MACROECONOMY FOR DECENT WORK[1]

The Latin American countries made deep economic reforms in the framework of the so-called Washington Consensus –intensive trade and financial liberalizations, privatizations, and introduction of fiscal discipline- convinced that stability, economic growth, and greater wellbeing would thus be ensured. The fact is that price-level stability was achieved in the course of the last two decades, but with meagre GDP growth and unstable production, employment, access to credit, and exchange rate. The volatile behaviour of these macroeconomic variables has discouraged capital formation, employment, and productivity in the economies, while financial capital flows have played a key role in this respect. As a result, it is necessary to move from the strong financial and short-term bias of the approach recommended by the Washington Consensus towards an outlook explicitly prioritizing the effect of productive development policies and their impact on equity.

1. Macroeconomic reforms since the 1990s

Prior to the reforms contained in the Washington Consensus, many countries of the region had experienced intensive inflation originated by fiscal imbalances financed via money issued by central banks. The foregoing justified reforms that prioritized combating inflation and imposing fiscal discipline. These measures had achieved their aim by mid-1990s, by way of improvements in fiscal balances and reductions of public debt as percentage of GDP.

Notwithstanding, and although most Latin American countries met the requirements of the Washington Consensus, outcomes in the level and stability of economic growth have been extremely meagre. Indeed, annual growth was barely 3.2% in 1990-2008, 1.6% if adjusted for the annual population increase, and GDP per worker barely increased by 0.5% per annum. Such meagre growth is closely linked to the instability of variables that determine global demand as faced by producers of goods and services (GDP), of macro prices (exchange rate and interest rate), and of the availability and cost of credit.

Aggregate demand has behaved as a kind of "roller coaster", given that its fluctuations have been quickly followed by fluctuations of GDP, which, by definition, involves fluctuation in the rate of utilization of available capital and jobs. The foregoing shows that, routinely, since the 80s the region has been operating significantly below the production frontier, with substantive ups and downs driving it closer to, and away from, potential GDP, but never keeping it there. This means serious macroeconomic disequilibrium, for operating below potential involves non-employed labour and capital, lower job quality, discouraged productive investment, and loss of fiscal revenues. Therefore, the fact that the macroeconomy focused on the two pillars mentioned above, i.e. low inflation and fiscal discipline, led to substantive imbalances in the real economy, and has been evidently unsatisfactory from the point of view of development.

1 The present note was prepared by consultant Mario Velásquez as a summary of the paper "Macroeconomy for decent work in Latin America and the Caribbean" (*Macroeconomía para el empleo decente en América Latina y el Caribe*) by Ricardo Ffrench Davis, Professor of Economics at Universidad de Chile. The complete paper may be found at: http://www.oitchile.cl/pdf/publicaciones/ele/Macroeconomia.pdf

2. Instability is recessive and regressive

The dynamism level of GDP and of employment depends on a number of factors, of which the rate of investment is a major determinant. This rate, however, has been remarkably low in recent decades, with respect to both the investment rate reached in other successful emerging economies and to achievements in the region in the 70s.

The low rate of investment is linked to the instability of domestic demand, since unstable global demand unavoidably means lower average net utilisation of productive capacity and lower actual productivity compared to a stable situation close to the production frontier. In turn, an unstable environment, of continuous adjustments and the associated regressive impact on labour, is linked to whichever sectors are usually most seriously affected by cyclical adjustments. In this regard, evidence shows that, e.g. in 1990-1997 and 1998-2003 most GDP adjustment (annual mean drop of 1.9 percentage points in the growth rate of the economy of the region) concentrated in production for the domestic market and, as such production depends on the local macroeconomy, the domestic markets have been where actual instability has focused most intensely. This relationship depends at determinant level on the quality of macroeconomic policy, and as management of the latter has been highly pro-cyclical, transmission of external shocks has multiplied rather than moderated.

In turn, the instability of real exchange rates, frequently associated with financial capital flows, has proved detrimental to the evolution of exports and the diversification of the composition and degree of integration of exports for national economies. Volatile capital flows have distorted decisions about productive investment, promoted speculative investment above productive investment, artificially displaced the production of tradable imports, and discouraged adding value to traditional exports, with negative effects on employment and employment quality. This flaw in exchange rate policy is a heavy burden for a development strategy led by exports, especially non-traditional exports and those with more added value.

Furthermore, exchange rate appreciation adds a marked pro-cyclical effect to the external sector, with depressive repercussions on sectors of production that compete with imports, many of them handled by small-scale enterprises. To waive regulation of the exchange rate, allowing the latter to float free of intervention by economic authorities is profoundly contradictory to an export-led development strategy, as well as to a strategy aiming to raise competitiveness in the economy as a whole (systemic competitiveness).

In sum, fluctuations in aggregate demand and its composition, in addition to the exchange rate, have been excessively determined by the capital account, and transmission to national economies of the pro-cyclical trend of the latter has proved detrimental to the development of production and, consequently, to employment and equity.

3. Ingredients of a macroeconomy for decent work

Domestic macroeconomic policies face the challenge of achieving an environment of reduced real volatility, sustainable external and fiscal accounts, and stable price levels. The deficient degree of overall stability, with its regressive impacts on employment, has been closely linked to capital flows and their volatility. However, such flows are part of the external savings required to supplement domestic savings. Therefore, a fundamental objective of macroeconomic policies, as well as of reforms to the domestic financial market, should be to take advantage of the potential benefits of external savings to develop domestic production, simultaneously mitigating the intensity of capital account cycles and their unfavourable effects on domestic economic and social variables.

a) Policy coordination

A coherent set of counter-cyclical policies –fiscal, monetary, exchange, for the domestic financial market and the capital account- is essential, together with efforts to “complete” the capital markets with the establishment of vigorous inclusive segments of long-term financing by active development banking.

The international financial crisis revealed the key importance of fiscal policy as a tool for macroeconomic stabilization. However, even if the counter-cyclical role of the latter could be perfected, it will normally prove insufficient, given that fiscal spending in the countries of the region amounts to only about one-fifth of aggregate demand. Little is therefore achieved by an active fiscal policy if other policies, which heavily influence private spending, are dependent on volatile flows and the opinions of pro-cyclical financial agents. It is therefore essential to ensure coordination among the various policies of macroeconomic scope.

b) Exchange-rate policy correction

The exchange rate is an essential macroeconomic variable for sustainability of macroeconomic equilibrium and for resource allocation. Conventional approaches hold that the sole exchange options are a fixed nominal rate or a totally free rate, assume the market will determine, benignly, a real exchange rate for sustainable balance. On the contrary, the problem that the new free exchange rate regime created in many countries of the region was that the rate became extremely sensitive to temporary changes in the supply of intrinsically volatile external funds; this gave rise to a profound contradiction, with serious implications. Indeed, liberalizing import reforms sought a key role for tradable items, under a rate of exchange that played a determinant part in international competitiveness. However, a policy was adopted based on a volatile exchange rate, dominated by short-term financial operators, compromising the viability of production ventures for export and the associated employment.

Intermediate managed flexibility regimes for the exchange rate are a serious attempt to reconcile such conflicting demands, with a view to having the real market forces - producers of export goods and importers and producers of import goods, which are major players in productive development and equity - prevail in determining the rate of exchange. Such is “the market” that must prevail, not the market of short-term operators and “rent”-seekers instead of creators of innovation and greater productivity.

In sum, a profound correction of the exchange policy is required. This would further help to achieve systemic competitiveness; that is, to develop productive capacity for external markets and for the domestic market, where the great majority of workers and enterprises are located. More systemic competitiveness helps to reduce domestic structural heterogeneity, which would create more egalitarian conditions for labour and business.

c) Deepening the capital market

An outstanding trait in the region is the “incompleteness” of capital markets, with some weak or non-existent segments. Furthermore, the distributive and resource-allocating incidence of the flaw in the capital market is aggravated by the considerable structural heterogeneity existing among the various economic agents, to the detriment of SMEs, self-employed workers, innovation, and agents with few assets. The close link to the most volatile international markets during recent decades has emphasized the gravity of such flaws and contributes to explain the scarce investment in production and the precarious status of labour.

Regarding interest rates, once liberalized, they were frequently unstable and substantially higher than international rates, with markedly greater spreads over lengthy periods. There are still systems operating with high financial costs, which, instead of deep markets as the neoliberal approach expected, have proved to be deeply segmented markets. These markets focus excessively on the short term, being particularly discriminatory with regard to smaller-sized enterprises and their capacity to create more jobs.

Accordingly, reorganization of the domestic financial system should aim to channel resources towards savings and productive investment creating sustainable employment. Institutions are needed comprising a vigorous long-term segment, to direct savings towards financing productive investment, governed by prudential and counter-cyclical regulations. Institutions should contemplate an active role for public and private development banking.

d) Counter-cyclical regulation of the capital account

In emerging economies such as those of Latin American countries, domestic market reform becomes extremely difficult vis-à-vis an indiscriminately open capital account. Effective and efficient counter-cyclical regulation of the capital account emerges as an essential condition to advance towards a macroeconomy for development, approaching decent work, simultaneously in direct connection to the production apparatus, reducing structural heterogeneity among different productive and social sectors.

Countercyclical regulations on capital inflows and outflows provide room for a reorganization of the financial system, enabling the channeling of resources towards savings and productive investment, in direct connection with the productive structure, thereby reducing the structural heterogeneity between different productive and social sectors.

More volatile capital account regulations can work as a counter-cyclical macroeconomic instrument,[2] acting upon the source of boom and contraction cycles. The latter reduce appreciating exchange pressures and allow

2 The successful experience of Chile in the first five-year period of the 90s is solid proof of the efficacy that counter-cyclical regulation of the capital account can achieve.

adoption of contractionary monetary policies during periods of financial euphoria. It is most important that during recessive situations like the present one, prior application of these regulations allows space for expansive monetary and fiscal policies.

Finally, the urgent reform of the reforms contained in the Washington Consensus should prioritize linking the financial system -both the domestic system and the capital account- to the internal investment process and the domestic economy rather than to short-term speculative foreign financial markets; it is essential to contribute to the stability of domestic demand and of such macro prices as the exchange rate, and to endeavour to deconcentrate economic power by granting preferential priority to SMEs.