and G. Sziraczki: *Lessons from privatization: Labour issues in developing and transitional countries*, Geneva, ILO, 1998; I. Islam: *Avoiding the stabilization trap: Towards a macroeconomic policy framework for growth employment and poverty reduction*, Employment Sector, ILO, Employment Paper No. 2003/53; R. van der Hoeven: *Adjustment, employment and missing institutions in Africa: Lessons from East and Southern Africa*, Geneva, ILO, 1999.

any possible outbreak of social unrest. In most country cases, simultaneous pursuit of strict monetary policies to curb inflation, and rapid compression of public expenditures and imports to reduce fiscal and current account deficits, have often led to a fall in aggregate demand and national output growth. It is equally important to establish that policies do not overly conflict, e.g. among those that reduce fiscal deficit and the ones needed to create a *fiscal space* for critical public expenditures, especially on poverty-related public goods [18] (see box 2).

Box 2

Nepal: The fiscal space for employment and poverty alleviation

Nepal, like many other developing countries, embarked on an economic reform programme to stabilize the economy, and to introduce greater liberalization and a freer play of market forces in an otherwise state-led growth regime. The policy measures have restored *price stability*. Yet, over the past decade, these have hardly yielded growth responses. A persistence of stability *without* acceleration in growth would in turn imply difficulties in *sustaining* such a stability. With inadequate growth, it would be immensely difficult for Nepal to reduce its high incidence of poverty and underemployment to 35 per cent, as targeted in the Tenth Development Plan.

This is the policy-planner's dilemma. A higher level of growth and employment generation would require substantially increased expenditure on infrastructure and development, while stabilization measures continue to squeeze the fiscal space for undertaking such expenditures. Special expenditures on poverty alleviation funds, possible extension of subsidies to poorer farmers, social protection or other forms of active labour market policies would require even further resources. The PRSP, which provides the basic blueprint for an employment-generating, poverty-alleviating growth strategy, would need to consider these critical constraints and trade-offs that go beyond stabilization, and how to engage national resource planning and international support in designing the *vital fiscal space* in a realistic growth and employment strategy.

Sources: 1. National Planning Commission, HMGN: Interim Poverty Reduction Strategy Paper, Nov. 2000. 2. ILO: *Decent work for poverty reduction: An ILO contribution to the PRSP in Nepal*, 2003.

4. From stabilization to PRSPs: Pro-poor growth?

15. During the latter half of the 1990s, the lack of sustained growth, and concern over the high incidence of extreme poverty in many countries, attention turned towards concerted measures to reduce poverty, especially in the developing world. The United Nations Millennium Declaration highlighted poverty in a number of forms and pledged amongst other things to halve the numbers living on US$1 a day or less by 2015. Both the World Bank and the IMF have made "poverty reduction" the focus of their concessional lending framework, through the Poverty Reduction Strategy Papers (PRSPs). In fact, the Bretton Woods institutions have defined the new strategy as critically dependent on country-owned, participation-based PRSPs, and initiated the process especially for those countries that qualified for debt relief considerations under the Heavily Indebted Poor Countries (HIPC) initiative. [19]

[18] For a country study, see, for example, T. Haq: *Fiscal strategy for growth and employment in Pakistan: An alternative consideration*, Employment Paper 2003/56, Geneva: ILO, 2003.

[19] In other low- and middle-income countries, such as Egypt, the World Bank is undertaking "social and structural policy" reviews, dominantly focused on poverty alleviation. Around 80 countries are currently participating in the PRSP process. The critical focus appears to be on the design of medium-term expenditure frameworks in which the PRSP countries would seek to demonstrate a fiscally sustainable strategy to generate growth and reduce high levels of poverty.

16. The International Labour Conference and the Governing Body [20] have strongly urged the ILO to engage vigorously in poverty reduction strategies, affirming an earlier proposal by the Director-General for the ILO to work with World Bank in supporting the preparation of PRSPs in five pilot countries. The programme has now expanded to nine additional countries in Africa, Asia and Latin America, with work on two more in Central Asia and Europe beginning in this biennium. The Committee was updated on this work in the March 2004 session of the Governing Body. [21] A further review of ILO involvement in the PRSPs is planned for 2005.

17. The work of the Office on country support for the PRSPs is based on advocacy of decent work as a development tool for poverty reduction, and on employers' and workers' organizations participation. The agenda is set out in the Report of the Director-General to the 91st Session of the International Labour Conference on *Working out of poverty*. The key target group is identified as the working poor as the main providers for families living in poverty. Their poverty is caused both by lack of work and by insecurity of work, low productivity and income, inadequate skills, insufficient protection, and weak rights. Generating jobs and decent work therefore requires coherence across a range of policies. [22]

18. The preliminary experience with the preparation of PRSPs and interim PRSPs suggests that there is still an uneasy and unresolved tension regarding how the *development agenda* that is evolving out of the PRSPs should link up with stabilization-focused macroeconomic policy. [23] The long-term viability of a poverty reduction programme would require: (i) an embedded macroeconomic policy that appropriately signals the allocative and redistributive framework to tackle a pro-poor development agenda, such as the one set out in the Decent Work Agenda; and (ii) a clearly employment-focused growth strategy, since sustainable poverty reduction can only be achieved with more and better employment, and job-based income entitlements. The World Bank/IMF's PRSPs often make no explicit reference to employment-poverty linkages. [24]

5. Macroeconomic policies for stability, growth and employment

19. The two decades of the stabilization practice have shown that attempts to get prices right may not automatically stabilize markets nor growth (financial stability often implied a low-growth equilibrium). Furthermore, restrictive monetary and fiscal policy, focused largely on inflation control, in many instances dampened aggregate demand and affected vital public expenditures on infrastructure development, maintenance and social provisions. Questions are re-emerging regarding the balance between the objectives of

[20] See the discussion on the Report of the Director-General to the 91st Session of the ILC and on the report of the World Commission on the Social Dimension of Globalization.

[21] GB.289/ESP/3.

[22] See *Policy coherence for poverty reduction – Towards a decent work development agenda*, INTEGRATION, Working Paper (forthcoming).

[23] For a country example, see Centre for Policy Dialogue: *State of the Bangladesh economy on the eve of the Development Forum 2002*, Dhaka, 2002.

[24] For an analysis of poverty-employment linkages, see GB.289/ESP/2; for a general assessment of the UNDP's position, see T. McKinley: *Macroeconomic policy, growth and poverty reduction*, Palgrave, 2001; and the World Bank position: B. Ames et al., in *Sourcebook for poverty reduction strategies*, World Bank, Washington, DC, 2001.

macroeconomic policy. Experience has shown that stability in one of prices, markets, or growth does not necessarily ensure the stability of the others. This is well summed up by Ocampo who argues that “the consistency that ought to characterize macroeconomic policies should be based on a broad definition of stability that recognizes that there is no single correlation between its alternative definitions and that significant trade-offs may be involved”. [25]

20. While some of these trade-offs are unavoidable, many analysts accept that the real concern of macroeconomic policies is a persistent quest for *pragmatism* and *policy coherence* to maximize growth and employment, and to minimize conflictual outcomes. [26] The practice and experience of macroeconomic policy-planning during the past half century, both by the developed and developing countries, have produced an extensive knowledge base from which the countries could draw pragmatic lessons on which coherently designed policies are likely to work better in the given economic and social circumstances of the country.

21. During the immediate post-Second World War decades, several industrialized countries adopted policies of demand management, often termed Keynesian, as the main instrument of ensuring full employment. From the early-1970s, many governments shifted to a strategy which gave greater emphasis to supply-side measures aimed at stimulating structural changes in the economy. However, the budget stance, either stimulating or deflating the economy, remains a focus of macroeconomics in most countries. The United Kingdom’s Chancellor of the Exchequer, in a keynote address discussing the balance between demand- and supply-side policies, advocated a “modern Keynesian” approach to sustain and enhance employment through stability and growth. He argued for a focus on the continuous blend of both macroeconomic and microeconomic measures, to simultaneously increase productivity and sustain stability, without one or the other being solely charged with inflation targeting or employment generation. [27] Not everything can be achieved at the national level, however. Horst Köhler, the former Managing Director of the International Monetary Fund, argued the need for an “international regulatory framework for globalization … even if this means that nation States have to give up a part of their sovereignty”. He further noted that a political framework to achieve this already exists through the United Nations system, “particularly through the World Bank, the World Trade Organization, the International Labour Organization and the International Monetary Fund”. [28]

22. There is obviously no unique “technology” of macroeconomic policy to suit all economies, at all times. For instance, in the context of the advanced, industrialized economies, the European Union’s Stability and Growth Pact (SGP) and the Lisbon process (see box below), and the largely free market approach of the United States provide different experiments in integrating stability and employment into macroeconomic policy

[25] J.A. Ocampo: “Rethinking the development agenda”, in *Cambridge Journal of Economics*, Vol. 26, 2002; see also B. Ames et al., op. cit.

[26] See, for example, MacEwan, op. cit.; Bruton, op. cit.; J. Stiglitz: *More instruments and broader goals: Moving towards the post-Washington Consensus*, WIDER Annual Lecture, 1998; Muqtada, op. cit.

[27] G. Brown: “The conditions for high and stable growth and employment”, in *The Economic Journal*, 111, May 2001.

[28] H. Köhler: “Towards a better globalization”, speech delivered at Eberhard Karls University, Tübingen, 16 Oct. 2003, at http://www.imf.org/external/np/speeches/2003/101603a.htm .

guidelines.[29] Whatever the country approach, there is now a greater recognition of the need for sustained and stable growth and employment generation, and to broaden the "focus from short-term requirements".[30]

23. In the case of developing countries, there is significant consensus among policy-planners that the generation of high and productive levels of development and employment through enterprise development is a key means of combating poverty and inequality, and of ensuring social cohesion.[31] Although large variations exist among countries regarding the instruments of macroeconomic policy, the importance of employment in economic and social policies does not have many dissenters.[32] However, a new development agenda is needed to underpin structural changes, increase labour demand and shift labour to higher productivity sectors through macroeconomic and other sectoral and institutional policies.[33]

24. An essential precondition for sustained labour demand is the enhancement in the levels of investment. The high-growth era of the East Asian economies was facilitated as much by public interventions in incentive structures, and physical and social infrastructures as by macroeconomic stability.[34] High savings-investment rates, among other factors, together with a relatively egalitarian growth, helped these economies to achieve full employment and structural transformation. Such achievements are absent where, as in large parts of Africa, a concentration on stabilization policies has lowered growth, rates of investment and savings (see box 3).

[29] A. Giddens (ed.): the *Global third way debate*, Cambridge, Polity, 2001. Many of the transition economies of Europe, especially the EU accession countries, have anchored their macroeconomic policy framework to the SGP.

[30] See H. Köhler: IMF former Managing Director's address to Board of Governors, Dubai, Sep. 2003.

[31] ILO: *Working out of poverty,* Geneva, 2002; *Tripartite conclusions concerning the achievement of full employment in a global context*, ILC, 1996. UN: *Social dimensions of macroeconomic policy*, Report of the Executive Committee of the Economic and Social Affairs, New York, 2001.

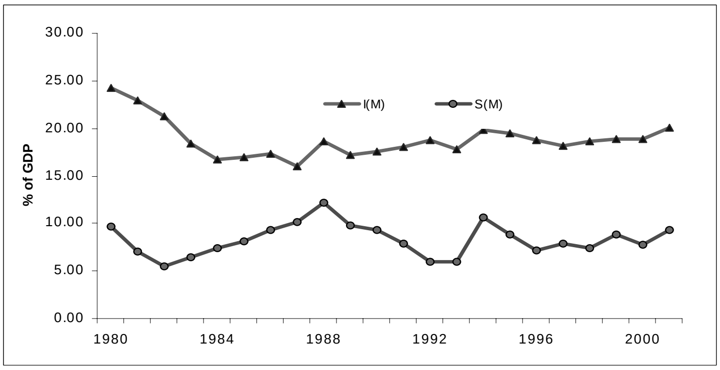
[32] See H.J. Bruton: *On the search for well-being*, University of Michigan Press, Ann Arbor, 2001. 1997. Bruton and many others define "sustained labour demand" as a *primary* objective of macroeconomic policy.

[33] For a historical account of these development debates, see G.M. Meier and J.E. Stiglitz: *Frontiers of development economics: The future in perspective*, World Bank and Oxford University Press, 2001. See also Bruton, op. cit.

[34] For an identification of the conditions for greater private investment in developing countries, see UN: *Unleashing entrepreneurship: Making business work for the poor*, New York, 2004.

Box 3

Trend in investment and savings: Africa



The figure above depicts a critical constraint to growth in the majority of African countries, viz. the investment-saving gap. For 53 countries, the median investment-GDP ratio is around 20 per cent, while the savings-GDP ratio stands around 10 per cent. Most countries thus face a major resource constraint to finance their growth and development, which is mitigated by public borrowings and ODA. FDI flows are feeble. It may be noted that the current investment levels return an average GDP growth rate of less than 4 per cent, hardly adequate to reduce current levels of unemployment and poverty. In order to halve poverty by 2015 (an MDG goal), countries would have to grow at 6-7 per cent, which would, all things being equal, require investment levels to reach 28-30 per cent. The *potential* investment gap is enormous. While it would be necessary to step up macroeconomic reforms to stabilize the economy, and financial and institutional reforms to encourage savings and resource mobilization, these would need to be strongly supplemented by FDI, concessional lending and debt relief in order to narrow the investment-saving gap. An aggressive resource mobilization policy, domestically and abroad, is required to facilitate attainment of the social goals identified by the PRSPs.

Source: ILO/Economic Commission for Africa: *Employment-friendly macroeconomic policy in Africa*, forthcoming, 2004.

Different country circumstances call for a different balance of policies in order to attain higher investment and employment, along with stability. In this regard, the report of the World Commission on the Social Dimension of Globalization identified a more coherent policy approach to "investment, growth and employment" as a key challenge for the multilateral system.[35] A macroeconomic policy framework must set macroeconomic targets that are feasible and flexible within bounds of alternative growth and employment scenarios. Previously, macroeconomic policies focused on achieving precise stability targets, in rather "short-termish dashes",[36] left very little room for manoeuvre, and little scope for damage control. The point to note here is that there can be several variations on any macroeconomic theme; this is a policy dimension increasingly recognized by the

[35] cf. *A fair globalization: Creating opportunities for all*, op. cit. Recently, the African Finance Ministers, in a memorandum to the Extraordinary Summit of Heads of State and Government on Employment and Poverty Reduction (8-9 Sep. 2004 in Ouagadougou), have called for "systematically mainstreaming the issue of employment into the development of strategies and programmes with technical and financial partners, in particular the Bretton Woods institutions".

[36] cf. G. Brown, op. cit.

World Bank/IMF,[37] especially that "policies take place within a specific institutional, social and historic context".[38]

25. During the past decade several countries were afflicted by economic and financial crises, often linked to short-term external lending, with serious adverse effects on jobs and incomes. Growth has become more volatile. As a result of the effects of more frequent and severe swings in economic performance governments are increasingly aware of the need to provide adequate social protection, as well as active labour market policies to assist the unemployed workforce, especially youth and other vulnerable groups, to find new jobs.[39] Such policies not only safeguard employment and income entitlements of the vulnerable population, but also help stabilize aggregate demand and output growth.[40]

26. For developing countries, especially those with a large underemployed workforce and pervasive poverty, the first steps towards a comprehensive social protection policy are focused government interventions to boost investment and employment generation. Given serious resource constraints, many developing countries require external support to create a fiscal space for such measures, through concessional loans, foreign direct investment and debt reduction programmes.

6. The environment for macroeconomic policies: Institutional reforms and international policy coordination

27. Macroeconomic policies designed to bring about a stable environment for growth and employment are unlikely to be effective unless embedded in a supportive institutional environment. In fact there is no automatic guarantee that getting prices right will sustain stabilization, that stabilization will enable resumption of growth, and that growth will lead to employment and poverty alleviation. Therefore, not only changes in macroeconomic policies are required, but in addition the macroeconomic policy framework needs to be supported by appropriate institutional policies, such as labour market regulations and

[37] See, for example, B. Ames et. al., op. cit. It may be noted that "Chile and Argentina have asked the IMF to adopt more flexible policies, including ones that would allow the governments to exclude investments by public enterprises from the calculation of their budget targets", in the *Financial Times*, 28 July 2004.

[38] cf. World Bank, 2004 (draft), op. cit.

[39] See UN: *Social dimensions of macroeconomic policies*, New York, 22 June, 2001. Equally, there are suggestions to design active labour market policies as an "automatic stabilizer"; see J. Quiggin: "Active labour market policy and macroeconomic stabilization", in *The drawing board – Australian review of public affairs*, University of Sidney, 2001; see Agell (1999): "On the benefits from rigid labour markets: Norms, market failures and social insurance", in *Economic Journal*, 109, issue 453; and Auer et. al. (forthcoming): *Active labour market policies: Coping with the consequences of globalization.* These authors argue that globalization will adversely affect labour markets and that shrinking employment security should be compensated by enhanced labour market institutions, for example labour market policies.

[40] A. Bhaduri: *Development with higher employment and productivity in the era of globalization*, Geneva, ILO, 2004 (forthcoming).

policies. Because the latter are country specific, a national approach is needed to formulating effective macroeconomic policies. [41]

28. A specific dimension of this "environment" is labour market policy, and the labour market institutions that support an employment-friendly macroeconomic policy framework, [42] but the broader environment is related to issues of governance [43] and institutions, regulations, and critically to social dialogue, especially when macroeconomic choices require decisions on trade-offs. Whether it is a question of devaluation, wage-moderation or social protection, there has to be consensus on shared responsibilities and transparency. [44] Democratic institutions, such as tripartism and social dialogue, when appropriately developed, support macroeconomic policy in providing efficient conflict resolution processes. In developing countries, with the formal sector accounting for a small percentage of the employed labour force, such a democratic representation and environment is weak. [45] This reinforces the importance of the strategies, agreed at the International Labour Conference in 2002, for decent work in the informal economy. [46]

29. While efforts to create the appropriate institutional environment for stable growth and employment-oriented macroeconomic policies remain primarily a national policy domain, the extent of "autonomy" with which a country can pursue macroeconomic policies appears to be changing. [47] With increasing globalization, a country's conduct of macroeconomic policies is increasingly sensitive to international influences and also impacts on other trading partners (see box 4).

[41] R. Burgess and A. Venables: *Towards a microeconomics of growth*, World Bank Policy Research Working Paper, No. 3257, Apr. 2004.

[42] See, for example, H. Bhorat: *The South African labour market in a globalizing world*, Employment Paper No. 2003/32, Geneva, ILO, 2003; J. Ghosh: *Macroeconomic reforms and a labour policy framework for India*, Employment Strategy Paper No. 2004/1, Geneva, ILO, 2004; G. Campero: *Macroeconomic reforms, labour markets and labour policies: Chile, 1973-2000*, Employment Strategy Paper No. 2004/2, Geneva, ILO, 2004.

[43] T.J. Banuri: *Economic liberalization: No panacea*, Clarendon Press, Oxford, 1990.

[44] For some successful cases where social dialogue has facilitated stability, growth and employment, see, for example, P. Auer: *Employment revival in Europe*, Geneva. ILO, 2000. See also M. Muqtada, op. cit., for the Barbados model of social compact on macroeconomic policy choices.

[45] D. Rodrik: *The new global economy and developing countries: Making openness work*, Washington, DC, Overseas Development Council, 1999.

[46] cf. ILO: *Decent work and the informal economy*, Report VI, ILC, 90th Session, Geneva, 2002; and resolution concerning decent work and the informal economy, adopted 19 June 2002.

[47] On limits to policy autonomy, see Bhaduri's exposition of "economic nationalism" in D. Nayyar (ed.): *Governing globalization – Issues and institutions*, WIDER Studies in Development Economics, Oxford University Press, 2002; in the context of Europe, see M. Rhodes: *Globalization, employment and European welfare States*, 1996.

Box 4

Macroeconomic policy and employment in Argentina, Brazil and Mexico in the post-crash era

The external opening of Argentina, Brazil and Mexico to international competition provides a number of important lessons concerning the need to integrate employment objectives within macroeconomic policy as well as how the tools of macroeconomic policy – monetary, fiscal and exchange rate policy – can be best used to promote job creation. Between 1995 and 2001, a mere decade after each country opened its goods and financial markets to external competition, the countries experienced an economic crisis which led to the abandonment of the fixed exchange rate regime, but only after experiencing sharp falls in GDP and a worsened labour market.

Since the crash, the countries have adopted flexible exchange rates, but with open capital markets and high debt burdens, particularly in Argentina and Brazil, the countries continue to have limited policy options. The risk that excessive devaluation will fuel inflation and derail meeting inflation targets, coupled with the increased cost of servicing the dollar-denominated debt when the currencies are devalued, has forced the countries to run fiscal surplus to finance debt repayments, as well as continue enticing capital inflows by offering high interest rates, in order to roll over existing liabilities. But as can be seen from recent experience, high interest rates can hamper economic growth and may worsen the prospects for debt repayment when country risk rises. It would be necessary to break this vicious circle of debt repayment, rollover and worsening economic performance, so that macroeconomic policy objectives can move beyond price stability and can focus on expansion of employment generation.

To refocus macroeconomic policy on promoting job growth, it would be useful to consider: (1) having debt payments indexed to the rate of economic growth; (2) using a wider range of macroeconomic policy tools, perhaps including capital controls, to ensure a competitive exchange rate; and (3) designing fiscal policy so that it is counter-cyclical. These policies would lessen volatility, create an environment more conducive to domestic and foreign investment which, in turn, is likely to boost internal and external demand for the countries' workforces.

Source: P. Auer, J. Berg and C. Ernst: Employment challenges in Argentina, Brazil and Mexico, forthcoming (provisional title).

30. Reduced national autonomy and increased vulnerability has stimulated a search for regional and international policy coordination mechanisms to support better macroeconomic outcomes at the country level. At the European level, the evolving Lisbon process offers a new approach to encouraging countries to pursue common goals in varying contexts for economic and social policies and in particular macroeconomic and employment policies (box 5).

Box 5

The Lisbon process

At the EU Lisbon Summit in March 2000 the EU adopted a strategy to make Europe the most competitive knowledge-based economy in the world by 2010. A new method of "open coordination" should promote sustainable economic growth with more and better jobs and greater social cohesion. This approach calls for setting targets and benchmarking progress, primarily through the EU Council that meets every spring to follow progress and determine new targets for the Lisbon strategy. At the Stockholm European Council in March 2001 sustainable development policy was added to economic and social policy as a third area for coordination.

31. Global engagement is also needed for designing mechanisms to insulate vulnerable economies against exchange rate fluctuations and investment volatility, to support increased foreign direct investment and stepped-up foreign aid to poorer countries, and facilitate the orderly migration of workers. [48] Such a global engagement would require the support and commitment of various stakeholders, with a critical role for ILO's social partners, at the local, national and international levels.

[48] See *A fair globalization: Creating opportunities for all*, op. cit.

7. The role of the ILO

32. The ILO’s interest in the design of macroeconomic policies stems from:

(i) the need to place productive employment generation at the centre of economic and social policy;

(ii) the importance of developing pragmatic coherent policy packages that assure financial stability without undermining growth, investment and employment;

(iii) the increased sensitivity of national policy efforts to external shocks, and the consequent need for international and regional policy coherence and resource support;

(iv) the need to incorporate measures of social protection and labour market activation into the macroeconomic framework in order to minimize volatility of aggregate demand, hence labour demand, and to mitigate its adverse social effects;

(v) the contribution that a process of social dialogue with unions and employers can make to the development of a broad-based societal consensus on policy goals and means. Since macroeconomic policies entail trade-offs and hard choices about the sequencing of policy reforms, wide participation by various stakeholders, especially the social partners, is critical to their design and successful implementation.

33. Further policy focused research based on global, regional and country experience is needed to underpin the development of macroeconomic policy frameworks supportive of growth, employment and social cohesion. Work in this field is already under way in the Office [49] and should be further developed as part of the ILO’s continuing interaction with the international financial institutions and UN agencies. Technical level meetings have started to investigate the scope for taking up the policy coherence initiative on “investment, growth and employment” recommended by the World Commission.

34. Many member States of the ILO, especially from the developing world, are intensely focused on measures to reduce unacceptably high levels of poverty and are committed to seeking measures to increase productive employment and to enhance the quality of employment based on fundamental rights at work. [50] As urged by the constituent partners, the ILO would continue to assist governments, with the fullest involvement of the social partners, in the design of employment strategies to enhance productive employment and decent work. A review of the macroeconomic policy framework is a central consideration in such strategies. As a result of the ILO’s work on PRSPs and decent work country programmes, the Office is developing its contribution to such macroeconomic policy reviews with a particular focus on ensuring a focus on decent work and the generation of employment through enterprise development.

35. An effective implementation of macroeconomic policies requires that these are articulated in an appropriate institutional framework. The ILO will continue its work on designing and promoting active labour market policies to support: macroeconomic reforms; a productivity-promoting and investment-enhancing industrial relations climate;

[49] E. Lee and M. Vivarelli: *Understanding globalization, employment and poverty reduction*, Palgrave, London, Sep. 2004.

[50] See, for example: *Working out of Poverty: Views from Africa*, ILO, 2004; see also the interim PRSP report of Bangladesh: *A national strategy for economic growth, poverty reduction and social development, 2002.*

fundamental rights at work; and an inclusive policy and enterprise management through social dialogue.

36. In the light of the above review, the Committee may wish to:

(i) discuss the role of macroeconomic policies for stability and growth with a particular focus on employment;

(ii) guide the Office concerning possible future action, both in respect of its analytical work as well as its advisory services, in the area of employment-friendly macroeconomic policy;

(iii) provide its assessment of and guidance on the strengthening of the Office's technical and advisory capacity.

Geneva, 4 October 2004.

Submitted for discussion.