International
Labour
Office

Geneva

Employment Policy Department

EMPLOYMENT
Working Paper No. 238

2017

Rethinking macroeconomic policies for full employment and inclusive growth: Some elements

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Employment
and Labour
Market Policies
Branch

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ISSN 1999-2939 (print); 1999-2947 (.pdf web).

First published 2017

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Printed by the International Labour Office, Geneva, Switzerland

Preface

The primary goal of the ILO is to work with member States towards achieving full and productive employment and decent work for all. This goal is elaborated in the ILO Declaration 2008 on Social Justice for a Fair Globalization which has been widely adopted by the international community. Comprehensive and integrated perspectives to achieve this goal are embedded in the Employment Policy Convention of 1964 (No. 122), the Global Employment Agenda (2003) and – in response to the 2008 global economic crisis – the Global Jobs Pact (2009) and the conclusions of the Recurrent Discussion Reports on Employment (2010 and 2014).

The Employment Policy Department (EMPLOYMENT) is engaged in global advocacy and in supporting member States in placing more and better jobs at the centre of economic and social policies and growth and development strategies. Policy research and knowledge generation and dissemination are essential components of the Employment Policy Department's activities. The resulting publications include books, country policy reviews, policy and research briefs, and working papers.

The Employment Policy Working Paper series is designed to disseminate the main findings of research on a broad range of topics undertaken by the branches of the Department. The working papers are intended to encourage the exchange of ideas and to stimulate debate. The views expressed within them are the responsibility of the authors and do not necessarily represent those of the ILO.

Azita Berar Awad
Director
Employment Policy Department

Foreword

The slow and uneven pace of economic and employment recovery since the 2008 global financial crisis highlights the need to reconsider macroeconomic policy thinking. There is a need for policy to be more pro-employment to ensure fast, inclusive and sustainable economic growth. This is especially important for emerging and developing economies striving to escape the “low-” and “middle-income” traps and achieve the Sustainable Development Goals (SDGs), especially Goal 8 “to promote inclusive and sustainable economic growth, employment and decent work for all”.

The International Labour Organization (ILO) has been working on pro-employment macroeconomic policies for a number years, assisting member States’ efforts towards decent work and productive employment for all. Constituents asked the ILO to identify promising macroeconomic policy frameworks, notably in the 2003 *Global Employment Agenda*, the 2008 *Declaration on Social Justice for a Fair* Globalization and the 2009 Global Jobs Pact. More recently, the 2014 International Labour Conference Conclusions concerning the Second Recurrent Discussion on Employment specifically called for assistance to macroeconomic policies that “support aggregate demand, productive investment and structural transformation, promote sustainable enterprises, support business confidence, and address growing inequalities” (ILO, 2014: 7(a)).

This paper reviews recent evidence and research by ILO and others concerning monetary, fiscal, exchange rate and capital account management policies, looking also at issues of policy coordination and the role of social dialogue. It argues that the rethinking of macroeconomics that is underway is providing ammunition for more active policies to strengthen labour market resilience in economic downturns; to support productive investment and private sector development, especially small and medium-sized enterprises; and to promote employment, productivity and stable and inclusive growth. The paper sets forth key elements of pro-employment macroeconomic frameworks as they were outlined by the ILO tripartite constituents at the 2014 International Labour Conference. Finally, it suggests areas for debates and research to inform the work of the ILO and other international organizations in the future.

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Acknowledgements

The authors are grateful to Francesco Saraceno (OCFE, Paris), Muhammed Muqtada and several ILO colleagues - Chris Ernst, Tarek Haq, Juan Chacaltana and Daniela Zampini - for their helpful comments. All remaining errors and missions are the sole responsibility of the authors. The views expressed in the paper are those of the authors and do not necessarily represent those of the ILO.

Contents

1. Introduction

"The crisis has thus resulted in a form of creative destruction, where established paradigms have been critically revisited, where flawed practices have been exposed and replaced by sounder ones and where new research addressed previously neglected aspects of our societies. This renewed effort has both greatly deepened our understanding of economics and shaped our policy response."

Mario Draghi, President of the European Central Bank, Tel Aviv University, 18 May 2017.

In the mid-1980s, countries in the developed world abandoned their post-WWII commitment to full employment and fervently embraced fiscal and monetary discipline to tame inflation and extensive market deregulation to sustain investment and job creation. The conventional thinking that underlined this approach saw price stability as the principal contribution of macroeconomic policy to job creation, by means of creating the conditions for a boost in private sector confidence and thereby automatically lead to higher investment, consumption, growth and employment. To this end, standard macroeconomic frameworks advocated a restricted role for public policy focusing on narrow inflation targets, limited fiscal policy interventions, a either free-floating or fixed-peg exchange rate, and full capital account liberalization. This was accompanied by a strong focus on nominal targets and fiscal rules to "tie the hands" of authorities and limit discretionary interventions.

Such policies, however, failed to prevent the burst of the global financial crisis in 2008 and were poorly effective in supporting adequate recovery from the economic downturn that followed, even exacerbating the negative impact in some countries and regions. They were also accompanied by growing levels of inequalities and persisting unemployment and underemployment in many countries. This has exposed shortcomings of the conventional approach and it is prompting a thorough rethinking of macroeconomics and macroeconomic policy.[1]

What is emerging is not a new consensus, but a growing convergence from various quarters on key features of a "new" approach to macroeconomic policy, an approach more friendly to employment promotion objectives thanks to a more aggressive management of demand by monetary and fiscal means and adequate financial regulation (e.g. Blanchard et al., 2013; IMF, 2013; Summers, 2016; Yellen, 2017). The new approach is not the upshot of a revisited coherent theoretical construct, but rather a mix of old and new ideas, buoyed by new evidence on critical issues such as, among others, flexible inflation targeting (Charpe and Kühn, 2015; Ozhan et al., 2013), counter-cyclical fiscal policy (Furman, 2016; Gechert, 2015; Ostry et al. 2016), exchange rates and foreign exchange reserves (Leigh. D. et al.,

[1] For a state-of-the-art review of current thinking, see Blanchard and Summers (2017) and Blanchard et al. (2016). Yellen (2016) accounts for a clear and perceptive review of the key questions for macroeconomic research raised by the financial crisis and its aftermath. Romer (2016) provides a critical perspective on the conventional modelling approach that has dominated academic macroeconomics until recently. Conventional thinking here refers to the views that prevailed among international financial institutions, academic economists and major academic journals and were crystalized and popularized in standard macroeconomic textbooks over the past three decades. Saraceno (2017) looks at the conceptual underpinnings of the conventional consensus, basically the shift from the Keynesian tradition to a "neoclassical" vision of the economy. Several streams of "heterodox" economic thinking did survive on the side – structuralist and institutional economists in addition to versions of Keynesianism; for a synopsis, see Earle and Perkins, 2016.

2015; Bussière et al., 2015) and capital account management (Blanchard et al., 2016b). It draws upon research from academic experts and international organizations as well the lessons learnt from the practice of central banks and fiscal authorities in some major economies in the wake of the global financial crisis. It is prompted by persisting and widespread concern for labour market distress, inequality and instability and their political consequences.

Governments and social partners at the ILO have been especially conscious of the need for vigorous policies to promote employment, a concern deeply rooted in the history and the practice of the Organization as exemplified in its Convention on Employment Policy No. 122 (1964) and a number of other international instruments and frameworks aimed at providing guidance to policy-makers.[2] At the 2014 International Labour Conference, the ILO tripartite constituents – ministries of labour and employment, employers' and workers' organizations – called for pro-employment macroeconomic policies to be part of "comprehensive employment policy frameworks" to promote full, decent, productive and freely chosen employment.[3] Pro-employment macroeconomic policies should strengthen the capacity of the economy to cope with the business cycle and reach its employment and output potentials. By taking into account issues of short-run economic stability as well as the effects of the macroeconomic framework on resource allocation and longer-run growth, they should encourage a self-reinforcing cycle of productivity-enhancing investment, quality jobs, and stable and sustained economic growth.[4]

This paper looks at the experience with macroeconomic policy and its employment impact in advanced, emerging and developing economies in recent years. Based on research by the ILO and others, it highlights elements that could make a national macroeconomic policy stance more employment friendly, in line with country needs and circumstances. Section 2, 3 and 4 look respectively at the employment dimensions of monetary, fiscal and exchange rate and capital account policies. Section 5 touches upon the issue of coordination. Some concluding remarks are offered in the final section.

The paper covers a wide range of issues that are complex, highly controversial at times, and in some cases still under-researched. It is intended mainly as a tool to inform tripartite constituents and ILO officials as they engage in the burgeoning debate on macroeconomic policy and employment. A tripartite perspective is imperative in such a debate, to avoid oversimplified solutions and build consensus for action.

The paper can also be of interest to those responsible for taking decisions affecting employment in ministries of finance, planning, development, trade and industry as well as in central banks. The quest for full employment and inclusive growth has become even more

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[2] The Convention, ratified by 111 countries, calls upon member States to "declare and pursue, as a major goal, an active policy designed to promote full, productive and freely chosen employment", consulting the social partners and taking into account national circumstances. Other relevant instrument and framework include the Global Employment Agenda (2002), the Sustainable Enterprise Programme (2007), the ILO Declaration on Social Justice for a Fair Globalization (2008), the Global Jobs Pact (2009, and the Conclusions concerning the First Recurrent Discussion on Employment (ILC 2010).

[3] Resolution concerning the Second Recurrent Discussion on Employment, International Labour Conference 103rd Session, June 2014.

[4] The level and composition of investment - especially investment in skills and physical capital, R&D expenditures, and the adoption of new technologies – are among the critical linkages, since current investment decisions have significant effects on current demand as well as on future productivity and growth. Those decisions hinge on how enabling is the environment for private sector development, including its legal, institutional and regulatory dimensions. This is beyond the scope of this paper, yet the ILO has a distinctive set of recommendations and practical tools to assist policy-makers in assessing the environment in which businesses start-up and grow (ILO, 2014a).

central since the adoption of the 2030 Agenda for Sustainable Development, especially sustainable development goal (SDG) 8 on "Sustained, inclusive and sustainable economic growth, full and productive employment and decent work for all". In the absence of robust and sound macroeconomic frameworks for job creation and business development, it is hard to think of making significant progress on many of the new sustainable development goals – decent work as well as poverty eradication; reducing gender and other inequalities; supporting industry, innovation and infrastructure; and promoting peaceful and inclusive societies.

2. Monetary policy

> *"It is now clear that, although it secured fifteen years of inflation control and steady economic growth, price stability, narrowly defined, morphed from healthy focus to a dangerous distraction. The financial crisis that exploded the Great Moderation was a powerful reminder that price stability is not sufficient to maintain macroeconomic stability, and that the evolution of credit and indebtedness can build up major macro problems for the future."*
>
> Mark Carney, Governor of the Central Bank of England, *Lamba*, speech given at the London School of Economics, Monday 16 January 2017.

Conventional economic thinking over the past three decades viewed inflation as the greatest macroeconomic impediment to economic growth and full employment, and focused on a single objective – price stability – via a strict inflation targeting framework (IT) to achieve credibility of policy action and anchor the expectations of firms, consumers and investors. Monetary policy was considered the privileged tool to cope with short-term business cycle variations, due to lags in the effect of fiscal measures and fears that government spending would only crowd out private investments and fuel inflation.

The great recession that followed the 2008 global financial crisis challenged this orthodoxy. Central banks in major economies responded via a host of unconventional monetary policies such as quantitative easing, forward guidance and near-zero or even negative interest rates. The massive increase in the monetary base of those countries stopped the global shock from becoming a depression. However, contrary to the predictions of conventional theory, it did not result in higher inflation nor it did have a fast and significant impact in bringing the demand for goods and services and the level of private investments back to pre-crisis levels. The persistence of low inflation and subdued economic recovery is raising questions about the adequacy of purely monetary measures vis-à-vis the risks of new asset bubbles and continuing financial instability.

2.1 Single versus multiple mandates

One lessons from the crisis has been the recognition that monetary policy alone is inadequate to prop up and stabilize a weak economy. This is opening the way to the revival of interest in fiscal policy as it will be discussed in the next section.

Another implication has been a thorough reviewing of key aspects of the inflation targeting framework (Williams, 2016). Some have proposed to raise standard target inflation rates from 2 to 4 per cent (e.g. Ball, 2014). Others have suggested to modify the operational definitions in order to grant central banks more flexibility around a medium-term credible goal of price stability (Gaspar et al., 2016). More ambitious proposals have involved central banks targeting not inflation but the nominal growth of national income (Avent, 2017), or even shifting to a dual mandate, which - without undermining price stability concerns - would allow more promptness and flexibility in balancing growth and jobs objectives (Islam and Hengge, 2015).

A dual mandate would see central banks adopt the explicit objective to maintain both price stability and full employment in function of the economic cycle. Without undermining the operational independence a central bank has within its own remit, such a mandate would allow greater flexibility to take into account labour market conditions in monetary policy decisions, facilitating coordination with fiscal and other relevant policies. Citing the well-known case of the US Federal Reserve, experts argue that a dual mandate did facilitate faster and more effective reaction to economic shocks compared to cases where action was constrained by a narrowly defined inflation target (Baker et al., 2017; Furman, 2016; Saraceno, 2015). In the wake of the crisis, central banks in several advanced economies *de facto* took employment considerations into account – i.e. an implicit dual mandate – in spite of their *de jure* mandates to focus primarily on price stability (Ernst and Merola, 2017). A dual mandate might also help communicate the monetary policy stance to the public and anchor and stabilize private sector expectations, in addition to granting public commitment to sustained employment levels.

2.2 Financial supervision and inclusion

A triple mandate for central banks has even been suggested, encompassing financial stability through macro-prudential surveillance as well as measures to improve the resilience of the financial system (Agénor and Pereira da Silva, 2013). In fact, another main lesson from the crisis has been about the importance of addressing the role of the financial system.

In most conventional macroeconomic models, financial intermediation was assumed away. People and firms were assumed to borrow at the policy rate set by the central bank (Blanchard, 2016) and no attention was paid to the characteristics of financial intermediation and how the financial sector actually interact with the broader economy - for instance what are the effects of oligopolistic financial structures, how unchecked risk accumulation threatens financial stability, or how changes in interest rates actually affect capital expenditure by enterprises (Sharpe and Suarez, 2014). Key features of the financial system - for example the fact that firms of different size face different constraints in accessing finance - have real economy implications that were ignored in standard macroeconomic analyses. Now, new studies are suggesting that the credit crunch that followed the financial crisis hit employment in small and young firms particular hard and might have been among the causes for the long duration of the crisis and the subsequent slow recovery (Duygan-Bump et al., 2015; Siemer, 2014). Similar research also suggests that banks were less willing to lend to firms with high R&D budgets, leading to a fall in R&D investment and a permanent fall in future output (de Ridder and Teulings, 2017).

By means of strengthening their supervisory and regulatory functions, central banks could play a role in promoting systems of financial intermediation that are more stable but also more effective and efficient in ensuring credit to productive and employment generating firms. To improve the way in which financial intermediaries - through their influence on the levels of interest rates and the availability of credit - affect consumer spending, business investments and the creation of new firms would be of great value for employment promotion. Micro, small and medium-sized enterprises (MSMEs) are likely to benefit the most, especially in developing countries. These enterprises tend to generate many new jobs (ILO, 2017), but can find it difficult to access finance to start, maintain and scale activities up, as regularly shown by enterprise surveys and business environment assessments in countries in all regions.

2.3. Developmental central banking

In developing countries, central banks may find it difficult to pursue an explicit full employment target - eg a desirable level of the unemployment rate - given the pervasiveness of underemployment and informality and the disconnect between employment numbers and the business cycle. Still, they could put their treasurable technical capacities to use for employment and development goals by means of encouraging financial intermediaries to reach out to small and young firms, start-ups, micro entrepreneurs and household enterprises. Policies for financial inclusion would include providing services for (usually poor) unbanked households, reducing their vulnerability to economic shocks while enlarging the economy’s pool of savings and facilitating transition to formality. Ultimately, greater financial inclusion and more efficient financial intermediation would help strengthen the transmission mechanism – i.e. the capacity of monetary policy to exert a reliable influence on aggregate demand and stabilize the economy– which is generally weak in most low income countries (Montiel, 2015).

Box 1. Monetary policy and financial inclusion in Bangladesh

Bangladesh has a history of financial inclusion efforts, starting with rural microcredit in the 1970s, and is one of a few developing countries where the central bank has an explicit development objective. Since 2006, the Bangladesh Bank chairs the Microfinance Regulatory Authority, which oversees the microfinance institutions and promotes social inclusion of the poor. The Bank has launched a range of measures to support financial inclusion:

- Access to finance for agriculture, using interest rate subsidies to direct commercial bank lending.
- A credit programme for sharecroppers – a particularly disadvantaged group – which was benefiting some 0.5 million persons in 2014.
- 10 Taka (BDT) accounts for farmers, wage labourers and other vulnerable groups: this allows them to open accounts with only BDT 10 (US$ 0.12). By 2013, nearly 13 million formerly unbanked persons had such accounts, which are used for savings, payments medium, and to receive Government input subsidies and social safety payments.
- Access to finance for SMEs based on credit lines by directing commercial bank lending to SMEs; this increased loans to SMEs by 14.9 per cent in 2012-2013. The Central Bank prioritizes small businesses and women entrepreneurs.
- Mobile banking: the Central Bank issued guidelines for mobile financial services in 2012 and grants mobile banking licences to extend financial services to unbanked areas.

Financial inclusion is a means to expand output and reduce volatility in the agricultural sector in Bangladesh, while financial deepening promises to strengthen the monetary policy transmission mechanism, strengthening the central bank's ability to pursue price stability. Its policies aim to boost productivity growth and structural transformation; thus far, they have not compromised the Bank's price stability mandate

Source: Muqtada, 2015

Central banks in some developing countries are already actively engaged in efforts to promote financial inclusion, by means of supporting and regulating microfinance institutions, providing financial education to micro-financiers and entrepreneurs or promoting mobile banking and other IT innovative initiatives. ILO research documented some of those experiences to identify good practices, see for instance the case of the Bangladesh Bank in Box 1. In Argentina and Brazil, to mention other cases, central bank financial education programmes target disadvantaged groups, such as the disabled or those in extreme poverty, while in Ecuador, the central bank has made financial inclusion a priority, focusing on the unbanked sector (Arias, 2015).

Monetary authorities can also contribute to job creation and long-term growth by means of channeling credit to targeted sectors. Epstein (2015) notes that this was the historic role of developmental central banks such as in France and Japan in the 19th century. Similar policies can help diversify the economy, encouraging higher-value production in agriculture, manufacturing or modern service activities according to the local circumstances and needs. Interventions can take the form of differentiated interest rates or reserve requirements for loans to the targeted sectors (Galli, 2017). Credit-channeling might be vital for greening the economy and achieving environmentally-friendly growth, in line with the Sustainable Development Goals. Volz (2014) underlines the example of the green credit given by the People's Bank of China, while the Bangladesh Bank encourages commercial banks to take environmental considerations into account in their lending decisions.

Highlights - Pro-employment monetary policy elements

- Set targets for inflation within a range/ adopt a dual mandate for the central bank encompassing price stability and full employment
- Strengthen supervisory and regulatory functions to promote effective and efficient systems of financial intermediation, ensuring an adequate supply of credit for small and young firms and start-ups
- Enhance financial inclusion of poor “unbanked” households and household enterprises
- Using transparent and consistent criteria, facilitate allocation of credit to priority sectors and industries to bolster job creation and structural transformation

3. Fiscal Policy

"Are there circumstances in which changes in aggregate demand can have an appreciable, persistent effect on aggregate supply? Prior to the Great Recession, most economists would probably have answered this question with a qualified "no." […] This conclusion deserves to be reconsidered in light of the failure of the level of economic activity to return to its pre-recession trend in most advanced economies. This post-crisis experience suggests that changes in aggregate demand may have an appreciable, persistent effect on aggregate supply – that is, on potential output"

Janet Yellen, Chair of the Board of Governors of the Federal Reserve System, *Macroeconomic Research after the Crisis*, speech at the 60th Annual Economic Conference sponsored by the Federal Reserve Bank of Boston, October 14, 2016.

The conventional view of fiscal policy focused on debt sustainability by means of predictable fiscal rules for budget deficit and public debt, and priority given to fiscal balance (Taylor, 2000). The emergence of a "new view" making the case for a pro-active fiscal stance is a distinctive feature of the current macroeconomic debate.

This shift has been prompted by the experience with economic policy in the post-crisis. After an initial spate of successful stimulus packages in major countries, there has been a trend towards fiscal consolidation and towards reliance on monetary policy as the only instrument to support recovery. There is now a growing sentiment that this is inadequate in a situation where interest rates have been low for ten years and are expected to remain low by historical standards for many years to go.[5] Technically, the case for the new view was also significantly strengthened by new estimates on the size of fiscal multipliers - ie the increase in GDP following an increase in government spending and/or tax cuts (see Box. 2).

Thus, after decades of neglect, new attention is paid to the mix of counter-cyclical fiscal policy tools –automatic stabilizers and discretionary fiscal measures - that can more effectively respond to economic shocks and sustain jobs and output in the short and long-run. The appropriate mix cannot be determined a priori. It depends on many factors including the nature of the economic shock, the distinctive circumstances of a national economy, the structure of the labour markets and the institutional frameworks and capabilities for policy-making. Countries should think in terms of a fiscal portfolio that should be managed flexibly and that should variously combine – according to national circumstances – measures aimed at promptly supporting incomes and spending even at some fiscal costs; measures to accelerate employment recovery, including projects for direct job creation in socially useful lower productivity activities; and measures to improve productivity and long-term growth and thereby ultimately reduce debt/GDP ratios and regain fiscal sustainability (Freeman, 2016).

[5] The range of those advocating for an active fiscal stance has grown unusually large, encompassing central bankers (Yellen, 2016), international organizations such as the IMF and the OECD (Ostry et al., 2016; OECD, 2016), financial magazines such as the Economist and the Financial Times, and investment bankers (Ubide, 2016). For a crisp review see Furman (2016). For a discussion of long-term trends in interest rates see Williams (2016).

Box 2. Fiscal multipliers revisited

New evidence on the size of fiscal multipliers – that is, the effect on GDP of the increase in government spending - has led to a significant reverse of widely held earlier views among economists on the effect of fiscal policy. The change was sparked by IMF research showing that in the earlier years of the global crisis fiscal multipliers were above 1, i.e. substantially higher than earlier assumed (Blanchard and Leigh, 2013). That meant that increasing (cutting) government spending resulted in more benefit (damage) that earlier thought. Before the revised estimates, IMF fiscal consolidation packages were designed under the assumption of fiscal multipliers of roughly 0.5, thereby underestimating the costs of expenditure cuts for the economy and the adjustment and recovery path. Further research corroborated the IMF revised estimates. Recent empirical estimates using different techniques – from quasi-experiment to different kinds of economic models – place the value of the multiplier for the United States between 1.5 and 2 during a recession (Auerbach and Gorodnichenko, 2015; Leduc, and Wilson, 2015; Furman, 2016) and between 0.9 and 1.7 for advanced economies after the crisis (IMF, 2013).

The composition of the fiscal package also has implication for the size of the impact and its employment effects. Ernst and Sarabia (2015) found that in the G20 countries the construction sector usually has a higher output and employment multiplier effect than other sectors. A meta-analysis of over 100 studies suggested that in general public spending multipliers were found to be close to one and about 0.3 to 0.4 units larger than tax and transfer multipliers, with public investment multipliers even larger by approximately 0.5 units (Gechert, 2015). Especially in developing countries it appears that increases in government investment have a positive impact on GDP growth while increases in government consumption have a much lower and even negative impact, one possible reason why fiscal policy tend to be pro-cyclical in developing countries (Ilzetzki et al., 2011). Other factors affect the size of the multiplier, such as the degree of trade openness of an economy, the exchange rate regime and changes in the monetary policy and interest rates.

In practice, no single multiplier applies at all times. Where the economy is operating at full capacity and there is no unemployment, an expansion in government spending is more likely to have a limited impact, as the additional demand might crowd out private spending. Aside from such "full employment" case – a situation very few countries actually enjoy, where capital and labour are underutilized there is now consensus among most economists that the fiscal multiplier is likely to be positive and greater than one, ie government intervention has a positive effect on output recovery

3.2. Automatic stabilizers

The capacity to respond promptly is an important consideration for a successful counter-cyclical fiscal portfolio. Automatic stabilizers – ie "passive" fiscal policies encompassing the existing systems for tax collection, social security contributions or transfer payments - are especially effective as first responders to a downturn: they provide immediate income support without going through the lengthy process of the adoption of new budget provisions.

The post-crisis experience has prompted a general call to make those systems stronger - where they are weak – and more efficient (Fatas and Mihov, 2012). In advanced economies, they exist most distinctively in the form of unemployment benefits. There have been long-standing controversies over the suitability and effectiveness of unemployment benefits, but recent ILO research has shown how they can be associated with faster job creation and enhanced productivity in the short- and long-term (Ernst, 2015; ILO, 2016d). Their scope, however, remains limited in most countries. Suggestions are being made to make their duration and their generosity more closely linked to variations in the business cycle, for instance having them change in line with indicators such as the unemployment rate in the economy (the Economist, 2016). A similar automaticity – designed in a way to make it budget neutral over the long run - might also be applied for other fiscal measures such as changes in income tax rates or other grants and allowances (Williams, 2016).

In emerging and developing countries, automatic stabilizers hardly exist in the form of unemployment benefits. Large social programmes have had some impact in mitigating the effects of the financial crisis in major emerging economies - such Bolsa familia in Brazil, the National Rural Employment Guarantee Act (NREGA) in India, and the Expanded Public Works Programme (EPWP) in South Africa. Overall, however, automatic stabilizers accounted for only one third of fiscal stabilization in the emerging market and developing economies, against more than two-thirds in the advanced economies (IMF, 2015b, p. 26).

Historically, fiscal policy has been found to have largely pro-cyclical effects in emerging and developing economies, in spite of the fact that output volatility is usually higher, with episodes of accelerated growth followed by deep crises and economic shocks often more severe than those of advanced economies. On the one hand, governments have found it difficult in those countries to maintain fiscal buffers during periods of boom, given vast developmental gaps, institutional weaknesses and the difficult political economy of managing the budget in highly unequal and divided societies. On the other hand, many of them have also found it difficult to expand spending during crises, given their poorly diversified economies, dependence on export of a bunch of commodities, and their poor international credit ratings.

This started to change slowly in the past decade (Frankel et al. 2011). An improved fiscal situation before the crisis and sound public spending choices have been among the factors that helped emerging economies bounce back more quickly than advanced ones. The success of social assistance and work fare programmes mentioned above played a role, as did improved institutions and greater accountability and transparency.

There is still much scope in most emerging and developing economies to further expand social protection and other programmes that have symmetric effects as automatic stabilizers. The poor coverage of social protection systems is one main factor behind the limited impact of automatic stabilizers. Expenditure for social protection can be as low as 3 per cent of the GDP of low income countries, vis-à-vis an average of around 20 per cent in high income countries (Damerau, 2016, p. 6). Greater social protection coverage and the introduction of national social protection floors providing a minimum set of basic income support to the most vulnerable groups could constitute major components of effective and affordable automatic stabilizers even for the lowest-income countries. The floors would ensure that citizens have access to health and basic income security over the lifecycle, including special provisions for children (education) and older persons (pensions). They could strengthen employment outcomes, notably by providing a minimum safety net for entrepreneurs and ensuring that investment in human capital through health and education is not compromised due to personal financial difficulties. Strengthening social protection in developing countries can also stimulate local markets through increased demand for goods and services, with potential multiplier effects for SMEs and employment (Behrendt, 2014).

3.2 Discretionary measures

Discretionary fiscal measures are needed to complement automatic stabilizers in the case of a severe downturn or localized labour market distress. Discretionary measures can be targeted to support employment recovery directly and/or to promote productivity-enhancing investments and structural adjustment. The configuration should be tailored to the circumstances and needs of a country, favouring interventions that contribute to overcome critical bottlenecks to economic and job recovery - whether they relate to weak aggregate demand, lack of credit or infrastructure, inefficient markets, skill mismatches or excessive vulnerability of some groups.

Discretionary changes in tax payments and social benefits

Ad hoc changes in tax payments and social benefits can be used counter-cyclically. Examples include tax cuts and direct transfers to low income households or investment incentives for selected groups of enterprises. Thanks to modern technologies, some of those measures can be implemented rapidly. Extra benefits and tax withholdings can accrue to households and enterprises within a few weeks, making the impact of fiscal measures as rapid as changes in monetary policy, and giving policy-makers greater leverage for fast and flexible responses (Freeman, 2016).

Changes in tax payments and social benefits targeting certain groups of people in the labour market can directly affect their employment and unemployment situation - eg by means of reducing the tax wedge on labour; implementing targeted cuts to employer social security contributions for some groups of workers; or increasing child care subsidies. The focus of those measures is often on the situation of women, youth and - especially in advanced economies - elderly workers. If well-designed, similar measures can lead to improvements in the labour market situation of selected groups while having wider beneficial effects. In the fiscal stimulus package adopted by Japan in 2016, child care subsidies were introduced as a measure to encourage women to participate more in the labour market. This is of special significance in a country where the working age population is diminishing because of ageing, and where enhancing the overall labour force participation rate is expected to have positive effects on the long-run growth rate. This approach, where fiscal expansion is linked to some form of structural reform aimed at enhancing long-run growth prospects, has been termed by some as “structural stimulus” (Posen, 2016).

However, the ultimate effects on output and jobs of income support measures can be unclear and hard to identify ex-ante. Tax cuts, simplified tax regimes or direct incentives to small and young firms are likely to have a positive impact on job creation, and the extra cash to poor households or unemployed individuals is also likely to translate into additional spending straightaway. But individuals and families - as well as entrepreneurs and firms – might prefer to use the extra cash to enhance their savings or reduce debt exposure, especially if there remains uncertainty about future growth prospects. This can mitigate the impact of a counter-cyclical stimulus via income support. Indonesia is a case where a fiscal stimulus package largely comprising tax cuts had limited effects, whereby the component on public investment in infrastructure had a significant employment impact (see Box. 3).

Box 3. Fiscal stimulus in Indonesia

In the wake of the 2008 financial crisis, the Government of Indonesia put in place a fiscal stimulus programme totalling 1.4 per cent of the national GDP, which included a large tax-cut component (75 per cent of the package), measures to prevent employee contract termination and improving product competitiveness; and increased investment in labour-intensive infrastructure. The overall impact was found to be limited, and the benefits of tax cuts mainly accruing to relatively affluent households. However, the infrastructure component, which represented 15% of the total package, demonstrated a significant and positive employment impact. Alarcón et al. (2011) calculated that it boosted GDP by 0.27 percent, generating a total of almost 290,000 jobs, mostly among the low skilled in rural areas. Of those jobs, 29,800 full-time positions were accounted for by the labour-intensive road construction component. Most of the employment was created indirectly in the farming sector via economy-wide spill-overs. As a consequence of the investments infrastructure in rural infrastructure, a boost in consumption was observed that benefitted poor rural farmers mostly.

Source: Alarcón et al., 2011; Hartono, 2010.

Public investments in infrastructure

The standard post-crisis response in advanced and emerging economies has been to spend more on infrastructure, an area which accounts for short-term benefits in terms of higher employment and demand as well as longer-term gains from greater productivity and business access to markets, and where estimates usually show relatively higher overall impact. The call for higher public investment in infrastructure has come from several quarters - from the G20 to the IMF, the World Bank, the European Commission and other regional and international bodies. Several commentators have noted that in the current situation where interest rates are zero or negative, such investment is likely to be self-financing and lead to a reduction in net public debt over the future (De Grauwe, 2015).

Maintaining large multi-year projects, where disbursements could shifted across years according to the business cycle, has also been advocated as an option for fiscal portfolios that account for effective counter-cyclical interventions.

How the money is spent remains of critical importance. Transparent rules for public procurement are a critical condition, to avoid infrastructure that is not needed or damages the environment. Multiplier effects are varied. They can be quite small if the additional public expenditure meets with constraints in domestic productive capacity and is largely absorbed by imports – eg. an international airport built by foreign contractors with foreign materials. The ILO calls for public works programmes and infrastructure investment projects that use employment-intensive technologies and other local resources, as an avenue to maximize job creation while also creating productive infrastructure and sustaining domestic economic activities.

It is in emerging economies and developing countries that the potential for labour-intensive methodologies is the greatest and the impact on poverty alleviation more powerful.

Construction and maintenance of road in rural areas using local production methods, for instance, contributes to creating jobs directly and indirectly, enhancing local purchasing power and improving much needed transport networks to expand the access of local people to markets and essential services. A study of the role of infrastructure in two states in India - Gujarat and West Bengal – finds a great potential for generating employment directly and indirectly especially from investment in buildings, rural roads and canal irrigation construction. Their employment impact has been documented in a number of emerging economies – as in the above-mentioned case of NREGA – as well as in fragile and conflict situations vulnerable situations, particularly in providing direct job opportunities for groups at risk. A set of tools tested methodologies has been developed by the ILO which can be used for special public employment programmes to sustain employment in distressed region or crisis situations in countries at all levels of development – from East Timor, Indonesia and Madagascar to Jordan and Greece (ILO, 2013; ILO, 2016c).

The strive for environmentally-friendly infrastructure presents another ground for employment-intensive public investment programmes, which can contribute to the ambitious goals of the 2030 Sustainable Development Agenda on responsible consumption and production and climate change. Simple estimates based on input-output tables and other methods suggest there is a great potential for decent green jobs in a wide variety of industries including construction, transportation and agriculture.

Active labour market policies (ALMPs)

Public works are a special category of active labour market policies (ALMPs) that can work well to directly create jobs in a situation of lacking aggregate demand. Other, more traditional types of ALMPs also account for a set of tools that governments might introduce or expand at their discretion to help job-seekers find a job and address localized labour market vulnerabilities and malfunctions. ALMPs cover a wide range of measures including training and retraining, job search orientation and assistance, wage subsidies and support to self-employment. Each caters to a distinctive set of constraints in the labour market - either information asymmetries, skills mismatches, vulnerabilities or lack of critical assets.

ALMPs are quite popular in OECD countries where their use has increased in the wake of the crisis, usually oriented toward enhancing training and retraining opportunities and improving job intermediation. Public expenditures for ALMPs range now between 1.5-2.0% of GDP in Sweden and Denmark to 0.1-0.2% in the US and Japan. In emerging and developing economies, ALMPs are much less common and the range of measures is narrower, largely focusing on training and entrepreneurship opportunities for young people.

The response to the crisis favoured measures to expand credit and support for SMEs as well as public works programmes for direct employment generation.

Research about the impact of ALMPs has multiplied and become more sophisticated in recent years through the proliferation of randomized trial studies to evaluate the impact of a programme. The myriad of results from those studies are proving helpful in suggesting ways to improve the design and delivery of distinctive programmes, improving the chances of targeted participants to enhance their position in the labour market and, equally important, introducing a culture of monitoring and fine-tuning of government measures.

But not all ALMPs have been found to work well. Programmes for youth entrepreneurship that combine training with access to credit and markets seem to have some impact. Similarly, skills development has been found to have some effective when it involves the private sector via on-the-job training, apprenticeships or skills councils. The overall evidence, however, points to mixed results. Most programmes have delivered less than expected in both developed and developing countries (see Crépon and Van den Berg, 2016 and McKenzie, 2017 respectively). Moreover, their aggregate impact on employment levels has hardly been assessed, a main obstacle being the difficulty to estimate the displacement effects, ie the possible job losses across non targeted groups as a result of the interventions (Cazes et al., 2009; Kluve, 2016).

In general, traditional ALMPs focusing on employability and the supply side of the labour market are not particularly effective in accelerating employment recovery following a crisis. Displacements effects can be strong, the more so the more job opportunities are rationed. Those policies can be more useful as a way to enhance productive capacities and tackling structural impediments to labour market efficiency and to greater participation of targeted populations, for example spatial mismatches or skills shortages than stand in the way of economic diversification to new businesses. Thus, they can be a useful complement to policies for economic diversification and territorial development.

3.3 Effects on long-run growth, employment and development

The post-crisis rethinking has largely focused on the cyclical components of fiscal policy in the advanced economies, but it has also led indirectly to a better appreciation of the role of fiscal policy in fostering long-run economic growth, employment and development. This is of special importance to developing countries.

A number of channels whereby the fiscal policy stance has long-term effects are commonly emphasized. At the macro level, it is widely accepted that counter-cyclical policies stance do help smooth output shocks, contributing to more stable patterns of consumption and less volatile returns from investment, in turn fostering a strong and stable flow of private investments (IMF, 2015b, chapter 2). At the micro level, it is acknowledged that tax reforms can enhance the incentives for firms to invest and for individuals to participate in the labour market (IMF, 2015a).

Fiscal spending, as discussed above, can also be designed to address gaps in productive capacities and contribute to greater accumulation of physical and human capital. This encompasses not just the longer-term effects of public investments in infrastructure, R&D and innovation but also ensuring broad and equitable access to education, training and health. Countries that have a sufficiently educated and skilled work force, for instance, are better able to develop and absorb technological and organizational advances that are a country's "endogenous" sources of growth.

Finally, it is accepted that fiscal redistribution via the tax system is a main instrument to serve equity objectives and reduce the risks that rising inequality can pose to durable growth.[6]

In an even more radical departure from conventional macroeconomic wisdom, the so-called "hysteresis" hypothesis suggests a close and direct connection between short term fluctuations in output and long-term growth trends. Under this hypothesis, a temporary decline in aggregate demand can lead to appreciable and permanent effects on long-term supply (i.e. potential output) via its impact on higher unemployment and lower productivity, investment and capital accumulation (Fatas and Summers, 2016, Yellen, 2016).

In other words, shortfalls in demand can drive capital investment down, impairing technological progress and productivity growth and setting the economy on a lower growth path. Capital investments, in fact, do tend to move in line with the business cycle. With a slack in demand and unused productive capacity, employers can be less keen on investing in equipment and machinery, R&D and the introduction of new technology. At the opposite, where demand is buoyant the incentive to invest in new equipment that embodies the latest technology is greater. This can be the more so, the more the economy nears full employment.

Hysteresis differs considerably from the conventional thinking where the potential output is determined exclusively by technological advances and other supply side factors regardless of the state of the business cycle. Accepting the hypothesis has implications for the evaluation of the costs and benefits of austerity, making the case for fiscal activism even more compelling. It also brings new light to the debate on productivity and its link with wage growth. Scarce labour and growing wages, in fact, are among the factors that can spur firms to invest more in capital goods and new technology. It could then be argued that a "high pressure" economy (ie full employment with rapid wage growth) could help boost productivity if it induces a faster pace of capital investments. This faster productivity growth might in turn mitigate the potential for higher inflation following the tighter labour markets.[7]

3.4 Fiscal space in developing countries

How much "hysteresis" does occur in developing countries remains unclear, given gaps in the stock of productive capacities and severe constraints to business development, including weak governance and poorly regulated business environments. But a situation of constantly subdued demand, vast underemployment and low incomes is not much of an encouragement to a sustained pattern of increases in investment and productivity.

Of practical interest would be to have a finer understanding of how in those conditions fiscal policies could play a catalytic role to encourage a virtuous circle of sustained public and private investments and better paid jobs. Despite some recent attempts (IMF, 2017), evidence on the modalities and impact of fiscal policy in developing countries remain limited. Of special interest would also be to be able to identify ways to create fiscal space, i.e. to mobilize resources for fiscally sustainable public investments to achieve employment and development goals and the SDGs.

[6] The negative implications of high inequality for economic growth are now well documented, thanks to work by IMF and others, see Ostry et al. 2016.

[7] See Bivens (2017) for evidence on the correlation between wage growth and business investment and its implications for the US economy. Tuckett (2017) shows evidence for the UK where relative wage growth by industry tend to lead relative productivity growth - ie wage levels are not automatically determined by productivity levels, the causality runs in both ways contrary to what it is assumed under the conventional economic theory.

Fiscal space generally refers to the capacity of a government to identify, allocate and manage budgetary resources for discretionary purposes, without undermining the sustainability of its financial position (Heller, 2005, p.3). Often, the term is used in a narrow sense to describe the scope for "sustainable" increases in public debt (Ostry et al. 2010: p.6). This leads to focus on the primary fiscal surplus as the critical requirement to align the level of public debt to the debt limit implied by the country's past record of fiscal adjustment.

From the point of view of meeting wider development objectives, a broader view should be maintained where all potential resources - not just public debt - are taken into account, as exemplified by the notion of the "fiscal diamond" originally introduced by the IMF and World Bank (2006).

A look at the first corner of the "diamond" would suggest the effort to mobilize domestic resources, starting with broadening the tax base, improving tax collection, reducing transfer pricing, and fighting illicit financial flows and capital flight. Fiscal capacity is low in most developing countries. Corporate income tax revenues account for similar shares in advanced and emerging economies - between 2 and 4 per cent of GDP. But in the emerging economies personal income tax revenues and social security contributions are much less significant, accounting respectively for an average of 2 per cent of GDP against 10 per cent in advanced economies in Europe. Those low revenues are likely to reflect tax elusion by the richest as well as widespread informality in the labour market. Progressive taxation and measures to assist firms in their transition to formality, as called for in the SDG target 8.3, could provide an avenue to expand the tax base, providing that the fiscal system can assure fairness, transparency and efficiency. The ILO Recommendation 204 concerning the Transition from the Informal to the Formal Economy sets forth a framework for integrated country programmes that combine legislative changes, business support measures and financial, insurance and social security services.

A second corner concerns the need to improve the effectiveness and efficiency of public expenditure. Budget-neutral shifts towards job-preserving and job-creating programmes that are carefully designed and monitored could encourage job-rich growth (Escudero and Mourelo, 2016). The ILO is setting up a repository of examples of active labour market and public employment programmes that work best for youth and women - and how to measure their impact – which could be helpful to countries aiming at advancing on the SDG5 on gender equality and empowerment as well as achieving SDG target 8.6 to substantially reduce the proportion of youth not in employment, education or training (NEETs).

A third corner refers to additional borrowing as a means to raise public spending (or to lower taxes), in particular in the current context where international borrowing rates are historically low and expected to remain so.

The challenge is that in most developing countries the benefits of a mounting public debt should be carefully weighed against the risk in terms of changing perception of debt sustainability by creditors, especially international financial investors who may remain very doubtful of any increase in public spending or even see it as an opportunity for speculative moves. The evidence about the actual impact of fiscal multipliers on output growth might not have yet been internalized in investors' judgements about fiscal sustainability. Cost-benefit analyses of fiscal discipline should find ways to take longer-run effects effect into account, for instance balancing the debt for future generations with the assets those generations are also inheriting as a result of such debt - roads, schools and hospitals, and institutions. International organizations that assist countries in designing credible medium-term frameworks for debt sustainability should take those aspects into account. There appears a temptation, on the contrary, to favour tight "pre-crisis" rules for macroeconomic convergence in several developing countries and regional groupings in Asia and Africa.

Finally, official assistance might be used to enhance fiscal policies and fiscal reforms, eg. to kick-start the introduction of social protection floors in the lowest income countries or for large infrastructure programmes. International financial assistance in the form of guarantees and frameworks for infrastructure and other development projects could be a way to catalyse the private sector initiative and reduce the risk of financial and productive investment in poor countries. Access to private international borrowing may be essential in order to move up to middle income status but it is also risky, as shown by countries such as Ghana.

Any strategy to create fiscal space to achieve distinctive employment or development goals should be based on careful consideration of the national context and initial conditions, and draw upon unbiased empirical analysis and tripartite consultations. But ILO preliminary research suggests that even in the poorest countries there are several options at hand (Ortiz et al. 2015).

Highlights - Pro-employment fiscal policy elements

- Adopt a counter-cyclical fiscal policy stance that works hand-in-hand with monetary policy to smooth the business cycle and sustain jobs and long-run growth;
- Build up capacities and institutional arrangements to maintain "fiscal portfolios" that comprise a balanced mix of automatic stabilizers in areas such as unemployment insurance and social protection together with discretionary countercyclical measures aligned to country situation and labour market needs
- Mobilize resources to provide fiscally sustainable support to public works programmes, employment-intensive public investment in infrastructure, employment guarantee schemes; training and retraining and other active labour market policies (ALMPs)
- Tax and financial incentives for small and young firms and households

4. Exchange rate policy and capital account management

"For long, the prevailing consensus among economists and international organisations had been that financial globalisation is unconditionally desirable, and a key to development and growth. Recent events – including the global financial and the European sovereign debt crises – shattered that consensus. There is now widespread acceptance that where financial markets are imperfect and regulatory and supervisory policies inadequate, capital inflows can fuel costly boom-and-bust cycles."

Benoît Cœuré, Member of the Executive Board of the ECB, speech at the SUERF/PSE/CEPII Conference on "Rethinking Capital Controls and Capital Flows", Paris, 15 September 2016.

Besides broad institutional factors such as secure property rights and effective governance, a stable and competitive exchange rate is an important element of the enabling environment for the promotion of domestic and foreign private sector investments. Several studies have found evidence that exchange rate volatility discourages investment and is negatively associated with GDP growth (Eichengreen, 2008; Rapetti et al., 2012; UNCTAD, 2016). Tempering fluctuations and keeping the value of the national currency on a stable path is therefore a main concern of authorities wishing to sustain growth and job creation. [8]

The level at which the exchange rate is maintained also has an influence on investment and consumption decisions. Changes in the value of a currency alter the relative price of imported and exported goods. Thus, an undervalued national currency can improve the price-competitiveness of domestic production, encourage exports, reduce imports and restore the balance of payments equilibrium, but also – if sustained beyond the very short-run - support profits, investments and jobs in outward-oriented domestic activities, encouraging a shift in the composition of output from non-tradables to tradables, ultimately contributing to set the economy on a higher-growth path.[9] Managing the currency can have an effect on the efforts of a country to export, diversify and upgrade its economy.

[8] A distinction is usually made between the nominal exchange rate – that is, the market price of the domestic currency in terms of foreign currency – and the real exchange rate (RER) – the nominal exchange rate adjusted for inflation. A distinction is also made between bilateral and multilateral (ie effective) exchange rates; the latter being a weighted index of the currencies of the major trading partners. These distinctions are not discussed in this paper.

[9] See N. H. Barbosa-Filho (2010) for a theoretical model of the links between the exchange rate, inflation and long-run growth and development. A key argument is that even a temporary exchange rate misalignment can have an influence on the production of tradable goods, which displays increasing returns to scale and accounts for higher technical progress and productivity growth relative to non-tradables. By this token, in line with the Kaldor-Verdoorn approach, an incentive to the tradable sectors can open the way to higher productivity for the whole economy and structural change. Conversely, a temporary overvaluation of a currency due to tight inflation targeting can lead to a permanent loss of competitiveness in some sectors.

4.1 Floating versus pegged exchange rates

A large body of empirical research has looked at how much the exchange rate matters for trade and economic performance, inspired by the successful experience of the catching-up developing economies of Asia (Rodrick 2008). Some studies suggest that the strength of the exchange rate as a tool to improve trade balances and encourage economic growth through higher exports might have been weakening in recent years, as a result of the spread of global value chains. Devaluations, in other words, might do less for trade and growth the more firms are integrated within cross-border production network - ie the more exported goods are produced using intermediate imported inputs (Ahmed, Appendino, Ruta, 2015).

Overall, however, the latest empirical evidence confirm that the relation between exchange rate movements and trade remains robust for countries at all levels of development, and it is particularly significant for the lowest income economies.[10] The way different firms and economic sectors react has a bearing on the effects.

Currency movements might have lesser impact on differentiated manufacturing products sectors. Large exporting firms are prominent in such sectors and might be better able to absorb the price shock and maintain market shares by means of reducing profit margins, increasing productivity, and introducing technological and organizational innovations. As it concerns their investment and relocation decisions, what might matter more are the prospects of vast and robust demand.

At the other end of the spectrum, smaller firms in less sophisticated sectors can be much more sensitive to price factors. Looking at firm-level data for EU countries, Berthou and Di Mauro (2015) show large heterogeneity in the response to real exchange rate variations across firms of different size and productivity, with large and more productive firms seemingly less affected and smaller firms being more reactive at the extensive margin. By this token, economies characterized by a large share of small and low productive exporters – such as those in Southern Europe as well as in most of the developing world – can thus benefit more from a depreciation, in terms of the growth of their exports as well as in terms of the growth in the number of newly exporting firms.[11]

In the conventional approach, the real economy effects of the exchange rate were relegated to secondary rank. Higher priority was placed on unqualified monetary stability and market liberalizations. Policy recommendations focused on either of two extreme solutions - the bipolar “corner solution”: either to adopt a free-floating foreign exchange regime, in order to retain an independent monetary policy while allowing the free movement of capital across national borders– a solution favoured in an inflation-targeting framework; or maintain a stable exchange rate through a fixed-peg foreign exchange regime – a solution

[10] Based on data from 50 advanced and emerging market and developing economies, IMF estimates that 10% real effective exchange rate depreciation implies, on average, a 1.5% of GDP increase in real net exports (Leigh et al. 2015). UNCTAD (2016) disentangles the impact of undervaluation on growth by the level of income per capita for a panel of 175 countries and finds that the effects are largest in poor countries.

[11] According to the authors, the greater responsiveness of small and least productive firms suggests that an exchange rate decline might be a powerful tool to help those firms start exporting and succeed in international markets, thereby contributing to economic diversification. As stated in UNCTAD, 2016:“It is hard to find a developing country with a large share of manufactures in its total exports where the real exchange rate has not been undervalued at times” (p. 207).

favoured to promote cross-border trade or as a way to enforce external discipline and control inflation (Fischer, 2001).[12] Neither stance has proved to be satisfactory.

On the one hand, emerging economies such as Argentina, Russia and Turkey that pegged their currencies to the US dollar as a classic strategy to lower inflation, had to dramatically abandon it (Pinto, 2014, chapter 2). In a similar vein, the EU countries in the EU "pegged" to the Euro found their capacity to adjust to external shocks significantly curtailed, as they could only rely on the so-called internal devaluation - i.e. lowering the level of domestic wages in order to reduce unit labour costs and regain competitiveness, with deflationary consequences for the domestic economy and its trading partners (Decressin et al. 2015).

At the other hand, a freely floating currency regime did not dispense economies – particularly emerging and developing ones – from highly volatile and highly pro-cyclical exchange rate behaviour, mainly as a result of sudden and large speculative capital flows moving in and out of a country, with negative implications for investment, employment and growth. As shown by the case of Latin America - and contrary to the predictions of conventional theory - free movements of capital across borders did not work to routinely bring the price of a currency to its long-run full employment equilibrium in line with the real economy fundamentals. Inflows and outflows were mainly influenced by readjustments of large portfolios of financial investments driven by short-term financial or purely speculative considerations (Ffrench-Davis, 2011).

4.2 Towards a balanced exchange rate policy

A pro-employment macroeconomic policy framework would suggest a managed float to maintain a competitive exchange rate, ie a rate that is either at its long-run full employment equilibrium path or undervalued relative to it.[13] A target exchange rate band can be introduced to allow some room for fluctuations around the desired trend rate while signalling what the intentions of currency authorities are - eg by means of announcing explicitly a lower bound target as in the case of the Swiss National Bank (see Box 4).

Active capital account management through measures such as targeted capital controls will be a critical condition for such strategies to work. Nowadays, there is solid consensus among economists with regard to the opportunity to introduce measures to restraint short-term speculative capital flows that have distinctively disruptive economic effects, while safeguarding cross-border financing of productive investments (Blanchard et al., 2013; Epstein, 2015). Some experts suggests a distinction between bond and non-bond capital flows, arguing that while the former should be subject to some form of control, the latter do increase the availability of credit to domestic producers and have a lesser effect on the domestic interest rate and the exchange rate value (Blanchard et al., 2015). Countries are

[12] Economic theory posits an "impossible trinity" between maintaining a stable foreign exchange rate, allowing a free movement of capital across national borders, and conducting an independent monetary policy – that is the three objectives cannot be achieved simultaneously. This idea is grounded in the Fleming-Mundell model, which extends the basic IS–LM macroeconomic model to an open economy situation where the exchange rate plays a role in determining output and employment equilibrium.

[13] The recommendation to pursue a competitive exchange rate was part of the Washing Consensus original list, although its proponent, John Williamson, later recognized that the actual consensus was for letting the currency to freely float (Williamson, 2000). More recently, Frenkel and Rapetti (2015) called for a stable and competitive real exchange rate SCRER that developing countries should target as part of their development strategies. Their definition of SCRER is the rate at which "the modern tradable sector of a developing economy reaches a risk-adjusted profit equal to that of the same sector in a developed economy" (2015, p.82).

indeed experimenting with different such measures, building on the experiences of Canada, Chile, China Malaysia and Sweden among others. (UNCTAD, 2016).

Box 4: The Swiss Franc's Honey moon
The Swiss franc (CHF) has gained a solid reputation as a safe haven currency, taking the place the Deutsche Mark had in the decades before the introduction of the Euro. Thanks to this reputation, large capital inflows flooded to Switzerland from all countries in search for safe investment at the burst of the global financial crisis. As a result, the Swiss franc moved from 1,61 EUR/CHF in January 2007 to 1,25 in January 2011. To protect their industries from such a sharp appreciation (exports account for about 80% of Swiss GDP), the Swiss National Bank set a ceiling of 1,20 Euro to the CHF in September 2011, making it explicit its intention to "enforce it with utmost determination". The Bank maintained its commitment successfully for almost 3 and a half years, at the cost of cumulating a huge amount of reserves in all currencies. When in January 2015 it unexpectedly announced its withdrawal from such commitment, the CHF appreciated overnight by some 40% against the Euro, causing a storm in the country's economy and the stock exchange. Since then, the currency has stabilised around a value of 1,10 to the Euro, about 10% higher than the pegged floor. The impact has been significant on unemployment but less on exports. Industries such as tourism has suffered, but overall the country has a highly sophisticated export baskets with a large share of high-tech manufactured goods. In those sectors companies have managed to keep export market shares by reducing profit margins, extending working hours, relocating or purchasing more abroad, and cutting production costs, mainly through lay-offs or retraining from recruitment.
Sources: Janssen and Studer (2017); Hult (2015).

4.3 Caveats

It is important to recall that the exchange rate is a relative price, not a policy variable under the full control of governments. There are limits to the capacity of a country to set the real value of its currency. Enforcing a totally arbitrary price can fuel black markets with disruptive effects. Yet, by means of buying and selling currencies, regulating cross-border capital flows, and managing domestic interest rates and inflation, governments have some indirect policy instruments that can help influence market sentiments and engineer alignment to a desired value.

Such capacity is asymmetric. Undervaluation is easier to achieve than overvaluation. The stock of foreign reserves sets a limit to the capacity of a country to purchase its own currency and sustain its value. But in the other direction, to sustain a depreciated floor for the exchange rate only requires issuing the home currency necessary to buy the desired amount of foreign currencies or foreign-denominated bonds (Barbosa-Filho, 2010). This can be done indefinitely for the largest economies. The massive programmes of monetary quantitative easing that in the wake of the financial crisis have helped restore growth prospects in the United States and the Eurozone have been equated to a form of indirect currency manipulation, given that part of that money has been flowing abroad in search of higher returns, leading to the undervaluation of the US dollar and the Euro and the grabbing of a greater share of world demand (Rajan, 2014; Sinn, 2017).

Overvaluation, however, can be commonly found in developing economies that rely primarily on their exports of primary commodities, on remittances from outmigrants or large inflows of foreign aid. For those countries, in order to adjust their growth path, get closer to full employment, and boost modern economic sectors, it is particularly important to avoid an overvalued exchange rate.

The policy mix to maintain a desirable exchange rate will have to be country-specific, as there are various caveats and possible trade-offs with other policy objectives.

First, and most important, devaluation is a zero-sum-game. An aggressive and sustained devaluation has visible negative spill-overs on other countries. Unilateral interventions to alter exchange rates shift demand across countries. If adopted systemically they can weaken global aggregate demand by means of raising the cost of self-insurance, prompting countries to react by means of accumulate very large reserves, thereby detract resources from productive investment. To restrain protectionism and currency manipulations across the systemically important economies has probably been the most sought-after outcome of the G20 and other international policy forums over the past decades.

Second, in a regime where there are no restrictions to cross-border capital flows, commercial banks can develop large currency mismatches by borrowing overseas in foreign currencies and lending in local currency to domestic consumers and firms in the non-traded sectors. In this case, to let a currency depreciate entails the risk of a deterioration in the balance sheet position of national banks and firms, if not bankruptcies. The policy implication is the need for greater attention to managing the capital account and monitoring external private borrowing and the extent of currency mismatches.

Finally, devaluations can facilitate the expansion of the tradable sector, enhancing competitiveness and technological innovation and the potential for better-quality jobs. They may appear as a convenient option especially for the smaller developing countries, where the external negative spill-overs for other economies are less significant. But even for those countries the exchange rate is only one measure of competitiveness. Other policies are needed to strengthen the micro foundations of productivity and growth: better infrastructure; education and vocational and on-the-job training, access to finance and a sound business environment. Exchange rates movements can facilitate or hamper the success of those other policies, not replace them. A fuller understanding of the macro-micro linkages - the linkages between macroeconomic choices and the concrete investment and organizational decisions of firms - is central to effective policy-making.

Highlights - Pro-employment exchange rate policy and capital account management elements

- Use a managed float to gear towards a stable real exchange rate and avoid overvaluation.
- Build up foreign exchange reserves as a prudential buffer for self-insurance against market volatility, avoiding excessive accumulation.
- Engage in active capital account management by reducing the impact of disruptive short-term capital flows and thus reduce exposure to international financial volatility and speculation
- Monitor external borrowing and currency mismatches by resident firms and banks.
- Ensure conditions for cross-border long-term financial and productive investments that can stimulate structural transformation and employment creation

5. Coordination challenges and social dialogue

No single macroeconomic measure or reform per se will be sufficient to ensure that the generation of quality jobs stays on a strong and sustainable path. In most cases, a comprehensive and coherent set of policies in complementary areas will be necessary in order to unlock virtuous circles of higher investment and productivity, more and better jobs, and sustained inclusive growth. Coherence and coordination between different ministries, central banks and other line agencies who are in charge of those different sets of policies are key to an effective pro-employment macroeconomic policy stance.

Coherence will be needed first across different areas of macroeconomic policy. The need for coordination to improve the policy space and tap the synergies of different macroeconomic policies working together has been acknowledged by the IMF in its recent call for a "comprehensive, consistent and coordinated" approach to economic policy (Gaspar et al., 2016). The benefits of similar macroeconomic policy packages include the higher credibility of policy interventions vis-à-vis the case in which they are taken in isolation; for instance, the higher chances of success of combined monetary and fiscal stimulus. This is a main departure from the earlier views where macroeconomic policies were to be designed and implemented in silos and their credibility and impact rested mainly in subscribing sternly to predefined simple targets and rules, with limited discretion left.

Coherence and coordination will also be needed between macroeconomic policies and other policies, eg labour market policies and structural reforms to improve the business environment or the functioning of the labour market. Providing business services, incentives or exemptions from bureaucratic requirements is likely to be fruitless in encouraging higher investments if tight monetary policies lift up the costs of credit, with interest rates over 30 per cent for SMEs as it is often the case in many developing countries. Likewise, the effects of product and labour market reforms depend on the overall economic conditions. In downturns, the costs in terms of lost jobs and incomes can be significant, vis-à-vis unspecified benefits at a later stage. Undertaking those reforms should be made in combination with complementary expansionary macroeconomic measures in order to mitigate the disruptive effects and enhance chances to reach their desired ultimate outcomes, a fact now recognized empirically by IMF (2016).

Focus on coherence and coordination at different levels helps shift the attention from rigid policy rules to the need to enhance the institutional framework and administrative capability of governments for macroeconomic management.

In its research, the ILO has started looking at the coordination mechanisms that selected countries have in place for the implementation of comprehensive national employment policies (Islam, 2014). Some have established top coordination committees that bring in a multiplicity of agencies within and outside governments - including ministries dealing with economic and financial issues, ministries of labour and social issues, planning agencies, central banks, social partners and, in some cases, independent experts. Examples are found in countries as diverse as Burkina Faso, China, Republic of Korea and South Africa. Observation suggests that active leadership from the high level executive office is a condition for success, as in China and the Republic of Korea (Box 5). This ensures that employment goals stands out as a priority and that other key actors – notably the ministry of finance and the central bank – remain engaged, an outcome especially relevant to countries where the central bank does not have an explicit employment mandate and where the ministry of labour may lack the resources and capacity to function as a leading coordinating entity of the employment policy.

Box 5. Employment policy coordination in China and South Korea

In China, coordination at the national level is ensured by the Inter-Ministerial Meeting on Employment chaired by the Ministry of Human Resources and Social Security (MOHRSS), but supervised by the State Council. It involves key stakeholders, such as the Ministry of Finance, the People's Bank of China, local government as well as employers', workers' representatives. The Inter-Ministerial Meeting plays a major role in national policy-making, monitoring of the allocated funds and project evaluation.

In South Korea, formulation and coordination of employment policy occur in two bodies. The National Employment Strategy Meeting includes the heads of each ministry as well as representatives from the Central Bank, planning agency and political parties. At times, research institutes and experts also participate. The broad goals are to formulate employment-friendly policies; address the skills mismatch; and improve labour market efficiency. A different body, the Employment Policy Coordination Meeting helps the various ministries and agencies translate the broad strategies into relevant policies and it coordinates their implementation. In addition, a Public-Private Job Creation Consultative Committee is chaired by the MOEL and it includes representatives from the five major employers' organizations. Social dialogue occurs at the Tripartite Commission. The Commission framed the "Grand Social Compromises" to respond to the financial crises of 1998 and 2009. In 2013, it agreed on a "Jobs Pact" to attain a 70 per cent employment target, focusing on job creation, decent part-time and public-sector social service jobs; job-targeting of young people, the elderly and women; and reducing working hours and revising the wage system.

Source: Islam, 2014; Zeng, 2014; Zhang et al., 2015, Kang, 2014

Social partners do contribute to the debates leading to the formulation of employment and labour market policies, and sometimes are part of the institutional framework for coordinating those policies. In Brazil and Germany, for instance, the agencies responsible for the implementation of employment policy are tripartite in composition.

Social dialogue on macroeconomic management, however, should be improved. In countries at all levels of development, social partners have helped design measures to mitigate the effect of economic adjustments or sectoral shifts, and facilitated achieving fast agreement on crisis response (Baccaro and Heeb, 2011). Their involvement has been significant in areas such as the reform of minimum wage systems, a step many countries have undertaken as a measure to support demand in the post-crisis slow recovery. But too often decisions about fiscal adjustment and post-crisis consolidation packages have been taken with little or no consultation with the social partners. Social dialogue has a potential to contribute to better decision–making by means of helping assess the whole range of immediate and long-term consequences of a set of policy measures, enhancing the chances to reach a good balance between the objectives of equity and efficiency, and fostering consensus and ownership of the policy course.

6. Conclusions

The private sector is the engine of job creation but public policy plays a role in setting the rules of the game, in sustaining employment and output over short-run business cycle fluctuations, and in encouraging investment, productivity and long-run economic growth. This paper presents a set of elements that implemented according to national circumstances could make macroeconomic policies more employment-friendly and thereby enhance social cohesion and political stability. Each element is supported by evidence about the way advanced, emerging and developing economies have reacted to the global crisis and earlier regional ones. Each also resonates with the shift in thinking about macroeconomics and macroeconomic policy that is underway.

Prompted by the post-crisis experience, a new understanding is emerging which combines old wisdom with new evidence and innovative ideas. In the debate among academic economists, central banks, international financial institutions and other decision-makers there is a growing convergence toward a view where abating inflation should not be the only goal of monetary policy; where fiscal policies can have appreciable, persistent positive effects on the real economy and at the same time be fiscally responsible; and where unchecked financial markets do not self-stabilize. In other words, policy-makers have greater room for manoeuvring the economy towards job-rich and more inclusive growth than just abide by simple policy rules as it was previously recommended.

A new consensus is not there yet. Conventional narratives are still common in day-to-day macroeconomic management. In spite of many far-reaching proposals, the actual changes in the macroeconomic policy regimes have been modest, especially in smaller economies. The result is growing estrangement and disillusionment in public opinion as people and voters perceive that macroeconomic policies have major implications for their lives, ask for a change, but are not clear about what choices are there and may become more open to simplified populist accounts of how to solve employment and economic problems.

The framework for pro-employment macroeconomic management explored in this paper and set forth in its Annex could provide a template for structured policy dialogue to broaden the range of employment policy options and reach widely shared and better understood decisions. Policy choices should be based on evidence of success and “good fit” to national needs and circumstances, not on “one-size-fits-all” technocratic assumptions. Greater collection of evidence based on a variety of methods including econometric modelling, quasi-experiments, longitudinal country case studies, and “natural” experiments would be necessary in order to inform policy makers and social partners in different country and regional contexts.

Some avenues for debate and research are suggested in the paper. They include:

- The scope for monetary policy to move away from a narrow focus on inflation to broader mandates encompassing price stability as well as employment goals, including new research on the relationships between inflation, wages and unemployment and the implications for monetary management.

- Exploring the potential developmental role of central banks’ supervisory functions in encouraging financial inclusion and an adequate supply of credit for productive investments by sustainable enterprises, especially in developing countries.

- The room for a more active fiscal stance, where countries build their capacities to maintain countercyclical “fiscal portfolios” that comprise a balanced mix of automatic and “shovel ready” discretionary measures aligned to labour market needs and country situation, including research on the aggregate demand effects of social protection systems and minimum wage policies.

- A richer collection of evidence about the short- and long-run employment multipliers of given fiscal measures and fiscal reforms - from investment in infrastructure and education to active labour market policies, training and retraining, public employment programmes and subsidies and incentives of various kind.

- A review of the options to expand fiscal space in developing countries to facilitate attaining employment and development objectives and the SDGs, as opposed to the temptation to return to pre-crisis ways.

Besides policy design, the process of implementation is key. Success rests on coordination across a comprehensive set of measures in complementary areas. Building capacity across all relevant ministries, agencies and institutions and the social partners is also important. Joint international action can amplify the gains.

Finally, social dialogue should be revived to play a stronger role in connecting the dots - that is, helping workers, enterprises and ordinary citizens better understand the broad implications of fundamental policy decisions and participate in their making.

Annex - Multiple dimensions of macroeconomic management and their key elements

Policy area	Conventional frameworks	Pro-employment macroeconomics frameworks
Monetary policy	Target low (single-digit) inflation and communicate commitment clearly to private sector to enhance credibility	Set targets for inflation within a range/ adopt a dual mandate for the central bank encompassing price stability and full employment Strengthen supervisory and regulatory functions to promote effective and efficient systems of financial intermediation, ensuring an adequate supply of credit for small and young firms and start-ups Enhance financial inclusion of poor "unbanked" households and household enterprises Using transparent and consistent criteria, facilitate allocation of credit to priority sectors and industries to bolster job creation and structural transformation
Fiscal policy	Focus on fiscal sustainability Monitor debts and deficits and institute explicit fiscal rules, if required	Adopt a counter-cyclical fiscal policy stance that works hand-in-hand with monetary policy; Build up capacities and institutional arrangements to maintain "fiscal portfolios" that comprise a balanced mix of automatic stabilizers in areas such as unemployment insurance and social protection together with discretionary countercyclical measures aligned to country situation and labour market needs Mobilize resources to provide fiscally sustainable support to public works programmes, employment-intensive public investment in infrastructure, employment guarantee schemes; training and retraining and other active labour market policies (ALMPs) Tax and financial incentives for small and young firms and households Broaden the tax base
Exchange rate policy and capital account management	Use exchange rate as a nominal anchor or allow for market-determined exchange rates – the "corner solution" Adopt an open capital account to attract investors and harness external resources	Use a managed float to gear towards a stable real exchange rate and avoid overvaluation. Build up foreign exchange reserves as a prudential buffer for self-insurance against market volatility, avoiding excessive accumulation. Engage in active capital account management by reducing the impact of disruptive short-term capital flows and thus reduce exposure to international financial volatility and speculation Monitor external borrowing and currency mismatches by resident firms and banks. Ensure conditions for cross-border long-term financial and productive investments that can stimulate structural transformation and employment creation

Note: Column 2 represents conventional macroeconomic frameworks as reflected, for example, in the accounts of typical adjustment programmes by international financial institutions. Column 3 represents suggested elements of employment-oriented macroeconomic frameworks. Based on ILO, 2014, p. 5.

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