

Planning for recovery: How to rebalance global growth and demand

As stimulus measures wind down, many governments are opting for austerity. According to the ILO's World of Work Report 2010, neither approach addresses the underlying drivers of global economic instability. Gary Humphreys reports.

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recovery

The end came quickly, but so did the response. Faced with the complete shut-down of interbank lending after the collapse of Lehman Brothers in September 2008, central banks slashed interest rates and provided massive support in the form of loan guarantees, capital injections and, in some cases, nationalizations. It was an expensive undertaking.

"Bailing out the global financial system is estimated to have cost the United States and the European Union a total of US\$11.4 trillion – about one-sixth of world GDP," says Raymond Torres, Director of the ILO's International Institute for Labour Studies.

There has been much criticism of the way the banking sector was shored up. In the words of Vasailis Xenakis, General Secretary for International Affairs at Greek trade union ADEDY: "The banks created the problem but the people were made to pay." But doing nothing at all – letting the banking system shut down and the global economy with it – would probably have been worse for everyone. "Without these policies there was a significant risk of a slide into a second Great Depression," says Torres.

And government support was not solely directed at the banks. Those governments that could afford it cut taxes and/or increased government spending in a stimulus drive that amounted to around 1.7 per cent of global GDP in 2009, according to ILO figures. Torres also commends policy-makers for not resorting to protectionism. "Keeping trade flowing was crucially important and especially for developing economies which are dependent on exports to drive economic growth," he says, pointing out that roughly 20 million jobs were saved or created¹ by the policy response, which in most cases focused on stimulating demand while at the same time at least partly alleviating the social impact of the crisis.

From stimulus to austerity

But in the past year things have changed as governments have veered from stimulus to fiscal austerity. This shift in policy happened very quickly. On 23 April when G20 finance ministers met in Washington they were still talking about the need for stimulus, but by 5 June the G20 position had changed to encouraging fiscal "consolidation".² Between those two dates Greece came close to defaulting on its sovereign debt. It is what happened, or almost happened, in Greece that has changed the tenor of global policy discussions.

But should it have? "The reality is that sovereign states need to borrow on the bond markets, and the buyers of sovereign bonds like to know if they're going to get paid," says Ekkehard Ernst, an ILO research analyst, offering an explanation for the change in tack. The creditworthiness of a country is based on the state of its accounts and so cutting back on expenditure can lower the cost of borrowing. This is what Greece is hoping to achieve in order to retain IMF and EU support. But what effect does austerity have on the broader economy of a country trying to recover from recession? What effect does it have on society?

"There is a real danger that fiscal austerity will weaken the fragile economic recovery that is under way," says Torres, pointing out that it is the developed countries that have been hit hardest by the

¹ International Institute for Labour Studies: *World of Work Report 2009: The global jobs crisis and beyond* (Geneva, ILO, 2009).

² G20 Finance Ministers and Central Bank Governors Communiqué, Busan, Republic of Korea, 5 June 2010.

downturn. An unprecedented number of workers have been left without jobs and, two years after the Lehman Brothers collapse, factories are still running well below capacity.

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According to OECD estimates, the gap between capacity and output in OECD countries is unlikely to close until 2015. Unfortunately it is the countries that are struggling economically – the countries that need stimulus most – that are being forced to slam on the brakes in order raise money in the capital markets. Laying off public-sector workers, or cutting back on welfare payments, depress consumer demand which in turn strangles businesses already weakened by tight bank credit (see next article), but it looks good in a bond issuance prospectus.

Faced with dwindling domestic demand, many governments are focusing on exports as a way out of recession, the United States being a notable example. President Obama made export growth a central theme in his State of the Union address in January and has committed to doubling US exports in the next five years. It has worked before. Sweden and Finland did the same thing in the early 1990s and the Republic of Korea, Malaysia and Thailand followed suit at the end of the decade.

But the world has changed a good deal since 1999, notably with regard to demand in developed countries. In fact, the United States has been exporting more to emerging markets than developed ones for some time, and in order to boost exports further it will need emerging market countries, notably China, to boost domestic demand. Foreign exchange rates play an important part in this, and the ongoing debate between China and the United States regarding the value of the Yuan is indicative of their importance.

Lessons from the crisis

But is focusing on trade balances missing a more important lesson offered by the crisis? ILO's Torres thinks so. “There is a need to think about alternatives to export-led growth, and to address the increasingly important issue of income inequality,” he says, pointing to the increasingly unequal distribution of wealth in developed economies as one of the main drivers of instability in the global economy, and a contributing factor of fundamental importance to the 2008 crisis. In the United States, median real wages grew by a mere 0.3 per cent annually between 2000 and 2006 (compared to productivity gains of 2.5 per cent annually) while the share of income accruing to the richest 10 per cent of households rose, notes Torres, pointing out that the ratio of executive compensation in the 15 biggest US corporations, relative to average wages in the country as a whole, jumped from 370 to 521 between 2003 and 2007.

One of the effects of this overall decline in wages was a decline in aggregate demand – a phenomenon witnessed in both advanced and emerging economies. However, because of relaxed lending regulations in certain advanced economies, notably Ireland, Spain, the United Kingdom and the United States, despite stagnant real incomes households were able to continue to purchase durable goods by racking up debt.³ It was debt that fuelled domestic demand in the United States until credit limits were reached and people began to default. And a similar dynamic was playing out at the macroeconomic level. Says Torres: “For a time the surpluses generated by export-driven emerging economies such as China funded the debt-led growth of other countries, but in the end debtors’ inability to finance their credit proved unsustainable.”

³ International Institute for Labour Studies: *World of Work Report 2008: Income inequalities in the age of financial globalization* (Geneva, ILO, 2008); Joseph E. Stiglitz: “Wall Street's toxic message” (2009); Raymond Torres: article in *International Labour Review* (forthcoming 2010).

Paying people a fair wage

If wages had reflected productivity gains there would have been less of a need for private debt or government subsidies to support low-income groups with in-work benefits, negative income taxes and other such policies. Needless to say, matching wages to productivity has not been central to G20 or World Trade Organization discussions of the recovery and how to achieve it.

To get it on the agenda labour market institutions will have to make themselves heard. Not that they aren't already shouting. Strikers marching in the streets of Athens, Madrid and Paris have been calling for a halt to the dissolution of welfare benefits in the name of austerity, but there has been little in the way of focused discussion linking productivity to pay.

Put simply, paying people a fair wage can take some of the instability out of the global economy by boosting aggregate demand. An example of the kind of initiative that has been seen to work is China's Employment Contract Law which took effect in 2008, strengthened workers' rights and freed pent-up pressures for wage increases and better working conditions, to catch up with earlier economic growth.

And more can be done. According to a recent study by the McKinsey Global Institute, a cautious expansion of China's public pension and health insurance systems would raise the share of consumption in Chinese GDP by between 0.2 and 1.1 per cent by 2025.⁴ This would help make domestic demand a stronger engine for the country's economic growth and of course increase opportunities for China's trading partners.

Of course trade imbalances are only one of the problems we face. In the coming decade Western Europe's working-age population is expected to start shrinking by roughly 0.3 per cent a year. In Japan, this number will be closer to 0.7 per cent a year. Even America, which has more robust population growth, will see the expansion of the working-age population slow to around 3 per cent, which is less than a third of the post-war average.

On the face of it, these trends appear to have an upside – fewer workers competing for jobs. But what they actually mean is a greater burden on social welfare programmes and health care. The stimulus versus austerity debate is going to be coming up a lot. For ADEDY's Xenakis the policy debate must be broadened to include issues other than the kind addressed by issuance prospectuses. "This is about deciding on the social model we want to live under," he says. "That is where the policy discussion should begin."

⁴ McKinsey Global Institute: Beating the recession (2009).