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FOR DEBATE AND GUIDANCE

SECOND ITEM ON THE AGENDA

Growth, investment and jobs: The international financial dimension

1. In its March 2005 session, the Working Party requested the preliminary reflections of the Office on the relationship between growth, investment and employment. Interest in the issue is topical for at least three reasons. First, and despite the return to reasonably robust rates of output growth in most developing countries in the past few years, rates of growth on average throughout the 1990s to date – an era of increasing globalization – have been less strong than in previous decades. Second, evidence suggests that the employment content of growth – at any particular level of growth – has declined. Third, global savings and investment are at historically low levels at this stage of the business cycle. These are all serious concerns for future growth trends and the jobs that they should generate.

2. With the present paper, the Office wishes to initiate a longer standing dialogue within the Working Party on the theme of growth, investment and employment. The topic has an extensive literature and is inherently complex. For example, investment is widely regarded as the engine of growth and with good reason. On the other hand, growth itself is an inducement to investment, as the return to investing in growing economies or growing sectors is a magnet for investment capital. Also, expanding demand during an economic upturn can further fuel growth. Employment, both in quantity and quality, is influenced by where that investment flows and where growth takes place. The subject is thus fraught with "dual causalities", or the difficulty in distinguishing which factor causes another and poses complex policy choices and trade-offs relating to growth sectors and those that are particularly labour-absorbing.

3. There is likewise a logical distinction to be made between the purely local factors that determine the investment climate, e.g. the tax regime, product market regulation, the degree to which property rights are protected, the quality of governance and social cohesion and the international context in which investments are made. The former are critical and significant determinants of the investment, growth and jobs linkage, and have been recently explored by the World Bank. The latter theme is more germane to discussions in the Working Party. One question, addressed in the present paper, is why has not the surge in international financial flows resulted in an equally robust surge in productive investment, that is, the investment that creates productive livelihoods? After all, if access to capital had been a constraint on the sorts of investments that lead to growth and jobs, then one would have thought that "freeing" the movement of capital across borders would have improved this.

4. The Office is proposing a series of follow-on discussions on investment and jobs in the global economy in the Working Party. The present paper kicks off the discussions with that facet of globalization that has proven to be most unfavourable to labour markets – the international movement of capital (particularly for speculative or portfolio purposes) and the relationship of this movement to macroeconomic volatility. Two factors dictate this choice: first, while there has been considerable debate and discussion over the impact of trade liberalization on labour markets, there is an emerging consensus in the academic literature that the movement of capital, particularly of a short-term, speculative nature is far more destabilizing on labour markets and thus a constraint on the aspiration for decent work. Second, other actors from the international system have begun to accept that the implications that economic policies have for decent work need to be taken into account, [1] and are now looking towards the ILO for inputs. For example, the G24 has expressed its interest in working with the ILO on the topic of financial openness and employment. It is thus essential that the Office develop views and policy advice on this issue in exchange with constituents, backed by firm evidence to support the argument.

5. The Office proposes to address the relationship of growth, investment and jobs in three ways.

- First, it is proposed that the Office prepare a paper – a reflection – on this topic as it relates to the main features of economic globalization. While the present paper deals with the financial dimension of global investment trends, subsequent papers could deal respectively with trade, investment and jobs, more long-term productive investments from abroad, i.e. foreign direct investment, growth and jobs, and finally technology, investment, growth and jobs. All of these themes are of signal relevance to the social dimension of globalization – and all are complex: for example, innovation underlies technological change and innovation is the consequence of investment as well as the source of investment.

- Second, in this process, the Office proposes to harness the expertise of its constituents – those who are in the best position to articulate the economic and social consequences of different growth and investment paths. As one example, a tripartite workshop on the relationship of growth, investment and employment is being arranged for later this year for the southern African subregion. The Office proposes that such constituent dialogues on this theme be arranged throughout the ILO’s global constituency.

- Third, in recognition of the fact that the matter of growth, investment and employment cuts across a variety of policy domains, the theme is key to forging greater policy coherence. The Office is also responding through the organization of a policy coherence initiative meeting on growth, investment and employment, involving the respective views of the Bretton Woods institutions and agencies of the multilateral system and scheduled for 21 November 2005.

Financial openness and jobs

6. In what follows, the present paper discusses aspects of the international financial system that are relevant for growth and employment in developing countries and highlights the effects of volatility and crises (that are primarily associated with portfolio flows) [2] on

[1] United Nations: *2005 World Summit Outcome*, A/60/L.1 (New York: United Nations), para. 47.

[2] See GB.285/WP/SGD/2 and GB.291/ESP/2. The effects of FDI are also discussed in a recent paper by A.K. Ghose: *Capital flows and investment in developing countries*, Employment Strategy

labour and enterprises. It is motivated by the concern expressed by the World Commission that "[g]ains in the spheres of trade and FDI run the risk of being set back by financial instability and crisis" [3] and draws the conclusion that volatility in international financial markets is currently perhaps one of the most harmful factors for enterprises and labour in developing countries. Building on the recommendations made by the World Commission and the previous discussions in this Working Party, the paper suggests how greater policy coherency between international and national economic and employment policies can give greater attention to employment and incomes.

7. In discussing the rules, conditions and behaviour in the international financial markets, different authors use different terms to describe the recent developments. In this paper, the following terms are employed: financial openness [4] is used as an umbrella term that includes both financial integration and financial liberalization. Financial liberalization in turn incorporates capital account liberalization, but also other elements such as less or different supervision and regulation of the banking sector. The difference between financial integration and financial liberalization is that the former describes a situation in which a country is more integrated in the world financial markets (i.e. through higher FDI/GDP ratio), while financial liberalization means changes in laws and regulations, which may (or may not) lead to greater financial integration. [5]

8. The remainder of the paper first maps some broad trends of financial openness and highlights three problematic aspects of the international financial system (section I). It then addresses the effects of financial openness on enterprises and labour in greater detail (section II) by investigating the direct effects of financial openness on growth (section II.a.) and the indirect effects on growth that are moderated through higher reserve holdings in developing countries (section II.b.). The impact of volatility and crises on developing countries in general (section II.c.) and on enterprises and labour in particular (section II.d.) receive special attention, as do the distributional consequences of financial crises (section II.e.). In the light of this discussion, the paper indicates how far financial openness should be an area of concern for the ILO (section II.f.). Some policy responses that could make the international financial system more conducive to the goal of productive employment and decent work are outlined in section III by drawing on previous discussions of this Working Party and the report of the World Commission. Policies in industrialized countries (section III.a.), new rules for the international system (section III.b.) and policies in developing countries (section III.c.) are in turn addressed before the paper attends to the role of institutions in designing and implementing coherent policies (section III.d.). The paper closes by pointing at future directions for the Office's activities that this Working Party might wish to discuss (section III.e.).

Paper 2004/11 (Geneva, ILO, 2004). Ghose concludes that the "available empirical evidence in fact suggests that capital account liberalization is neither necessary nor sufficient for including FDI inflows." (ibid., pp. 23 ff).

[3] World Commission on the Social Dimension of Globalization: *A fair globalization: Creating opportunities for all* (Geneva, ILO, 2004), para. 400.

[4] Prasad et al. use another term, namely financial globalization; i.e. close what others and this paper call financial openness. See E. Prasad et al.: *Financial globalization, growth and volatility in developing countries*. NBER Working Paper No. 10942 (Cambridge, MA, National Bureau of Economic Research, 2004).

[5] It should be noted that some countries have become more financially integrated, without or with little financial liberalization (e.g. China), while other countries have financially liberalized but have not become more financially integrated – either because of geopolitical circumstances, or because they have been ignored by the international financial markets (various African countries would fall into this category). See the discussion in para. 16.

I. Some characteristics of current capital flows and financial openness

9. The current wave of globalization is characterized by a more liberal policy stance at the international and national levels. While policy for trade liberalization dominated the international agenda since the 1960s, policies for financial liberalization have been of a much more recent vintage. They have been applied in the wake of stabilization and adjustment policies which characterized the 1980s and early 1990s. The major result expected from financial liberalization was that it would allow (developing) countries to utilize resources better and to increase capital formation, through stimulating foreign direct investment (FDI) and other international capital flows such as private portfolios investment. A more open national financial system was seen as a necessary complement to the lifting of impediments to international capital flows. Over the last decade, many countries have liberalized their capital accounts and almost all policy measures related to foreign direct investment favoured a more open regime (see graph 1 in the appendix).

10. As a consequence, international capital flows accelerated, especially in the mid-1990s. Worldwide gross private capital flows – the sum of the absolute values of foreign direct, portfolio and other investment inflows and outflows – have been equal to more than 20 per cent of world GDP for the past seven years, compared to less than 10 per cent of world GDP before 1990 (see appendix, table 1). Worldwide FDI flows, a subcategory of private capital flows, also rose substantially during the 1990s and equalled 4.9 per cent of world GDP in 2000. They have since declined, but they are still well above the level of the 1980s or 1970s. Yet, despite this substantial increase in capital flows, a number of worrying trends remain:

- *During the surge in foreign capital flows since the 1990s, actual investments into new infrastructure and productive capacity stagnated.* Gross fixed capital formation (the most commonly used measure for physical investments) equalled 22 per cent in 2000 (the year when international capital flows peaked), only marginally above the level of the early 1990s (see appendix, table 2). This divergence in trends can in part be attributed to the fact that much FDI (a subcategory of private capital flows) was spent on mergers and acquisitions, and did not go into new factories and machinery. [6] This also explains why, despite the perception of an investment boom during the 1990s, gross fixed capital formation was on average actually lower since 1990 than in the 1980s or the 1970s. [7] It is thus not surprising that world GDP growth, too, was slower than in previous decades (see appendix, graph 2).

- *Foreign capital flows are still largely a phenomenon of developed countries.* In 2002 (the latest year where data are available for all regions), gross private capital flows equalled 23.2 per cent of GDP in high-income countries, but only 12.3 per cent of GDP in middle-income countries and 4.6 per cent of GDP in low-income countries (see appendix, table 1). While there was a positive balance between in- and outflows for developing countries as a group, over 90 per cent of net inflows went to middle-income countries since the early 1990s (see appendix, table 3). Low-income countries

[6] UNCTAD data show that the FDI boom was in part driven by mergers and acquisitions (M&A): from 1998 to 2001, total cross-border M&A sales were equal to more than 70 per cent of total FDI outward flows, up from less than 50 per cent between 1992 and 1994. See UNCTAD: *World Investment Report 2004* (Geneva and New York, 2004), annex, table B.7.; and UNCTAD: *Handbook of Statistics 2004* CD-ROM (Geneva and New York, 2004).

[7] The respective figures are 21.7 per cent of GDP (1990s), 22.5 per cent of GDP (1980s) and 23.8 per cent of GDP (1970s). See World Bank: *World Development Indicators 2005* CD-ROM (Washington, DC, 2005).

therefore still draw, to a large extent, their foreign resources from official development assistance which, despite lofty statements at various international forums, has not increased during the last 15 years. [8]

- *International capital movements have led to greater volatility, a trend that has been well documented.* [9] Most research points to the direction that volatility in turn has led to more frequent financial and economic crises in developing countries (while this is not necessarily the case for industrialized countries). [10] Such crises have negative effects on growth, investment and incomes not only in the short term, but also in the long run. [11] Hence, volatility and financial crises that are caused by financial integration should be seen as a serious problem for enterprises and labour – contrary to earlier views that, with proper national institutions and so-called safety-net programmes, countries would be able to withstand the medium- and long-term negative aspects of volatility and crises.

11. In the light of these concerns, the purpose of this paper is to review the effects of financial liberalization and especially greater volatility on enterprises, employment and incomes and provide some suggestions for greater policy coherence between international and national economic and employment policies.

II. Financial openness, enterprises and labour

12. How does financial openness affect enterprises and labour? In this section, several lines of argument are followed.

(i) First, the section briefly reviews the effects of liberalization on growth. Here, two arguments are advanced: in addition to the potential direct positive effect of capital flows on growth (as countries gain additional resources that can be invested), there can also be an indirect negative effect on growth. In particular, financial liberalization forces countries to hold a larger amount of foreign reserves which reduces incomes and growth potential. If financial flows have on balance a positive impact on growth, this is generally not only beneficial for enterprises, but also for labour. On the other

[8] Official development assistance and official aid (ODA/OA) to all low- and middle-income countries actually declined through most of the 1990s, falling from 65.5 billion current US$ in 1991 to a low of US$52.3 billion in 1997. The recovery thereafter brought it back to US$65.3 billion in 2002 and to US$76.2 billion in 2003. Despite this nominal increase, ODA/OA was about equal to its 1991 level in real terms in 2003. See World Bank: *World Development Indicators 2005* on CD-ROM, op. cit.

[9] I. Diwan: *Debt as sweat: Labor, financial crisis, and the globalization of capital*. Draft as of July 2001 (Washington, DC, World Bank, 2001, mimeo); E. Prasad et al.: *Effects of financial globalization on developing countries: Some empirical evidence* (Washington, DC, International Monetary Fund, 2003, mimeo); E. Prasad et al.: *Financial globalization, growth and volatility*, op. cit.; and V. Cerra and S.C. Saxena: *Growth dynamics: The myth of economic recovery*, IMF Working Paper 05/147 (Washington, DC, International Monetary Fund, 2005).

[10] A. Singh: "Capital account liberalization, free long-term capital flows, financial crisis and development", in *Eastern Economic Journal*, 2003, Vol. 29, No. 2, pp. 191-216; W. Easterly, R. Islam, and J. Stiglitz: "Shaken and stirred: Volatility and macroeconomic paradigms for rich and poor countries", in World Bank: *Annual Bank Conference on Development Economics 2000* (Washington, DC, 2001), pp. 191-212.

[11] I. Diwan: *Labor shares and financial crises* (Washington, DC, World Bank, mimeo, 1999); Diwan: *Debt as sweat*, op. cit.; Cerra and Saxena: *Growth dynamics*, op. cit.

hand, slow growth is usually disadvantageous for labour. However, even in the case of fast or steady growth, the distributional impact on different categories of labour needs to be taken into account. Labour might be benefiting less than appropriate and necessary for long-term institutional and human capital development.

(ii) Secondly, the section looks into the effects of international financial flows on volatility and their role in provoking financial crises. If financial crises become more frequent, their negative consequences for growth (both in the short and long run) could cancel out any benefits from financial liberalization, or even lead to a net negative effect of financial openness on growth. Moreover, financial crises can have impacts on labour (and enterprises) that go over and above their general economic impact. It is thus reviewed how firms have been affected by crises and discuss their direct impact on employment. This is followed by a discussion of wage shares and how they have evolved during crises.

II.a. Direct effects of financial openness on growth

13. Contrary to expectations, the growth impact of financial liberalization has been largely disappointing. A recent study [12] by researchers associated with the IMF has confirmed the main findings of earlier studies such as those undertaken in UNCTAD, [13] it is difficult to establish a robust casual relationship between financial integration and growth. In general, growth is more dependent on the quality of domestic institutions and careful macroeconomic management. Another recent IMF paper argues in the same direction and demonstrates that the conflicting evidence produced by previous research crucially depended on the country coverage, the choice of time period and the indicator for capital account openness. [14]

14. However, capital account liberalization can still be beneficial to middle-income countries under certain conditions, [15] while low-income countries with a poor regulatory framework and weak institutions have little to gain: good institutions and an adequate policy framework are generally a precondition for reaping benefits from capital account liberalization. It has been argued that “[b]y itself, capital account liberalisation will deliver relatively little”, while leaving poor countries more vulnerable to crises. [16]

15. The argument that the impact of financial flows is highly conditional also holds for FDI. The effects of FDI on the host country depend very much on country-specific circumstances and in particular whether they meet demand for investment finance (e.g. to build up an export-oriented manufacturing industry). However, FDI does not always add to the productive capacity of the recipient country, but can also crowd out domestic

[12] Prasad et al.: *Financial globalization, growth and volatility*, op. cit.

[13] UNCTAD: *Trade and Development Report 2001* (Geneva and New York, 2001).

[14] H.J. Edison et al.: “Capital account liberalization and economic performance: Survey and synthesis”, in *IMF Staff Papers*, 2004, Vol. 51, No. 2, pp. 220-256.

[15] ibid.

[16] Ch.L. Gilbert et al.: “Capital account convertibility, poor developing countries, and international financial architecture”, in *Development Policy Review*, Oxford, 2001, Vol. 19, No. 1, pp. 121-141.

investment. [17] The overall effects of FDI on employment are mixed, as a recent ILO Governing Body paper argues:

> When viewed together, the findings from empirical research show that employment effects of FDI inflows to developing countries are rather weak and are not unambiguously positive or negative. Such inflows at best make a weak contribution to increasing the rate of investment in recipient countries. At the same time, a rising share of FDI in total investment tends to reduce the overall employment elasticity while shifting the pattern of labour demand in favour of high-skilled labour. Rising wage inequality is also a consequence. On the positive side, a rising share of FDI in total investment leads to an improvement in the average quality of employment for both high-skilled and low-skilled labour. [18]

16. An important point in the debate on financial openness is the distinction already made above: that between financial liberalization and financial integration. Financial liberalization includes "de jure" measures such as the relaxation or abolishment of rules and regulations concerning foreign capital, as it is often required as part of the conditionality for financial support by the international financial institutions. Many countries in Latin America fall under this category. Financial integration relates to increases in a "de facto" financial openness indicator, irrespective of whether rules have changed or not. [19] In this situation, however, the causal relationship is more difficult to establish. Did financial integration lead to higher growth or did higher growth induce financial integration? It has been argued that especially in India and China, growth induced greater financial integration – and not the other way around. [20] Policy discussions should therefore emphasize firstly appropriate growth strategies and, in the light of these, consider all the variants of liberalization.

II.b. Indirect growth effects through increased reserve holdings

17. As a consequence of financial liberalization and their integration into the global financial system, all developing countries have to cope with the system's instability. In response, they have been rapidly building up foreign reserves. [21] For some countries these reserves were created by surplus on the current account; others built up reserves through capital inflows which were not spent on foreign goods. Since foreign reserves are mainly held in low-yield treasury bonds issued by industrialized countries, the returns are significantly lower than those that could be realized by investing the resources into physical or human capital. The opportunity cost of increased reserve holdings is thus large. It has been argued that for most countries the gains of trade liberalization in terms of higher GDP growth

[17] Ghose: *Capital flows and investment*, op. cit.

[18] GB.291/ESP/2, para. 35.

[19] India and China, but also other Asian countries fall into this category. For a related argument see E. Prasad et al.: *Financial globalization, growth and volatility*, op. cit.; and S. Collins: Comments on *Financial globalization, growth and volatility in developing countries* by Eswar Prasad, Kenneth Rogoff, Shang-Jin Wei and M. Ayhan Kose (Cambridge, MA, National Bureau of Economic Research, 2005, mimeo).

[20] D. Rodrik: *Growth strategies*. NBER Working Paper No. 10050 (Cambridge, MA, National Bureau of Economic Research, 2003); and Singh: *Capital account liberalization*, op. cit.

[21] D. Baker and K. Walentin: *Money for nothing: The increasing cost of foreign reserve holdings to developing nations* (Washington, DC, Center for Economic and Policy Research, 2001); and J. Stiglitz: "Capital market liberalization, economic growth, and instability", in *World Development*, 2000, Oxford, Vol. 28, No. 6, pp. 1075-1086.

were actually "eaten up" in the 1990s by the earnings foregone on holding higher reserves. [22]

18. Why would countries build up reserves? Part of the explanation was that, especially Asian countries after the East Asian financial crisis, built up reserves quickly to avoid requesting support from international financial institutions in case of a future crisis. What is striking, however, is that the trend of the 1990s of building up reserves by developing countries has accelerated in the first years of the current century to a somewhat alarming level (see appendix, table 4). Reserves for all low- and middle-income countries were equal to 21.5 per cent of their gross national income in 2004, compared to 7 per cent in the first half of the 1990s – more than a threefold increase. The substantial increase took place both in low- and in middle-income developing countries and across regions.

II.c. Financial openness, volatility and crises

19. An important consequence of financial liberalization is higher consumption volatility and increased GDP volatility in developing countries. [23] This is especially the case when capital flows are predominantly in the form of bank borrowing or portfolio investment and less so in the case of long-term FDI. [24] This observation is consistent with the argument that the absence of sound financial regulation, both at the national and international levels, makes developing countries much more vulnerable to negative impacts of capital flows. [25] When institutions with the ability to manage greater volatility are absent or not fully effective, the generally procyclical nature of international capital flows (the "when it rains it pours" syndrome) adds to the effects of fiscal policies and to a certain extent also macroeconomic polices, that tend to be procyclical in most developing countries. Such procyclical behaviour deepens and prolongs downturns.

20. Developing countries have also become more vulnerable to currency and banking crises after financial liberalization. [26] Countries from East Asia and Latin America have suffered from such crises during the 1990s and thereafter, with the Argentinean crisis of 2000-01 being a particularly stark example. Other countries, such as the Russia Federation and Turkey, have also been severely affected. [27] When crises break out, they often cannot primarily be explained by any deterioration in a country's so-called "fundamentals". Rather, they can occur as a result of volatility in international capital markets that leads to changes in risk perceptions and risk averseness of investors and creditors. As the research

[22] Baker and Walentin: *Money for nothing*, op. cit.

[23] Prasad et al.: *Financial globalization, growth and volatility*, op. cit.

[24] ibid., pp. 21 ff.

[25] G.L. Kaminsky et al.: *When it rains, it pours: Procyclical capital flows and macro-economic policies*. NBER Working Paper No. 10780 (Cambridge, MA, National Bureau of Economic Research, 2004).

[26] Ch.W. Weller: "Financial crises after financial liberalisation: Exceptional circumstances or structural weakness?", in *Journal of Development Studies*, London, 2001, Vol. 38, No. 1, pp. 98-127.

[27] For a comprehensive overview see G. Caprio and D. Klingebiel: *Episodes of systemic and borderline financial crises* (Washington, DC, World Bank, 2003).

on contagion has investigated in great detail, a crisis can therefore spread from one country to another even when there are few economic linkages between them. [28]

21. Financial crises typically have a large impact on the real economy. In the five countries most affected by the East Asian crisis of 1997-98, GDP per capita fell between 2.8 per cent (Philippines) and 14.8 per cent (Indonesia). In Latin America, the Mexican crisis of 1994-95 led to a decline in incomes by 7.8 per cent and the Argentinean financial crisis of 2001-02 reduced the country's per capita incomes by 16.3 per cent. [29] A recent study documents that so-called "sudden stop" crises (a reversal in capital flows and a simultaneous currency crisis) on average cause a cumulative output loss of 13 to 15 per cent of GDP over a three-year period. [30]

22. Moreover, even a subsequent recovery is usually insufficient to bring a country back on its old growth path. A recent IMF paper indicates that recessions are typically not followed by high-growth recovery phases, either immediately following the trough, over several years of the subsequent expansion, or even over the complete subsequent expansion that follows a complete recession. Indeed, for most countries, growth is significantly lower in the recovery phase than in an average expansion year. Thus, when output drops, it tends to remain well below its previous trend level. [31]

23. Frequent crises and instabilities can therefore prevent a smooth convergence process that would allow poorer countries to catch up with the richer countries. The above cited paper concludes that "[w]hen shocks derail growth, incomes [between countries] diverge. Poor countries have respectable expansion and therefore do not appear to be stuck in a poverty trap. However, many poor countries do appear to be mired in a crisis trap. Countries that experience many negative shocks to output tend to get left behind and their long-term growth suffers." [32] Argentina and Turkey, which were hit by several financial crises in sequence, are prominent examples for this category.

II.d. The impact of financial crises on enterprises and employment

24. The impact of financial crises can be clearly observed at the level of individual firms. A large survey of firms in five East Asian countries shows that output and capacity utilization fell sharply during the 1997-98 crisis. Firms list the drop in domestic demand, rising costs

[28] G.L. Kaminsky and C.M. Reinhart: "On crises, contagion, and confusion", in *Journal of International Economics*, Amsterdam, 2000, Vol. 51, pp. 145-168.; C. van Rijckeghem and B. Weder: "Sources of contagion: Is it finance or trade?", in *Journal of International Economics*, 2001, Vol. 54, pp. 293-308; F. Caramazza et al.: "International financial contagion in currency crises", in *Journal of International Money and Finance*, 2004, Vol. 23, pp. 51-70; I. Goldstein and A. Pauzner: "Contagion of self-fulfilling financial crises due to diversification of investment portfolios", in *Journal of Economic Theory*, New York, 2004, Vol. 119, No. 1, pp. 151-183.

[29] World Bank: *World Development Indicators 2005* CD-ROM, op. cit.; based on series "GDP per capita (constant 2000 US$)"; see also appendix, graph 3.

[30] M.M. Hutchison and I. Noy: "Sudden stops and the Mexican wave: Currency crises, capital flow reversals and output loss in emerging markets", in *Journal of Development Economics*, Amsterdam, 2005, forthcoming.

[31] Cerra and Saxena: *Growth dynamics*, op. cit.

[32] ibid., p. 24.

for imported inputs and the high interest rates as the most important reasons.[33] The declining capacity utilization had adverse impacts on the average profitability and liquidity of firms and many companies abandoned or scaled down planned investments.[34] Interest rate and currency shocks also forced many companies into bankruptcy. In Korea alone, 13 large conglomerates became insolvent during 1997. Delays in payments by the large corporations dragged many small and medium enterprises (SMEs) into the crisis; 8,200 of them failed in 1997 and a further 10,500 in 1998. Companies in Thailand, Indonesia and Malaysia also found themselves unable to service their debt, much of which was in foreign currency.[35] Exposure to foreign denominated debt also significantly deteriorated the balance sheet position of companies in Mexico after the peso devaluated sharply during the so-called "Tequila Crisis" and led to a sharp fall in investments.[36] By contrast, the evidence concerning the impact on firms of the 1998-99 crisis in Chile is mixed.[37]

25. In response to the economic difficulties and declining capacity utilization during a crisis, many companies dismiss workers. Data from five countries worst affected by the East Asian crisis (Indonesia, Republic of Korea, Malaysia, the Philippines, Thailand) show that about half of the surveyed firms reduced their workforce in 1998, while only a small fraction hired more staff.[38] Dismissals inevitably mean that firm-specific human capital is lost, although there are some indications that firms tried to limit this effect by primarily dismissing workers with short tenures.[39] Nonetheless, the loss of human capital is another factor that will adversely affect the future growth potential of enterprises. In combination with widespread bankruptcies and a restraint on investments, the impact of financial crises on enterprises is a likely explanation for why post-crisis recovery is often weak.

26. Financial crises are not only associated with economic decline, but also have severe social costs. These can most prominently be detected in terms of rising open unemployment, falling employment-to-population ratios, falling real wages, or a combination of the above.[40] The job losses are often substantial. During the East Asian crisis of 1997-98, about 2.1 million non-agricultural jobs were destroyed in the Republic of Korea, about

[33] D. Dwor-Frécaut et al. (eds.): *Asian corporate recovery. Findings from firm-level surveys in five countries* (Washington, DC, World Bank, 2000), Chapter 1.

[34] ibid., passim.

[35] See M. Kawai et al.: "Financial stabilization and initial restructuring of East Asian corporations: Approaches, results, and lessons", in C. Adams et al. (eds.): *Managing financial and corporate distress: Lessons from Asia* (Washington, DC, Brookings Institution Press, 2000), pp. 77-136.

[36] M. Aguiar: "Investment, devaluation, and foreign currency exposure: The case of Mexico", in *Journal of Development Economics*, Amsterdam, 2005, Vol. 78, pp. 95-113.

[37] J.M. Benavente et al.: "Debt composition and balance sheet effects of exchange rate depreciations: A firm-level analysis for Chile", in *Emerging Markets Review*, 2003, Vol. 4, pp. 397-416.

[38] Dwor-Frécaut et al.: *Asian corporate recovery*, op. cit., pp. 4 ff.

[39] ibid.

[40] See E. Lee: *The Asian financial crisis. The challenge for social policy* (Geneva, International Labour Office, 1998); see also the discussion in R. van der Hoeven and M. Lübker: *Financial openness and employment: The need for coherent international and national policies*. Draft paper prepared for the XXI G24 Technical Group Meeting, 15-16 September 2005 (Geneva, ILO, 2005, mimeo.).

2.5 million in Indonesia and some 1.4 million in Thailand.[41] Real wages declined throughout the crisis-affected countries and by as much as 41 per cent in the case of Indonesia.[42] As Argentina went through two financial crises within ten years, unemployment rose from a moderate 6.7 per cent (1992) to almost 20 per cent (2002).[43]

27. When adequate social safety nets are missing, workers forced out of the formal sector often resort to employment in the informal economy or in subsistence agriculture, where both productivity and earnings are low.[44] The combined effect of the labour market turbulence is an often substantial loss of incomes and many families are pushed back into poverty. For example, in South-East Asia, the number of working poor (using the threshold of US$1 per day) rose from its pre-crisis level of 33.7 million in 1996 to 50.6 million at the height of the financial crisis in 1998 – an increase of almost 17 million.[45]

28. Moreover, the harm is not limited to the short term. Even when GDP per capita has regained pre-crisis level, the consequences of the crisis are normally still evident from the employment indicators. For example, Malaysia and the Philippines regained their pre-crisis per capita GDP in 2000, while unemployment was still above its pre-crisis level two years later (see appendix, graph 3). In the Republic of Korea, unemployment rates approached their pre-crisis level three years after the economic rebound, helped by the Government's substantial employment-generation programme and particularly strong growth.[46] In other countries, such as Brazil and Chile, unemployment rates have only modestly recovered after the financial crises of the late 1990s. For the worst-affected countries – such as Argentina, Turkey and Indonesia – the most recent figures indicate that unemployment was still rising in 2002.[47]

[41] See G. Betcherman and R. Islam: "East Asian labour markets and the economic crisis: An overview", in G. Betcherman and R. Islam (eds.): *East Asian labor markets and the economic crisis* (Washington, DC, and Geneva, World Bank and ILO, 2001); and the more detailed discussions in S.-H. Kang et al.: "Korea: Labor market outcomes and policy responses after the crisis", in Betcherman and Islam (eds.): *East Asian labor markets*, op. cit., pp. 97-139; R. Islam et al.: "The economic crisis: Labor market challenges and policies in Indonesia", in Betcherman and Islam (eds.): *East Asian labor markets*, op. cit., pp. 43-96; and M. Mahmood and G. Aryah: "The labor market and labor policy in a macroeconomic context: Growth, crisis, and competitiveness in Thailand", in Betcherman and Islam (eds.): *East Asian labor markets*, op. cit., pp. 245-292.

[42] Betcherman and Islam: *East Asian labor markets*, op. cit., pp. 14 ff.

[43] ILO: *Key indicators of the labour market*, 3rd ed., online update as of Aug. 2005 (Geneva 2003).

[44] Such a shift is evident for many countries affected by financial crises; see van der Hoeven and Lübker: *Financial openness and employment*, op. cit.

[45] See S. Kapsos: *Estimating growth requirements for reducing working poverty: Can the world halve working poverty by 2015?* Employment Strategy Paper 2004/14 (Geneva, ILO, 2004), pp. 14 ff. For the concept of the "working poor" see N. Majid: "The working poor in developing countries", in *International Labour Review*, 2001, Vol. 140, No. 3, pp. 271-291.

[46] See Kang et al.: *Korea: Labor market outcomes*, op. cit., pp. 109 ff.

[47] ILO: *Key Indicators of the Labour Market*, op. cit.

II.e. *Financial openness, financial crises and labour shares*

29. Contrary to the conventional wisdom that sees the labour share in GDP as constant, recent research has shown that the proportion of GDP that goes into wages and other compensation paid to employees is variable over time. [48] When one differentiates between poorer and richer countries (based on average GDP per capita in 1985), the following broad trend emerges: in the group of poorer countries, labour's share fell on average by 0.1 percentage points per year from 1960 to 1993. The decline in labour's share was more rapid after 1993, when it fell on average by 0.3 percentage points per year. In the group of richer countries, labour's share grew by 0.2 percentage points per year from 1960 to 1993, but fell by 0.4 percentage points per year thereafter. This indicates a trend reversal for the richer countries post-1993 and an acceleration of an already downward trend for the poorer group. [49]

30. While the changes in factor shares are primarily linked to changes in capital/labour ratios, financial crises and indicators of financial openness also play a role. One particularly relevant finding is that exchange rate crises lead to declining labour shares, suggesting that labour pays a disproportionately high price when there are large swings in exchange rates. On the other hand, capital controls are associated with an increase in labour's share, suggesting that imposing such controls is beneficial to labour. Other factors, such as government spending, also matter. Increasing government spending is associated with an increase in labour shares, for both rich and poor countries. Finally, foreign investment inflows are associated with a fall in labour's share. [50] These results point to a systematic negative relationship between various measures of globalization and labour's share.

31. These results are in line with those of other studies. One such study uses the share of wages in GDP as an indicator and reports, based on a large sample of countries, an average drop in the wage share of 5 percentage points per crisis and a modest catch-up thereafter. In the three years after the crisis, average wage shares were still 2.6 percentage points below their pre-crisis average. [51] It has been argued that, "[s]ince many countries undergo more than one crisis, the decline of the wage share during a crisis and the partial recovery following it has led to a secular decline in the wage share". [52] This phenomenon is known as a "ratchet effect".

[48] Diwan: *Debt as sweat*, op. cit.; and A. Harrison: *Has globalization eroded labor's share? Some cross-country evidence* (Cambridge, MA, National Bureau of Economic Research, 2002, mimeo).

[49] Harrison: *Has globalization eroded labor's share?*, op. cit.

[50] ibid.

[51] The cumulative drop in the wage share over the last 30 years is estimated at 4.1 per cent of GDP, and is especially large for Latin America where the figure reached 6.7 per cent of GDP over the period 1970-90. See Diwan: *Debt as sweat*, op. cit., p. 6.

[52] R. van der Hoeven and C. Saget: "Labour market institutions and income inequality: What are the new insights after the Washington Consensus?", in G.A. Cornia (ed.): *Inequality, growth, and poverty in an era of liberalization and globalization*. WIDER Studies in Development Economics (Oxford, Oxford University Press, 2004), pp. 197-220.

II.f. Financial openness, labour and the role of the ILO

32. On balance, the capital account liberalization that many developing countries embarked upon in the 1990s has delivered disappointing results. This disappointment is well summarized in a recent World Bank report that reviews the growth performance of the 1990s:

> Contrary to expectations, financial liberalization did not add much to growth, and it appears to have augmented the number of crises. As expected, deposits and capital inflows rose sharply as a result of liberalization. But, other than in a few East Asian and South Asian countries, capital markets did not provide resources for new firms. Numbers of stock market listings declined, even in the newly created markets in the transition countries that were sometimes used for privatizations. Also, although relevant time-series data on access are weak, and contrary to expectations, it appears that access to financial services did not improve substantially after liberalization. [53]

33. The preceding discussion has also shown that financial liberalization fell not only far short of expectations, but did serious harm to some countries, destroyed enterprises and had an often disproportionately negative effect on labour. The frequency and severity of financial crises since the 1990s is part of the explanation why growth has not delivered enough jobs. As the Harvard economist Richard Freeman has argued, "[t]he consequences of mistakes in financial markets, where capital is volatile and mobile globally, far exceed the consequences of mistakes in the labour markets, where labour is largely immobile across national lines". [54]

34. It is indeed well-argued that financial liberalization has far-reaching consequences for labour, which can impede attainment of the ILO's goal to "promote opportunities for women and men to obtain decent and productive work, in conditions of freedom, equity, security and human dignity". [55] As the Declaration of Philadelphia has entrusted us, "it is a responsibility of the International Labour Organization to examine and consider all international economic and financial policies and measures" [56] in the light of our fundamental objective. It is thus well within our mandate to discuss the implications of the international financial architecture for the well-being of workers around the world.

35. So far, the ILO has been mainly working with constituents to mitigate the consequences of financial crises and to help countries to lay the foundations for decent work when they emerge from crisis. For example, presentations have been made at the International Labour Conference on activities in Argentina, [57] at an international tripartite seminar on

[53] World Bank: *Economic growth in the 1990s. Learning from a decade of economic reform* (Washington, DC, 2005), p. 21.

[54] R. Freeman: *Responding to economic crisis in a post-Washington Consensus world: The role of labor* (Cambridge, MA, Harvard University, 2003, mimeo.).

[55] ILO: *Decent work. Report of the Director-General* (Geneva, International Labour Conference, 87th Session (1999)), p. 3.

[56] Declaration of Philadelphia, II(d).

[57] See e.g. ILO: *Argentina emerging from crisis*, ISBN 92-2-016170-2. Special Event, International Labour Conference, 14 June 2004 (Geneva, 2004).

Indonesia, [58] while also at some recent sessions of the Employment and Social Committee country presentations included, inter alia, reporting on activities related to the negative social consequences of financial crises.

36. However, parallel to such country activities, it is suggested to give greater attention to the question of how financial crises can be prevented and how an international financial system can be made more conducive for labour. The following section also partly builds on the discussion in preceding sessions of the Working Party on the Social Dimension of Globalization and makes some suggestions on how such an international financial system might look.

III. Financial openness and employment: The need for greater policy coherence

37. There is now a global consensus that the current international financial system needs reform and thus a window of opportunity to make the ILO's concerns heard. As the World Commission has argued, "[o]ur goal should be to build a stable financial system that stimulates sustainable global growth, provides adequate financing for enterprises and responds to the needs of working people for decent employment". [59] In order to serve this goal, the international financial system should have three different sets of properties: [60]

- *Firstly, it should provide liquidity in the international system.* Liquidity is needed to respond to demands for foreign exchange and for foreign investment. In effect the downfall of the original Bretton Woods system was due to lack of liquidity of the system as a whole and the reliance on only one currency to provide international liquidity.

- *Secondly, an international system should provide stability for global markets.* As indicated above, the absence of stability during the last decade has caused severe and, some have argued, even irreparable damage to the growth potential of a number of developing countries.

- *Thirdly, an international financial system should provide a large degree of policy autonomy for participating countries.* This is extremely important as countries not only have different factor endowments but also different socio-economic systems. In order to find equilibrium between various policies to satisfy different economic and social demands, each country and society must be able to use the policy instruments and to work with institutions which are best fitted to the country.

38. The major question is, therefore, whether these required properties are compatible with each other? There is no guarantee in that different sets of policies would automatically meet all three requirements. *A greater sense of policy coherence is therefore called for. We can distinguish policy coherence at, and between, three different levels in order to achieve an international financial system that is more aware of concerns for employment and*

[58] See e.g. ILO: *Labour market policies and poverty reduction strategies in recovery from the Asian crisis*. Report of the ILO – Japan – Government of Indonesia tripartite subregional seminar, Jakarta, Indonesia, 29 April-1 May 2002 (Bangkok, 2002).

[59] World Commission on the Social Dimension of Globalization, *A fair globalization: Creating opportunities for all*, op. cit., para. 404.

[60] I. Adelman: "Editor's introduction" (Special section: Redrafting the architecture of the global financial system), in *World Development, 2000*, Vol. 28, No. 6, pp. 1053-1060, p. 1058).

labour as discussed above. Namely, (a) policies in industrialized countries; (b) the set of multilateral rules as has been developed since the Second World War; and (c) policies in developing countries.

III.a. Policies in industrialized countries

39. Despite the success of emerging economies such as India and China, policies in industrialized countries and their outcomes circumscribe the economic and social policies of developing countries. Hence, even if the focus of concern is to increase the importance of employment and labour in the process of development, policies in industrialized countries need to be part of such considerations. The following set of policies is considered to be extremely relevant: [61]

- More coherent economic policies between the G3 (Europe, Japan and the United States): uncoordinated fiscal, monetary and foreign exchange policies have created a highly volatile and unstable system which is not geared towards growth and of which the spillover effects for developing countries are serious.

- There is almost unanimous agreement that the United States economy cannot be the engine of growth for the rest of world. Japan and Europe should give greater reflection to growth through better coordination of fiscal and monetary policies and their effects on employment and growth and not rely only on export growth. The 2005 IMF World Economic Outlook suggested that the European Union should review the stringent stability and growth pact in order to increase potential for growth and employment in the Euro area and hence achieve a better balance between Europe, Japan, the United States and the rest of the world. [62]

- Apart from the specific consideration of growth and employment concerns in the growth and stability pact, a greater concern for growth employment creation in general is called for from all three G3 areas. The G3 also has a third important responsibility in providing development assistance and in stimulating other sources of finance to enhance growth and development and so contribute to a better functioning international financial system. [63]

III.b. Rules of the international system

40. Such changes in G3 policy stances should be embedded in changes in multilateral rules and the functioning of international financial agencies. Again, the discussion does not need to start from zero, but the recommendations made by the World Commission can be built on. [64] Their principles are:

[61] Some of these are discussed in World Commission on the Social Dimension of Globalization: *A fair globalization: Creating opportunities for all*, op. cit., pp. 90 and 110.

[62] See IMF: *World Economic Outlook: Globalization and external imbalances* (Washington, DC, April 2005), p. 29.

[63] See World Commission on the Social Dimension of Globalization: *A fair globalization: Creating opportunities for all*, op. cit., p. 103.

[64] See the more detailed discussion in the report of the World Commission on the Social Dimension of Globalization: *A fair globalization: Creating opportunities for all*, op. cit., pp. 88 ff.

- Capital account liberalization should depend on a country's circumstances to maximize investment and to avoid volatility.

- In order to reduce volatility and contagion in emerging markets, the international system should have greater resort to emergency financing.

- In order to make the international system more coherent, developing countries should be better integrated into it through:

  – greater involvement in the reform process of the international financial institutions (IFIs);

  – removing barriers caused by new codes to financial market access by developing countries;

  – providing a better system for debt reduction.

41. An important point in considering the rules of the international system and the policies applied by the international financial institutions is that the general context of the international financial landscape has changed considerably. This warrants different approaches from those of the past two decades. One of the most salient points is that the continuous opening of trade, despite some recent setbacks and the application of fairly drastic adjustment and stabilization policies in the 1980s and 1990s have dampened worldwide inflationary tendencies. [65] Moreover, the trade opening makes it improbable that inflation will soar in the future. *Hence prices are fairly stable and are likely to remain so. But greater price stability and monetary discipline have not resulted in financial and macroeconomic stability, while financial liberalization has led to increasingly sharp business cycles and sharp fluctuations in economic activity.*

42. It is, therefore, a logical step to argue that the focus of the international system should shift from concerns about price instability to concerns for the instability of financial markets and asset price instability in particular. International policies therefore have to shift. This would require firstly greater surveillance by the IMF on asset instability and secondly a review of its policy towards capital account liberalization. The World Commission has recommended that no dogmatic approach should be pursued towards capital account liberalization, arguing for more cautious steps by developing countries and outlining that, at times, the reintroduction of capital controls can be warranted. [66] If the current reform debate leads to an internationally accepted system of managed capital account liberalization, the concerns for high and sustained levels of employment would be well served. [67]

[65] Y. Akyüz: *Issues in macroeconomic and financial policies, stability and growth* (Geneva, ILO, 2004, mimeo.).

[66] See World Commission on the Social Dimension of Globalization: *A fair globalization: Creating opportunities for all*, op. cit., p. 90.

[67] There are signs that the international policy agenda is shifting in this direction. This is evident from the World Bank: *Growth in the 1990s*, op. cit., but also from a recent report by the IMF's Independent Evaluation Unit, that sees the role played by the IMF in the past as follows: "Throughout the 1990s, the IMF undoubtedly encouraged countries that wanted to move ahead with capital account liberalization, and even acted as a cheerleader when it wished to do so, especially before the East Asian crisis. […] In multilateral surveillance, the IMF's analysis emphasized the benefits to developing countries of greater access to international capital flows, while paying comparatively less attention to the risks inherent in their volatility." It comments on the shift in

III.c. Policies in developing countries

43. Changes in rules and policies at the international level and the current low level of inflation would also allow developing countries to undertake more coherent policies in order to stimulate development, employment and growth. A potential effective set of policies would combine a flexible system of capital controls with a managed real effective exchange rate. [68] The flexible system of capital controls would allow for more coherent national policies to be undertaken and reduce volatility which has, as documented earlier, serious consequences not only in terms of short-term welfare losses but also in terms of reduced growth potential.

44. The aim of a system of managed real effective exchange rates is to keep the industry and the economy in general at high levels of capacity utilization and so to aim for full employment, as discussed in the following paragraphs. However, before attending to this, one first needs to address the question of whether a coherent approach of social and economic policies is at all possible. This relates to the so-called policy trilemma of international economic policies, [69] which states that national policy space is circumscribed by the impossibility to achieve three policy objectives simultaneously, viz.:

- open capital account;
- stable exchange rates;
- independent monetary policy;

and that only two out of these three policy objectives can be achieved. For example, under a system of an open capital account and with fixed exchange rates, countries cannot pursue an independent monetary policy. Conversely, if countries need to undertake an independent monetary policy, they have either to revert to flexible exchange rates or opt for a closed capital account.

45. However, some recent research argues that the policy trilemma, which has been guiding national and international policy-makers for several decades, can be relaxed by avoiding corner or triangular solutions, i.e. not going for fixed versus flexible exchange rates, or for open versus closed capital accounts etc., but by choosing intermediate options in these three policy domains (i.e. managed exchange rates, managed capital controls, etc.). [70] This

focus: "More recently, however, the IMF has paid greater attention to various risk factors, including the linkage between industrial country policies and international capital flows as well as the more fundamental causes and implications of their boom-and-bust cycles. Still, the focus of the analysis remains on what emerging market countries should do to cope with the volatility of capital flows (for example, in the areas of macroeconomic and exchange rate policy, strengthened financial sectors, and greater transparency)." See IMF Independent Evaluation Office (2005): *The IMF's approach to capital account liberalization* (Washington, DC, 2005), pp. 5 ff.

[68] Diwan: *Debt as sweat*, op. cit.; World Bank: *Economic growth in the 1990s*, op. cit.; and A. Charlton and J.E. Stiglitz: "A development round of trade negotiations?", in World Bank: *Proceedings from the annual bank conference on development economics 2004* (Washington, DC, 2004).

[69] See M. Obstfeld et al.: *The trilemma in history: Tradeoffs among exchange rates, monetary policies, and capital mobility*. NBER Working Paper No. 10396 (Cambridge, MA, National Bureau of Economic Research, 2004).

[70] See C.I. Bradford Jr.: *Prioritizing economic growth: Enhancing macroeconomic policy choice*. Paper presented at the XIX G24 Technical Group Meeting, 27-28 September 2004 (Washington, DC, Intergovernmental Group of Twenty-Four, 2004).

requires more fine turning and coherence in policies rather than relying on rule-of-thumb policy interventions and national institutions with explicit mandates and capabilities to achieve this.

46. In paragraph 38 above, it has already been indicated that a managed capital account, through avoiding crises, could contribute to a stable investment climate, sustained growth and employment creation. How would a system of managed real effective exchange rates affect employment? [71] A system of a managed real exchange rate:

- will allow for higher capacity utilization in times of unemployment, if it is applied in combination with the appropriate mix of macroeconomic and fiscal policies;

- will stimulate output growth and hence employment, if it is combined with appropriate industrial policies, as the experience in various Asian countries has shown; [72]

- will affect the sectoral composition of exports, in any case to more labour intensive goods and hence increase the employment elasticity of the economy as a whole compared to another system. [73]

47. Another possible solution for the policy trilemma would be to include one or two additional policy instruments to complement the fiscal and monetary tools. For example, social pacts or coordinated wage bargaining to hold down inflation. [74] Also, a greater concern for inequality and reducing national inequalities could contribute to reducing inflationary pressure and could be added as a further policy instrument. [75]

III.d. Building institutions for coherent policies

48. The conclusion of these deliberations is that a coherent approach in national and international financial policies to stimulate employment growth is possible. However, it requires different rules, better fine-tuning of different components of national policies and appropriate institutions. For national institutions to function well, one can point to two distinct national configurations: theoretically, one configuration would be a repressive State with a strong and autonomous bureaucracy that is able to coordinate a well-functioning and coherent set of policies. The other would be a national system of consensus and willingness for policy dialogue that can design a coherent set of policies that are acceptable to citizens and can therefore be implemented without resort to authoritarian methods.

[71] D. Rodrik: *Growth strategies*, op. cit.; and R. Frenkel: *Real exchange rate and employment in Argentina, Brazil, Chile and Mexico*. Paper presented at the XIX G24 Technical Group Meeting, 27-28 September 2004 (Washington, DC, Intergovernmental Group of Twenty-Four, 2004).

[72] A.H. Amsden: *The rise of "the rest": Challenges to the West from the late-industrializing economies* (Oxford, Oxford University Press, 2001).

[73] This is a comparative static argument comparing two equilibriums under different policy regimes. This is independent of a secular decline of employment elasticity, which various observers have been discussing.

[74] Bradford: *Prioritizing economic growth*, op. cit.

[75] Van der Hoeven and Saget: *Labour market institutions*, op. cit.

49. The authoritarian path is neither desirable nor viable in the long run; it would often mean the violation of basic human rights (such as freedom of speech and association) and would not be internationally accepted either. [76] Hence the configuration of an open and consensus-prone society is the only feasible option in the long run. However, as it is more difficult to reach consensus in unequal societies, more attention needs to be given to distributional issues, in order to reach consensus and implement coherent policies. Hence reducing inequality can contribute to better implementation of economic policies and to greater policy coherence.

50. Labour market institutions can play an important role in achieving this objective. One can use three efficiency criteria to evaluate the efficiency of labour market policies, namely allocative efficiency (matching supply and demand to reduce unemployment), dynamic efficiency (quality future labour force) and equity efficiency (containing inequalities). [77] Labour market systems are often only evaluated on the basis of allocative efficiency, but some studies evaluating the role of labour market institutions in more advanced countries, where longer time series are available, found that societies do not have to decide on economic efficiency grounds what type of labour market system to adopt and therefore can let distributional considerations play an important role in designing an appropriate labour market system. [78] It has recently been demonstrated that there need not be a trade-off between redistribution and growth, and that national socio-economic structures should determine the proper mix of growth and redistributive policies. [79] This point was recently underscored by the United Nation’s report on the world social situation. [80]

III.e. Concluding observations

51. The Working Party is invited to give its views on the following:

- The work of the Office and how the Office can strengthen the technical capacity needed to constructively engage in the current debate on the reform of the international financial system.

- How constituents and especially representatives of those groups which are most affected by financial instability, can be involved in building up a coherent message for the ILO and how their knowledge can enhance the ILO’s capacity to effectively operate at the international level.

[76] See the report of the Commission on Human Security: *Human security now. Protecting and empowering people* (New York, United Nations, 2003).

[77] Van der Hoeven and Saget: *Labour market institutions*, op. cit.

[78] R.B. Freeman: *Single peaked vs. diversified capitalism: The relation between economic institutions and outcomes*. NBER Working Paper No. 7556 (Cambridge, MA, National Bureau of Economic Research, 2000).

[79] H. Dağdeviren et al.: “Redistribution does matter: Growth and redistribution for poverty reduction”, in A. Shorrocks and R. van der Hoeven (eds.): *Growth, inequality, and poverty prospects for pro-poor economic development*. WIDER Studies in Development Economics (Oxford, Oxford University Press, 2004), pp. 125-153.

[80] United Nations: *Report on the world social situation 2005: The inequality predicament* (New York, 2005).

- The means the ILO should use to express its concern with the consequences the current international financial system has for enterprises and workers, and how it should suggest improved policy coherence between the different international organizations to enhance growth, decent employment and investment. In particular, steps could include dialogue and/or cooperation with the international financial agencies and other actors of the international system. [81]

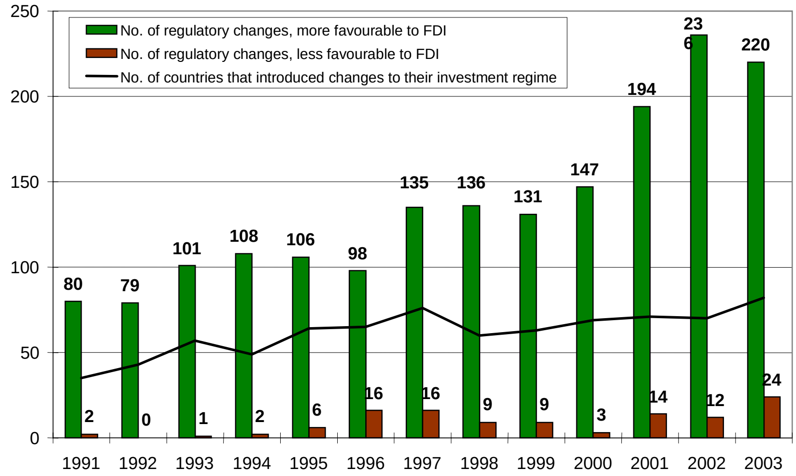
Geneva, 7 October 2005.

Submitted for debate and guidance.

[81] Such as the regional development banks, the different organs of ECOSOC, the Regional Commissions of the United Nations, the Group of 24, the European Union and other regional or thematic international bodies, as well as international research and NGO networks.

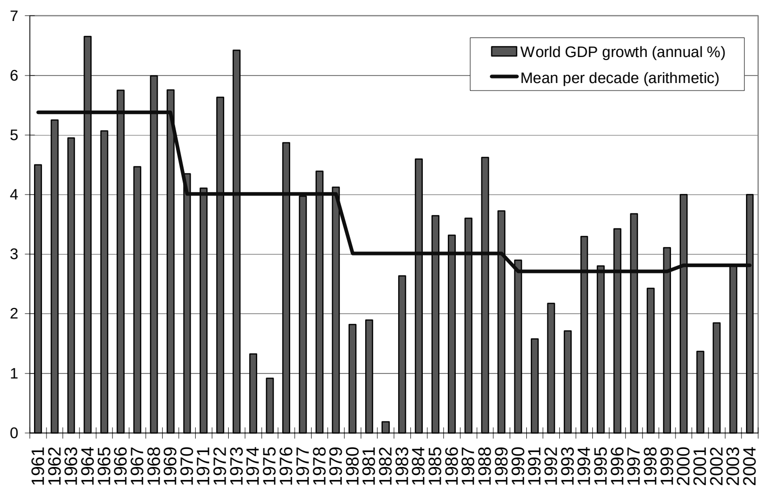
Appendix

Graph 1. National regulatory changes towards FDI, 1991-2003



Source: UNCTAD, *World Investment Report 2004* (Geneva and New York, 2004), p. 8.

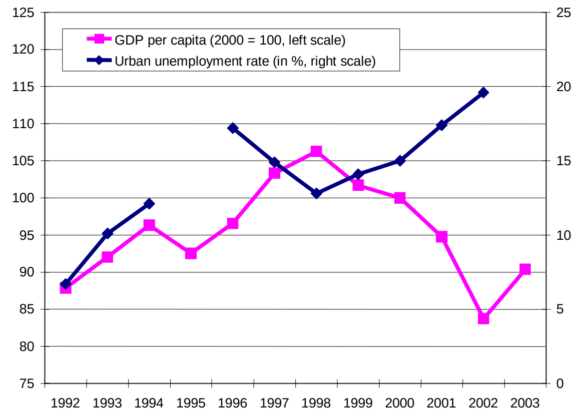
Graph 2. World GDP growth, 1961-2004



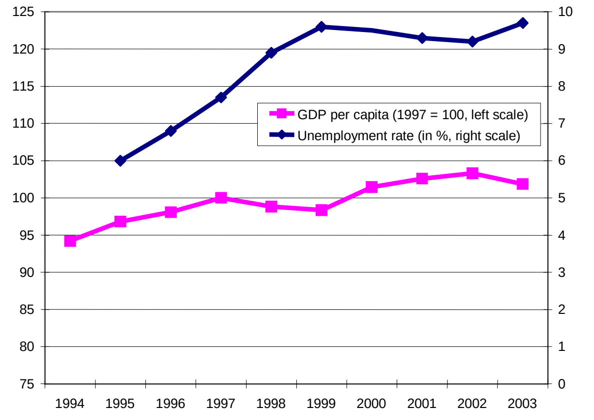
Source: World Bank: *World Development Indicators 2005* CD-ROM (Washington, DC, 2005).

Graph 3. Medium-term effects of major financial crises on unemployment

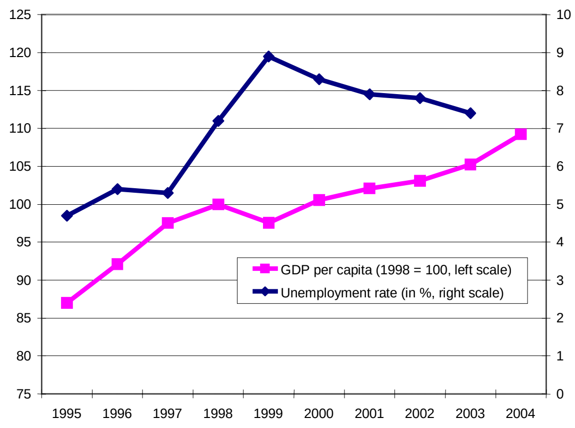
Argentina (financial crises in 1995 and 2001-02)



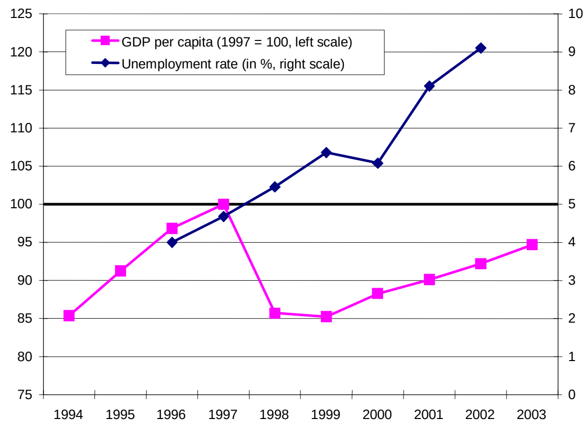
Brazil (financial crisis in 1998-99)



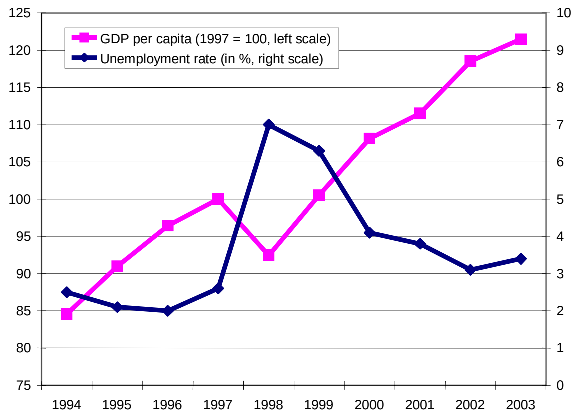
Chile (financial crisis in 1998-99)



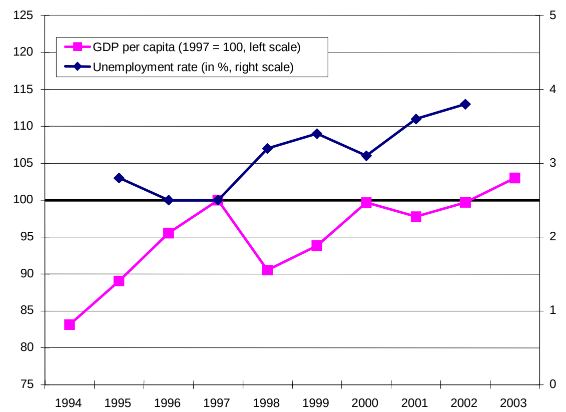
Indonesia (financial crisis 1997-98)



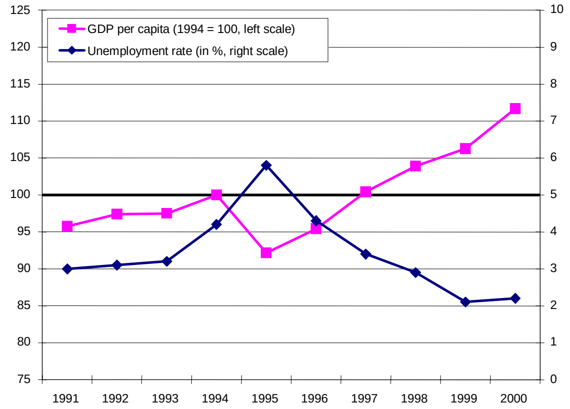
Republic of Korea (financial crisis in 1997-98)



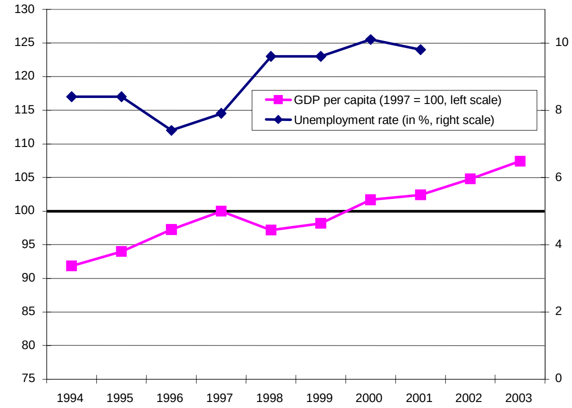
Malaysia (financial crisis in 1997-98)



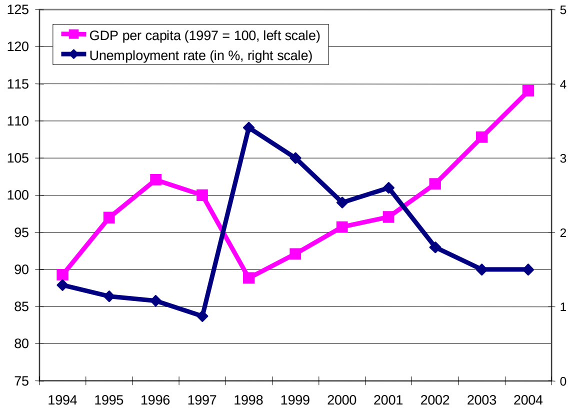
Mexico (financial crisis in 1994-95)



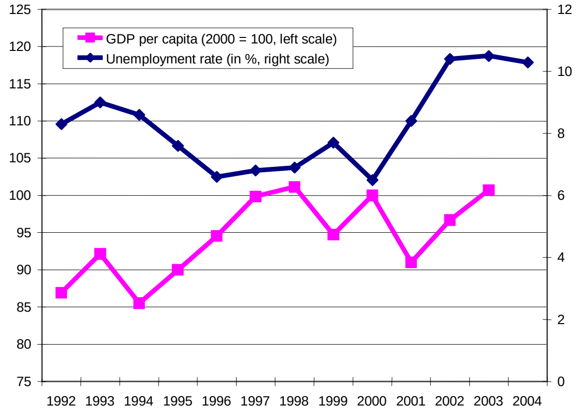
Philippines (financial crisis in 1997-98)



Thailand (financial crisis in 1997-98)



Turkey (financial crises in 1994, 1998-99 and 2001)



Source: World Bank: *World Development Indicators 2005* CD-ROM (Washington, DC), series "GDP per capita (constant 2000 US$)"; and ILO: *Key indicators of the labour market*, 4th edition (Geneva 2005).

Table 1. Gross private capital flows, 1977-2003
(in % of GDP)

	1977-79	1980-84	1985-89	1990-94	1995-99	2000	2001	2002	2003
World	6.3	7.7	9.3	11.2	18.6	28.6	23.5	21.0	24.2
High income	6.4	7.9	10.1	11.8	20.5	32.6	26.4	23.2	26.6
Low and middle income	5.7	6.7	5.3	7.9	10.6	11.2	11.1	11.2	12.8
Middle income	6.8	7.8	5.9	8.6	11.3	12.2	12.2	12.3	13.2
Low income	1.7	2.1	2.7	4.3	5.6	4.7	4.2	4.6	–
East Asia and the Pacific	–	–	3.8	8.1	11.0	13.9	11.4	10.2	14.5
Europe and Central Asia	4.0	2.5	–	–	11.9	14.5	13.2	14.1	16.5
Latin America and the Caribbean	7.1	9.4	7.2	9.2	11.8	10.8	12.6	13.7	9.9
Middle East and North Africa	8.1	9.6	6.3	10.7	7.4	7.5	7.3	10.2	12.6
South Asia	0.4	0.6	1.2	2.9	3.8	3.4	3.0	3.4	–
Sub-Saharan Africa	2.8	4.2	6.1	6.9	13.7	11.8	16.5	10.7	6.7

Note: Gross private capital flows are defined as "the sum of the absolute values of direct, portfolio and other investment inflows and outflows recorded in the balance of payments financial account, excluding changes in the assets and liabilities of monetary authorities and general government" (ibid.). Figures for the periods from 1997 to 1999 are arithmetic averages.

Source: World Bank: *World Development Indicators 2005* CD-ROM (Washington, DC, 2005).

Table 2. Gross fixed capital formation, 1977-2003
(in percentage of GDP)

	1977-79	1980-84	1985-89	1990-94	1995-99	2000	2001	2002	2003
World	24.0	22.9	22.2	21.8	21.7	22.0	21.4	20.6	–
High income	23.9	22.9	22.2	21.5	21.2	21.6	21.0	20.0	–
Low and middle income	24.3	23.2	22.7	23.2	23.6	23.4	23.3	23.1	23.9
Middle income	25.3	24.0	23.3	23.7	24.0	23.7	23.6	23.4	24.2
Low income	18.2	18.3	19.3	20.3	21.1	20.9	21.3	21.7	21.9
East Asia and the Pacific	27.8	28.0	28.1	31.4	32.9	32.5	33.4	34.9	37.8
Europe and Central Asia	–	–	–	22.3	21.8	21.1	20.5	19.6	19.5
Latin America and the Caribbean	22.9	20.6	19.5	19.0	19.4	19.7	18.9	17.6	17.3
Middle East and North Africa	28.8	25.4	21.9	21.3	20.8	20.5	20.5	20.5	21.0
South Asia	17.5	18.9	20.6	21.4	21.7	21.6	21.4	21.7	21.9
Sub-Saharan Africa	24.6	21.6	17.7	17.4	17.7	16.8	17.5	17.9	18.1

Note: Gross fixed capital formation is defined to include "land improvements (fences, ditches, drains and so on); plant, machinery and equipment purchases; and the construction of roads, railways and the like, including schools, offices, hospitals, private residential dwellings, and commercial and industrial buildings. According to the 1993 SNA, net acquisitions of valuables are also considered capital formation" (ibid.). Figures for the periods from 1997 to 1999 are arithmetic averages.

Source: World Bank: *World Development Indicators 2005* CD-ROM (Washington, DC, 2005).

Table 3. Net private capital flows to low- and middle-income countries, 1975-2003 (in billion current US$)

	1975-79	1980-84	1985-89	1990-94	1995-99	2000	2001	2002	2003
Low and middle income	33.6	47.6	30.6	102.2	235.5	186.0	174.3	160.3	199.4
Middle income	30.5	41.9	24.6	94.2	221.0	170.9	160.8	146.3	177.9
Low income	3.1	5.7	6.1	8.0	14.4	15.1	13.5	14.0	21.5
East Asia and the Pacific	3.7	8.4	9.8	42.2	69.0	35.9	36.6	47.1	62.0
Europe and Central Asia	3.3	5.5	5.0	12.6	41.5	42.0	37.7	55.4	67.1
Latin America and the Caribbean	18.9	25.5	5.9	38.2	102.9	82.7	71.3	35.6	41.1
Middle East and North Africa	4.5	2.8	4.1	2.2	3.3	5.3	9.4	8.1	4.8
South Asia	0.1	1.7	3.7	4.7	6.9	9.7	5.2	6.5	11.1
Sub-Saharan Africa	3.2	3.8	2.2	2.3	11.8	10.4	14.0	7.6	13.2

Note: Net private capital flows are defined to “consist of private debt and non-debt flows. Private debt flows include commercial bank lending, bonds and other private credits; non-debt private flows are foreign direct investment and portfolio equity investment. Data are in current US$” (ibid.).

Source: World Bank: *World Development Indicators 2005* CD-ROM (Washington DC, 2005); data for high-income countries as a group are not available.

Table 4. International reserve holdings by low and middle-income countries, 1977-2004 (in % of GNI)

	1977-79	1980-84	1985-89	1990-94	1995-99	2000	2001	2002	2003	2004
Low and middle income	5.9	5.0	4.5	7.0	11.1	12.5	13.7	16.6	19.3	21.5
Middle income	5.6	4.4	3.5	4.6	7.2	9.2	10.3	13.1	15.2	–
Low income	6.0	5.1	4.7	7.4	11.7	13.1	14.3	17.2	20.1	–
East Asia and the Pacific	6.4	7.8	8.3	11.9	16.3	18.4	20.6	23.9	28.3	34.0
Excl. China	10.1	8.4	10.4	15.1	18.8	23.5	24.4	24.4	25.2	–
China	3.5	7.2	6.8	9.1	15.0	16.1	19.0	23.7	29.5	–
Europe & Central Asia	–	–	–	–	10.2	13.7	14.3	16.6	18.2	18.8
Latin America and the Caribbean	8.2	6.6	6.2	7.2	8.9	8.4	8.8	10.1	12.1	12.0
Middle East and North Africa	21.3	11.1	5.8	11.9	14.0	13.8	15.2	19.1	22.6	23.9
South Asia	6.1	4.7	3.8	4.7	6.7	7.9	9.3	13.2	16.1	17.4
Sub-Saharan Africa	6.2	5.1	4.5	5.7	8.6	12.1	12.2	12.4	10.4	11.8

Source: World Bank: *Global Development Finance 2005*, online database (Washington, DC, 2005); based on series “International Reserves (US$)” and “Gross National Income (US$)”.