Abstract

The global financial and economic crisis which erupted in 2008 led to an exceptionally comprehensive, job-centered policy response. Unlike in earlier crises, macroeconomic policies were used as an anti-cyclical devise and many employment and social protection measures were reinforced or introduced. This approach helped recovery in emerging and developing countries and attenuated the recession in advanced economies. However, as the paper shows, the key income and financial imbalances which led to the crisis have not been properly addressed. This partial approach to the crisis may constrain job recovery in advanced economies and compromise balanced growth worldwide. The paper ends with key policy requirements for sustainable crisis recovery.
1. Introduction

The financial crisis which erupted in the wake of the collapse of Lehman Brothers in 2008 led to a reconsideration of earlier policy approaches based on the self-regulating ability of markets. In particular, the role of anti-cyclical macroeconomic policies in sustaining the economy and jobs was widely acknowledged (IMF, 2009). In addition, unlike in earlier crises, social protection was reinforced and in particular the level and duration of unemployment benefits were improved – thereby departing from the view that higher benefits automatically aggravate market distortions (Howell, 2008). The initial results of this new approach were positive. Indeed another Great Depression has been probably avoided thanks to the anti-cyclical monetary measures and socially-inclusive fiscal stimulus packages adopted in 2008 and 2009.

However, as from 2010, a change in the policy stance was done without addressing the factors that had provoked the crisis. Indeed, the economic imbalances resulting from inefficient and unequal income distribution have not been properly addressed (IILS, 2008; Rajan, 2010). And not enough progress has been made in regulating the financial system. The result is that, progressively, the scope for stimulatory macroeconomic policies to revive the world economy has become very narrow. The paper starts by highlighting the real and financial causes of the crisis and their inter-linkages. It then examines the extent to which fiscal and monetary policies – i.e. remedies which, crucial as they are, do not address the real causes of the crisis— can support a return to balanced growth. Policy lessons from the analysis are drawn in a final section.

2. Economically-inefficient income inequalities

While the crisis originated in the financial system, a more fundamental trend was the inefficient distribution in the gains from growth during the pre-crisis period. In most countries, wages grew less than justified on the basis of productivity developments during the two decades preceding the crisis. This is why wages as a percent of GDP declined in the majority of countries (Table 1), while the share of gross profits in GDP correspondingly increased. In many countries, wage moderation meant stagnant real incomes for low-pay workers and their families. In the United States, for example, median real wages grew by a mere 0.3 percent per year between 2000 and 2006. During the same period, labour productivity increased by 2.5 percent per year. Simultaneously, the revenue share that goes to the richest 10 percent of households has been on the rise, suggesting that the moderation in wage growth of low- and middle-income households is even more pronounced than indicated by the fall in the wage share. Given the relatively high consumption

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1 This paper draws heavily on an article published recently in the *International Labour Review* – see Torres (2010a).
2 Director, International Institute of Labour Studies, ILO, Geneva.
propensity of low-income households, wage moderation introduced a downward bias in aggregate demand of both advanced and emerging economies.

Table 1: Wage moderation around the world
(Share of wages as a percent of GDP)

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>China</td>
<td>52.3</td>
<td>51.9</td>
<td>39.7</td>
</tr>
<tr>
<td>Korea, Republic of</td>
<td>83.8</td>
<td>76.9</td>
<td>77.0</td>
</tr>
<tr>
<td>Japan</td>
<td>63.6</td>
<td>61.7</td>
<td>57.7</td>
</tr>
<tr>
<td>India</td>
<td>67.2</td>
<td>75.0</td>
<td>74.1</td>
</tr>
<tr>
<td>Canada</td>
<td>63.0</td>
<td>61.3</td>
<td>60.8</td>
</tr>
<tr>
<td>France</td>
<td>68.8</td>
<td>67.5</td>
<td>67.3</td>
</tr>
<tr>
<td>Germany</td>
<td>69.8</td>
<td>70.0</td>
<td>64.9</td>
</tr>
<tr>
<td>Italy</td>
<td>70.3</td>
<td>66.2</td>
<td>67.2</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>67.7</td>
<td>69.2</td>
<td>68.5</td>
</tr>
<tr>
<td>United States</td>
<td>67.4</td>
<td>68.6</td>
<td>65.7</td>
</tr>
<tr>
<td>Brazil</td>
<td>42.6</td>
<td>40.5</td>
<td>40.1</td>
</tr>
</tbody>
</table>

Note: The Table shows the share of total compensation of employees as a percent of GDP, corrected for changes in the incidence of salaried employment (except in China, where such a correction could not be made due to lack of data). This correction is standard practice and is necessary in order to control for the mechanical impacts on wage shares of changes in the composition of employment.

Source: Author’s estimates based on national accounts.

Wage moderation had two mutually-reinforcing effects. First, in some advanced economies such as the US, the UK, Spain and Ireland, wage moderation caused a build-up of private debt. Despite stagnant real incomes, households could purchase durable goods and housing through recourse to bank credit (IILS, 2008; Stiglitz, 2009). Reflecting inadequate regulations, banks were in a position to provide credit to these households—even though, under prudent criteria, such loans would not have been provided. Thus, the expansion in domestic demand in the US and some other advanced economies was funded from an accumulation of private debt.

Second, in the case of emerging economies where the financial system was more tightly regulated, wage moderation had a direct impact on weaker domestic demand (Ghosh, 2010). In these countries, domestic demand was further depressed owing to the weak social safety net. In the absence of adequate pension and health systems, households tend to hold large precautionary savings, therefore depressing spending. So it was crucial for economic growth in these countries to gain wider access to markets of advanced economies, especially those where domestic demand was especially dynamic—partly fuelled by debt creation. This is how several emerging economies as well as resource-rich countries generated growing external surpluses and a global “savings glut” that allowed interest rates to reach historical lows in the early 2000s, providing cheap financing conditions to even risky borrowers and fuelling housing bubbles (Bernanke, 2005).

For a while, the coexistence of debt-led growth in certain developed countries with export-led growth in large emerging economies seemed sustainable. The surpluses of the latter countries served to finance the deficits of debt-led countries (Table 2). And the world economy was expanding fast. However, debt-led demand proved to be the Achilles’ heel of the growth process. As US monetary authorities raised interest rates in 2006-07, the relatively small increase in borrowing costs which resulted from this measure was enough to provoke a cascade of failures in
loan repayments. This quickly spread throughout the financial system as a result of both the complexity of financial products—which made it difficult to assess the degree of risk—and the close international connections between financial institutions.

Finally, it is important to note that wage moderation and the associated increase in profit shares did not support real investment. The share of real fixed capital formation in GDP has tended to decline in advanced economies—as well as for the world as a whole (Table 2). This vividly illustrates failure of wage moderation and debt-led growth to boost potential growth. Reflecting the sluggish performance of real investment before the crisis, studies have shown that trend productivity tended to decline in advanced economies since the early 2000s (Blackfield and Oliveira Martins, 2009). In short, growing income inequalities have proved to be economically inefficient.

| Table 2: Wage moderation has not translated into higher investment globally |
| (Real fixed capital formation as a percent of GDP) |
| World | 23.4 | 22.1 | 23.1 | 21.5 |
| Advanced economies | 22.7 | 21.3 | 21.2 | 18.0 |
| Emerging & Developing economies | 26.2 | 24.9 | 28.5 | 29.2 |


3. Responding to the crisis without properly addressing its root causes: benefits, limits and costs

Governments acted quickly and massively to address the consequences of the crisis. First, they substituted private debt-led demand—which had come to a standstill as a result of the crisis—with public debt-led stimulus. Most countries that had budget space implemented fiscal measures in the form of discretionary tax cuts, higher government spending or a combination of both. According to ILO estimates, the fiscal stimulus measures amounted in 2009 to around 1.7 percent of world GDP (IILS, 2009a).

Second, in the face of the paralysis of inter-bank credit and the risk of a systemic collapse of the financial system, monetary authorities reduced interest rates to historically low levels. They also provided massive support to banks in the form of loan guarantees, capital injections and outright nationalization of ailing banks, among others.

Third, an attempt was made to avoid inward-looking solutions which would aggravate the collapse in demand and trade associated with the crisis. This was especially important for developing and emerging economies which had relied on exports as a driver of their growth strategy. The risks of wage deflation were also acknowledged. In June 2009, Governments, employers and workers
representations from around the world agreed on a Global Jobs Pact which warned against a spiral of wage cuts.

3.1. Benefits of curing the symptoms without treating the causes of the crisis

Overall, the measures succeeded in supporting the economy but also in avoiding further significant job losses (IILS, 2009a). This relatively favourable outcome reflects, first, the rapidity of the policy response. By adopting stimulus measures soon after the start of the crisis, countries could expect a significant positive impact on employment by mid-2010. By contrast, a postponement of the measures by 3 months would delay employment recovery by 6 months –illustrating the disproportionate costs of inaction for employment (IILS, 2009a).

Second, the fall in employment was cushioned by the nature of the policy response itself (Torres, 2010b), which also benefitted from evidence of socially-inclusive employment policies gathered before the crisis (OECD, 2006). In many of the most successful recoveries, crisis responses focused on stimulating aggregate demand while at the same supporting existing jobs. In particular, an effort was made to enhance social protection (Brazil, India), extend unemployment benefits (Japan, US), avoid cuts in minimum wages and adopt other support measures for low-income groups. In countries like France, Germany and the Netherlands, short-time working was promoted aided by government subsidies. In other countries like Australia and the US, part-time employment surged. These interventions, by sustaining the purchasing power of low-income groups, effectively boosted aggregate demand while also alleviating somewhat the social costs of the crisis.

3.2. Limits to partial remedies

Despite these initial results, the strategy did not succeed in addressing the main imbalances that had led to the crisis. This is particularly the case as regards the dysfunctional financial system. As stated by the BIS, “a financial crisis bears striking similarities to medical illness. In both cases, finding a cure requires identifying and the treating the causes of the disease” (BIS, 2009).

In its 80th Annual report, the BIS notes progress with international agreement on the direction of the reforms (BIS, 2010). There is recognition among the most important central banks that the capital base for banks needs to be improved in both quantitative and qualitative terms. Guidelines have been presented to “reduce the perverse incentives that drive managers to increase short-term profits without regard to the long-term risks imposed on the firm and the system”. New monitoring tools have been developed. Improvement in the regulation of the perimeter of bank operations - to avoid excessive off-banking - have been discussed. However, these much–needed guidelines and promised reforms do not seem up to the task.

A first consequence of the graduality of financial reform is that the volume of credit to the real economy has been slow to recover in many advanced economies. The situation is especially worrisome for small business. According to existing surveys, for example, for the European Union, it is still the case that many enterprises, in particular small and medium-sized enterprises, continue to have difficulty having access to the credit system.
Secondly, a significant moral hazard problem has been created by bailing out banks without imposing deep reforms. It is an issue of incentives rather than bank size (Blundell-Wignall et al., 2009).

Third, in an unreformed financial system, international capital flows will remain highly volatile. There is evidence that international capital flows have become much more volatile in the area of financial globalization than before, and the result of that is a larger number of financial crises. Even before the crisis of 2008, there had been a series of crises – a well-known one is the Asian crisis at the end of the 1990s, but in Latin America there have been several financial crises as well, provoked in part by a mismanagement of the macroeconomic system but also by volatile capital flows.

Forth, a more fundamental problem is that the financial sector has developed beyond reasonable boundaries and its practices have spread through the non-financial economy. It has long been claimed that today’s profits would be tomorrow’s investments and the day after tomorrow’s jobs. But reality has not kept to the promise. A large share of the increase in profits has accrued to the financial sector – the financial sector’s share of total corporate profit reached 42 percent before the crisis, up from about 25 percent in the early 1980s (IILS, 2009b). During the 2000s, less than 40 percent of profits of non-financial firms in developed countries were used to invest in physical capacity, which is 8 percentage points lower than during the early 1980s.

3.3. Costs and social implications

The exceptional measures adopted in the wake of the crisis have come at a significant cost for the public purse. Government debt has increased significantly, mechanically offsetting the decline in private debt which has taken place since the start of the crisis – the so-called deleveraging process (Table 3). In addition, the role of monetary policy has been pushed to the limits. With nearly nil interest rates and significant increases in liquidity, central banks have approached the limits of how much they can compensate for the credit crunch. As a result, since 2010, governments started to shift from stimulus to austerity.

Table 3: Public debt has taken the place of private debt

(Percentage point change in the ratio of household debt and general government debt as a percent of GDP)

<table>
<thead>
<tr>
<th>Country</th>
<th>Change in household debt 2002-2007</th>
<th>Change in government debt 2007-2009</th>
<th>Average Change in household debt 2007-2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canada</td>
<td>18.3</td>
<td>5.6</td>
<td>-.85</td>
</tr>
<tr>
<td>France</td>
<td>14.0</td>
<td>13.7</td>
<td>-3.4</td>
</tr>
<tr>
<td>Germany</td>
<td>-10.4</td>
<td>5.9</td>
<td>-10.4</td>
</tr>
<tr>
<td>Italy</td>
<td>12.1</td>
<td>12.0</td>
<td>-4.8</td>
</tr>
<tr>
<td>Japan</td>
<td>14.1</td>
<td>14.7</td>
<td>-6.4</td>
</tr>
<tr>
<td>Spain</td>
<td>28.0</td>
<td>19.1</td>
<td>-12.9</td>
</tr>
<tr>
<td>UK</td>
<td>24.0</td>
<td>23.5</td>
<td>-34.3</td>
</tr>
<tr>
<td>US</td>
<td>19.1</td>
<td>16</td>
<td>-8.5</td>
</tr>
</tbody>
</table>

Note: The change in household debt for Japan and the UK is calculated over the period 2002-08 and 2002-06, respectively. The change in government debt is calculated over the period 2008-09 for Japan and 2006-09 for the UK.

Source: Author’s calculations based on OECD National Accounts and IMF (2010b).
The Greek crisis which blew up at the end of 2009 and with renewed vigour in early 2010 gave the first major signal that fiscal policy would move to austerity. Investors, which had been saved by generous support—partly responsible for the rising public debt—became reluctant to finance growing government deficits.

The result is fiscal austerity spreading across Europe and beyond, weakening the economy recovery that was underway. Given the bleak domestic demand outlook, it is unclear whether foreign demand becomes the main engine of economic growth and job creation. Someone else has to import. And this is unlikely if the austerity contagion spreads, or if emerging economies, especially China—which have tended to rely on exports to drive growth—fail to boost domestic demand to a sufficient extent.

Fiscal austerity will also exert a direct impact on employment directly, now as well as in years to come. Many workers are employed in enterprises that benefit from shorter hours and other partial unemployment support, which, if withdrawn, will provoke new job losses. For those already unemployed, it is crucial to maintain well-designed social protection and programmes to support job search and update skills. Otherwise the unemployed tend to get discouraged and exit the labour market—depriving the economy of valuable resources and eroding social cohesion.

Depressed employment trends will impact on low-income groups disproportionately. The process of long-term unemployment and loss of skills is particularly acute for these groups. The result is wider income inequalities, which come on top of inequalities produced by the imbalanced growth patterns of the pre-crisis period.

It is not surprising that perceptions of social injustice are spreading fast in nearly all developed countries. The youth unemployment rate, now nearly 2.5 times higher than for adults, will only aggravate perceptions of injustice. Confidence in government is on the decline. Among advanced economies, it has fallen by over 10 percentage points over the course of the crisis. In short, the shifts to austerity measures without treating the causes of the crisis have created a fertile ground for social discontent.

4. Key policy priorities

In many advanced economies, the risk of persistent unemployment can be addressed through well-designed activation policies and job-search support. Evidence suggests that these policies are effective and also relatively cheap to the public purse (OECD, 2006 and Figure 1). Special attention needs to be devoted to vulnerable unemployed groups such as youth and lone parents.
It is crucial to ensure that wages move in line with productivity. Before the crisis, wages had grown less than productivity in most countries, which is one reason why households in developed countries had recourse to debt to finance housing investment and consumption. In some emerging economies, subdued wage gains have depressed domestic demand, which was offset for a while by growing net exports to deficit, debt-ridden countries. In addition, there is social discontent among workers, as recent events in the Arab region as well as in some Asian countries demonstrate.

Several authors have already stressed that economic growth in emerging economies needs to rely more on domestic demand, thereby moving away from the export model that prevailed before the crisis (Blanchard and Miles-Ferretti, 2009). Strengthening social protection could play a critical role in this respect. This would not only serve social goals, but would also reduce excess savings, boost domestic demand and contribute to alleviate global imbalances. There are encouraging signs that such a rebalancing process may have started already. In China, for instance, the fiscal stimulus package adopted in the wake of the crisis included a major component of social assistance and retirement income transfers. According to a recent study, a cautious expansion of the public pension and health systems in China would raise the share of consumption in GDP by between 0.2 to 1.1 percent, by 2025 (McKinsey Institute, 2009). This would contribute to make domestic demand a greater engine of economic growth in China and support sustainable recovery worldwide.

Of course, exchange rate changes would help reduce global imbalances as well. However a revaluation of currencies in surplus countries vis-à-vis deficit countries will shape the real economy with a relatively long lag. By contrast, a boost to domestic demand in surplus countries will act quickly while addressing some of the root causes of the crisis (von Arnim, 2009).
Table 4: Policy options for rebalancing the world economy
(short-term impact on unemployment, by policy option)

<table>
<thead>
<tr>
<th>Policy Option</th>
<th>United States</th>
<th>China</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yuan appreciation</td>
<td>0</td>
<td>1.8</td>
</tr>
<tr>
<td>Asia rebalancing</td>
<td>-0.1</td>
<td>-1.4</td>
</tr>
<tr>
<td>Aggressive cut in US deficit</td>
<td>3.1</td>
<td>0.7</td>
</tr>
</tbody>
</table>


The tax and benefit system needs to be more supportive of employment and fair income distribution. There are good examples for that. For example, in Nordic countries it has been possible to limit and to facilitate job creation and at the same time avoid too much income inequality. There are examples of social protection systems that at the same time protect people and provide adequate work incentives for people to participate.

The tax system itself should be more progressive. Over the past two decades, top marginal income taxes declined in the majority of countries and therefore the tax system has become less redistributive.

It is also important to make sure that international labour standards are better implemented. There is a wide variety of Conventions and Recommendations, but the fact is that before the crisis there has been an increase in income inequality, job precariousness was on the rise and it was certainly the case that economic growth was not followed by equivalent and parallel developments of social progress.

Financial reform is needed to ensure adequate funding of sustainable enterprises. A clearer separation between investment banking and commercial banking would help in this respect. The adoption of a bank tax, as recently announced by EU countries, would also go in the right direction. Finally, a fee on financial transactions would help make the financial system less subject to “maniacs” and panics, which are so destabilising to the real economy.
References


