ILO Employment Policy Research Symposium

The Future of Full Employment

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I am delighted to be back at the ILO to participate in to what promises to be a very interesting and pertinent conference. During my years as an economist at the UNDP, I was privileged to collaborate very closely with colleagues at the ILO who were not afraid to challenge the then prevailing consensus which sought explicitly to exclude employment and human development from the macroeconomics agenda.

As we gather here, the world is considerably more open to our ideas than before. It is important that we deliver on this challenge to shape a new macroeconomics that is focussed on questions of transformation, equality and inclusion rather than being condemned to the solitary confinement cell of "stability".

I think there are three changes in the theorization of economic policy making that afford scope for this intellectual transition. First, the theory of efficient markets is dead. It has not been buried in the minds of many, and in the textbooks that continue to shape undergraduate thinking on this subject but, in the real world of policymaking, it has effectively been cremated.

Second, the notion that aggregate demand and aggregate supply are exogenous to each other is well and truly buried and its grave diggers has been its erstwhile champions, prominently, Lawrence Summers and Janet Yellen. Let me quote the latter at some length.

QUOTE "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" END OF QUOTE

The third change follows from the first two. Economic theory has long held that it is heretical to intervene in relative prices even if circumstances warrant intervening in individual markets. To give two examples, the interest rate has been used by all central banks as a tool to determine the administered price of wholesale credit to control inflation. But the idea that this administered price would be set with relative prices of other factors of production in mind was considered heresy with all theories including, most recently, output-gap theory, treating the relationship between this administered price and the inflation target as a univariate relationship. Again, the idea that merit goods like health and education were deemed worthy of price intervention through price controls or subsidies was accepted in policymaking: policymakers were willing to break with economic orthodoxy in the public interest. But the idea that higher incomes would make access to these merit goods affordable was nowhere a feature in the calculus of such subsidies.

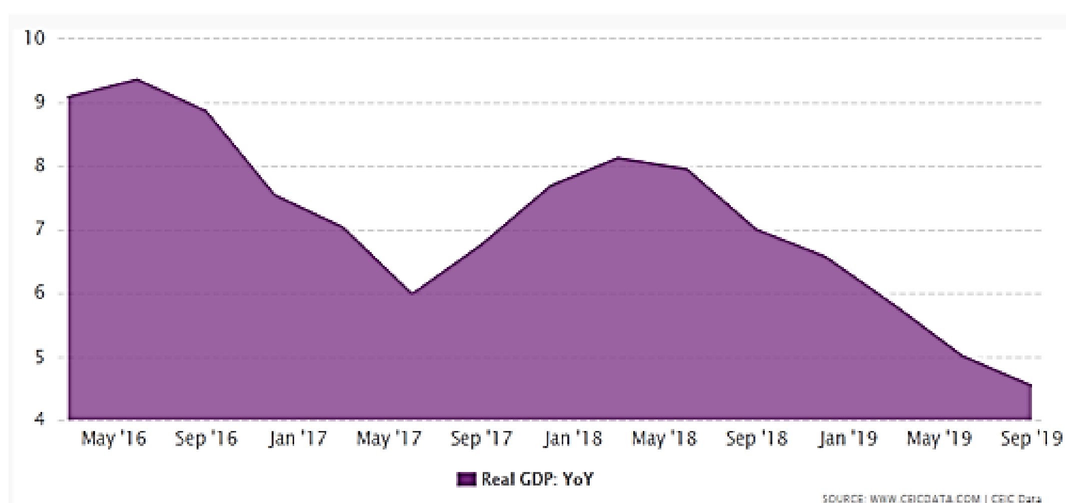
It however follows from the death of the efficient market hypothesis and the endogeneity of aggregate supply and demand that there is a case to intervene if relative prices do not yield desired public policy outcomes. This has, in my view, has not been fully realised in most policy circles and I wish to use my participation in this conference to see if our research and policy work can advocate this case for intervention more explicitly.

There is a fourth change in thinking which impacts emerging economies that are fundamentally developing economies in the sense that, whatever their income levels, they are not in the steady state. When I returned to India to work in policymaking I was struck by the casual use of the word “cycle”, the phrase “countercyclical” and the use of “output-gap dynamics” in macroeconomic discussion. I began to interrogate the discussion by pointing out, that a polynomial in three degrees does not, in and of itself, provide evidence of a business cycle. There is need for economic theory and analytics to justify identifying such a polynomial as a cycle, particularly in economies that are growing and are not at steady state. Fortunately, Gita Gopinath and Joseph Aguiar published a couple of interesting papers that showed that in emerging economies such polynomials could be the result of high frequency shocks to trend: that is, in emerging economies, trend growth rates may be frequently shocked by exogenous or internal phenomena and a time mapping of such shocks to trend might plausibly provide a best fit for successive polynomials in three degrees around a meta trend. This is an important insight because the policy medicine for shocks to trend is most certainly not the same as, or even significantly overlapping, the medicine one would use to address peaks and troughs in the business cycle.

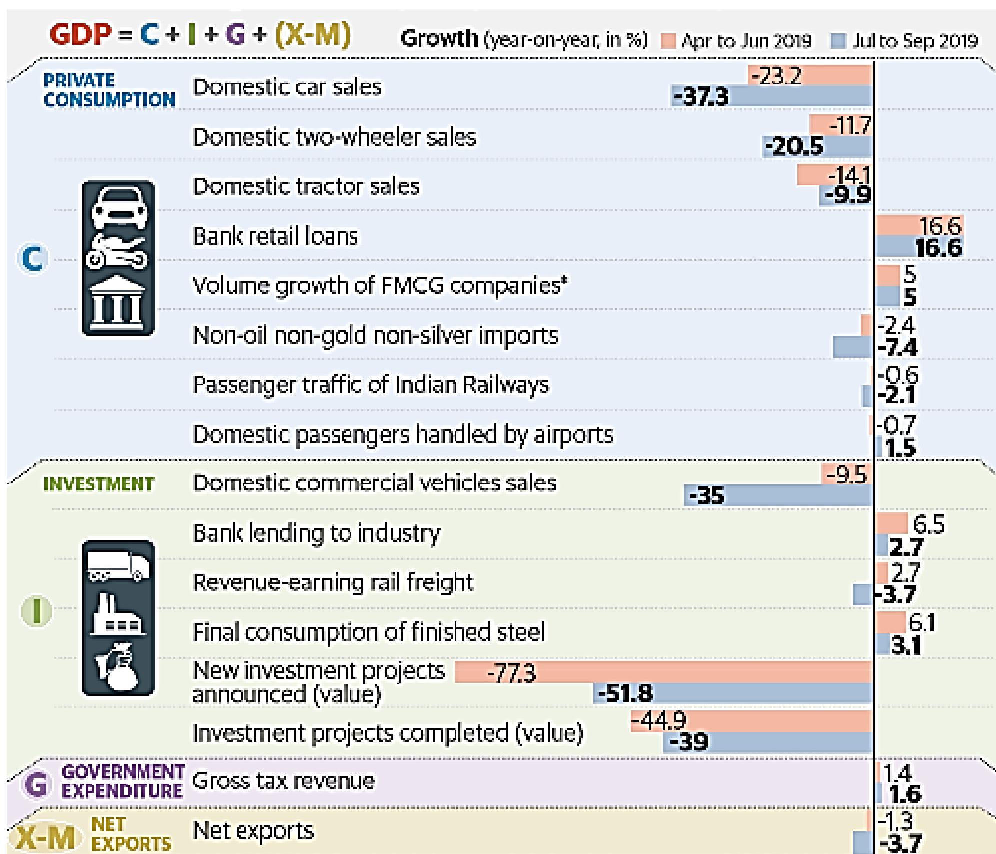
In emerging economies, therefore, the rethinking of macroeconomic policy would require harder work than simply using macro policy instruments in a countercyclical fashion. But if this were to be done, then the traditional toolkit of macroeconomic policy, which sought to secure internal and external account stability and moderate inflation, would need to expand if shocks to trend were the result of, or related to, the endogeneity of aggregate demand and supply. Further, if growth slowdowns were impacted by suboptimal relative prices which manifest as insufficient aggregate demand, or income inequality acting as a binding constraint on growth, then the aims, objectives and instruments of macroeconomic policy would need a fresh look.

This has many implications and I will illustrate these with reference to the recent policy discussion in my own country India.

Real GDP growth, quarterly



From being the fastest growing economy in the world just three years ago, the real growth rate in India has declined precipitously to 4.5 percent in the third quarter of this year. It is clear that this is an across the board slowdown.



Initial attempts to deal with this slowdown as a purely cyclical phenomenon, did not bear fruit, and there is a growing recognition that the root cause of this slowdown is structural.

It has been ascribed by many commentators to various structural shocks in the financial and credit markets, as well as medium term shortcomings in the investment-credit relationships that have governed Indian growth over the medium term. Various measures have been suggested to improve credit off-take, liquidity, and the attractiveness of investment.

Short term measures to ameliorate the slowdown are necessary. The government has done a lot to secure this amelioration using the instruments at its direct disposal. More could be done by deploying monetary and credit policy instruments that would be part of any structuralist or new-Keynesian toolkit, but have fallen into disuse due to the obsession of the now discredited orthodox macro-economic framework with the mono-variate relationship between output, growth and inflation. I will come to a specific example in my conclusion.

There is a lot of merit in these arguments but, in my view, the current slowdown has signalled that the underlying structural weakness of India's growth story needs to be addressed even though it may not be the leading proximate trigger.

The endogeneity of supply and demand can be described very simply as follows: demand is a function of the price at which goods and services are offered. Supply side constraints may result in equilibrium prices being so high that aggregate demand is limited. This happens when these constraints lower productivity, and therefore, prices are too high for aggregate demand to be generated at the scale required to support output growth. With no barriers to trade, such demand could also be met through increased imports, which would not contribute to raising domestic output and growth.

I see this playing out in the plateauing of the India growth story. The India growth story since 1991 has not been about export led growth except at the margin. It has been powered by domestic consumption and derivative investment demand. In essence, the relative prices of the commodities that the top 150 million people consume have fallen since 1991. Relative to the incomes of this segment of the population the prices of goods that are seen as the "leading indicators" of economic growth- cars, fast moving consumer goods, air travel etc.- have fallen continuously, as a consequence of liberalisation, rising incomes and capital gains accruing to this segment, and adequate availability of producer and consumer credit to these sectors. There is evidence that aggregate demand growth from this segment is tapering off.

However, structural barriers continue to limit aggregate demand for the things consumed by the next 300 million. Thus, mass market textile imports from Bangladesh and Vietnam absorb Indian aggregate demand as domestic industry is not able to move out of high wage islands to competitive low wage geographies in northern and eastern India. Despite government being the largest landowner in the country, especially in cities, regulatory and institutional barriers limit the utilization of this land to produce affordable housing at scale. Indians earning the minimum wage are unable to afford quality health and education without subsidies.

Thus, aggregate demand for things that those earning the minimum wage wish to purchase is squeezed by high prices due to supply side constraints. High logistics costs, expensive and unreliable energy supply, poor investment in human capital, and in research and development, ineffective and discretion based regulation and administration, lack of coherent and consistent medium term fiscal and credit policies compound the problem by lowering productivity, increasing costs, and further limiting the scope for increasing the output of these goods and services at scale and quality.

For India to complete its development transformation, a switch to a broad-based and more inclusive composition of domestic demand is of the first importance. This is a medium term task, but execution must commence with simultaneous short term amelioration measures. If this is not done short term fixes will, ultimately, only result in stagflation. India needs to design incomes and industrial policies that secure a more broad based and inclusive growth process, if it is not to fail in its development transformation and fall into some version of the middle income trap that has been the fate of many countries that have been inattentive to this problem.

Thus, India needs a broader macroeconomic policy toolkit and, in my view, incomes policy is an important component of this. The case for incomes policy rests on the fact that the relative prices in India are distorted. Things demanded by the top 15 percent of the population are now available at much lower prices, relative to their incomes, compared to 1991. This is not true of the things that those earning the minimum wage seek to consume unless as in the case for textiles. They are able to import them. Hence, intervention in relative prices is a necessary policy action.

What is the macroeconomic case for a relative price intervention? This case was made by John Maynard Keynes for developed countries and was part of the standard macroeconomic toolbox until forty years ago. It is back in the toolbox as neo-liberal macroeconomics is in discredited tatters after the 2008 crisis. In essence, the macroeconomic role of wages is expressed through linking the wage share to consumption and, transitively, to aggregate demand. The wage share could rise as unemployment falls and/or wage rates rise. This relationship is mediated through an Incomes policy which acts to secure relative prices of labour and capital that are consonant with macroeconomic stability. In developing countries, the problem was often expressed in terms of a wage good constraint limiting home market demand driven, often, by low returns to agriculture employment.

I have argued that in an emerging market economy like India, incomes policy would mediate relative prices through a national floor minimum wage (NFMW). For this reason I welcome the code on wages, 2019, which for the first time stipulates a NFMW.

"In principle" objections to this measure come from neo-liberal economists who are out of date. The balance of contemporary theoretical and empirical research establishes that a NFMW contributes positively to aggregate economic welfare and growth, and that any negative employment effects are offset by the positive impact on human capital formation and the stability and magnitude of aggregate home market demand. I am not preaching to the converted at the ILO but mention this here only to bring to your attention the fact that there is now no serious pushback to this idea when the research case has been presented. The ILO should be congratulated for its part in this endeavour.

However, there is an important hurdle to cross which I hope this conference will contemplate. For about thirty years now, the argument for the minimum wage has been based on microeconomic, distributional, or special interest reasoning. We need to work together to make the macroeconomic case.

Arguments for a minimum wage in the Indian context have been based not on macroeconomic reasoning but on some notion of a safety net and Victorian notions of relative status. The calculation of the proposed NFMW is based on the basic needs that a family would need to meet to feed, clothe, and house itself at a basic level with some additional amount for emergencies. Thus, the proposed NFMW allows for a net intake of 2700 calories per household member which is not significantly higher than the intake used to define the poverty line. At the same time (as I discovered as member 7th Central pay Commission), the Government of India used a 1950s metric called the Aykroyd formula which provides for a more diverse and better quality basket of consumption in line with the supposedly higher STATUS of a government employee. This tends to be 40-50 percent higher than the minimum wage stipulated for everyone else.

This approach is attractive to an old-fashioned socialist or feudal who sees minimum wages through a prism of class struggle/class hierarchy but not very helpful if the minimum wage is seen as the cornerstone of a macroeconomic incomes policy. There is no literature on this subject in India since it is only now, with this government, that we have a NFMW.

In my view, the NFMW should be determined based on macroeconomic considerations, namely (1) whether the NFMW would increase aggregate demand for mass home market consumption. (2) Whether there are supply bottlenecks in responding to such aggregate demand and, if so, calibrate the NFMW to not cause inflationary pressures by driving up demand that would not elicit a domestic supply response- mass market textiles is a good example. (3) The impact of the minimum wage on the factor distribution of income i.e. wage and profit shares should be a key consideration not from the point of view of equity, but from that of macroeconomic stability and growth optimisation. (4) Subnational minimum wages could be set above the floor as desired with other considerations in mind.

Finally, it is important to bear in mind that this approach has macroeconomic trade-offs. A higher NFMW may mean lower profits and therefore lower taxes and lower public expenditures/fiscal stress. The NFMW may be lower than desired by those concerned with household welfare, dignity of labour etc. Political pressures to raise the NFMW may defeat the macroeconomic purpose in economies with weak political buffers. So these complexities will need to be addressed. But they do not detract from the need for an incomes policy, anchored in a NFMW determined by macroeconomic considerations, which is of urgent importance in the face of the structural demand slowdown.

We gather here, in common cause, to reinstate equality, inclusion and employment in the macroeconomic agenda. I have identified important changes in the theorization in the economic policymaking afford scope to bring employment back to the centre of this. In addition, there is a fundamental rethink in emerging economies about the toolkit of policymaking and the need for this toolkit to break out of the narrow confines of business cycle management. I have then cited the example of my own country and the ongoing economic slowdown in India, to illustrate how it is possible to specify a structural problem that takes cognizance of the endogeneity of aggregate supply and demand and makes the case to intervene when relative prices inhibit growth optimisation. I have also argued that there are ways in which an incomes policy spearheaded by the national floor minimum age as a macroeconomic policy instrument can be used to solve for this endogeneity and to secure the desired changes in relative prices. I hope that these thoughts that I have shared will be useful and inform the following deliberations which I keenly look forward to.