Growth, investment and jobs: The international financial dimension

Working Party on the Social Dimension of Globalization

November 14th, 2005

Growth, investment and jobs

- At times of global economic integration, global growth and employment performance have been disappointing:
  - Public attention has often focused labour market effects of trade.
  - Impact of Foreign Direct Investment (FDI) has been addressed by WP/SDG.
  - Increased volatility and financial crises can have strong impacts on enterprises and workers.

Growth, investment and jobs

- Understanding labour market impact of financial liberalization is crucial:

  "The consequences of mistakes in financial markets, where capital is volatile and mobile globally, far exceeds the consequences of mistakes in the labour markets, where labour is largely immobile across national lines."

  (Richard Freeman, Harvard & LSE)

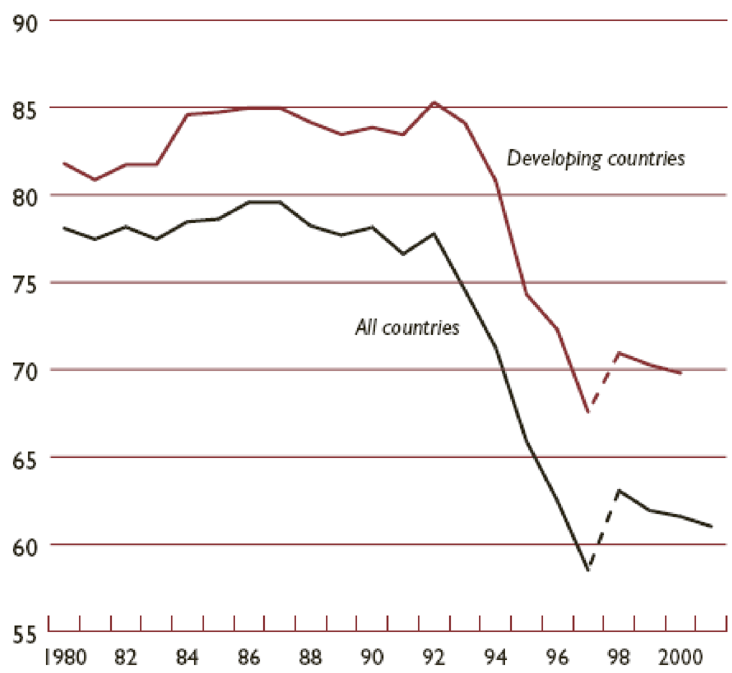
The rationale behind financial liberalization

- Assumption: Investment in developing countries is constraint by the lack of capital. Freeing up the international movement of capital will give developing countries access to capital, and therefore increase investment, raise growth, and create employment.

Financial liberalization since the early 1990s: Capital account

- Widespread capital account liberalization since the early 1990s.
- Many countries have removed *all* restrictions on international capital flows.

Countries with Capital Controls, 1980-2001 (in % of total IMF membership)

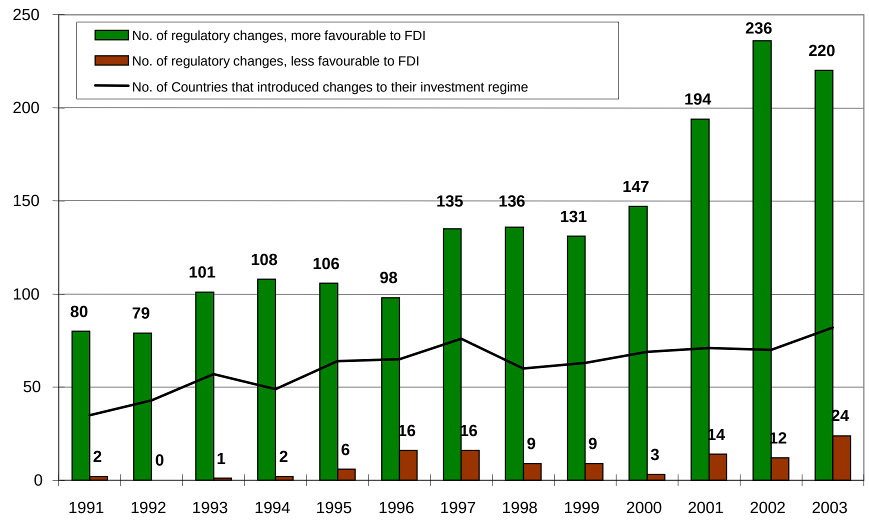


Source: IMF.

Financial liberalization since the early 1990s: FDI

- Regulatory changes were favourable to FDI (a sub-category of capital flows).

National Regulatory Changes towards FDI, 1991-2003

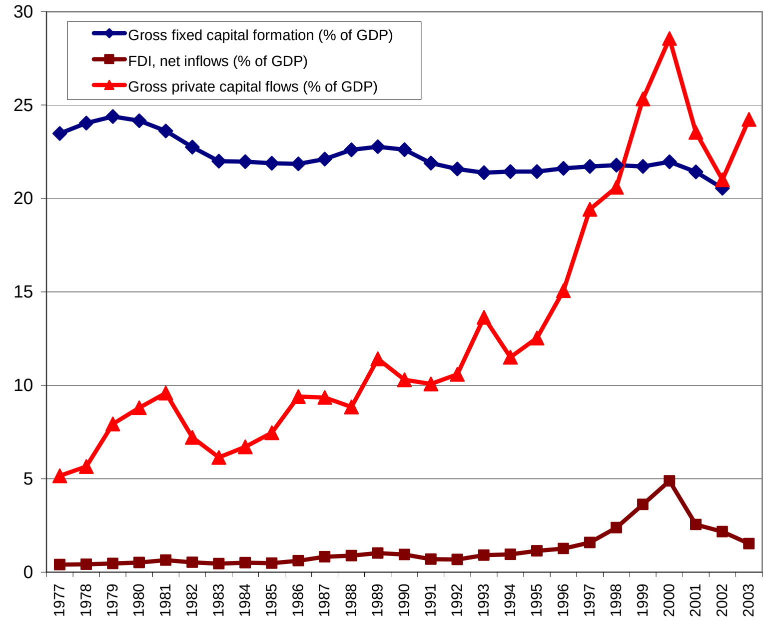


Source: UNCTAD.

Trends in international capital flows and investment

- Rapid expansion of international capital flows (both gross private capital flows and FDI).
- Stagnation or fall in worldwide investments (GFCF).

International Capital Flows and Investments, 1977-2003 (World)

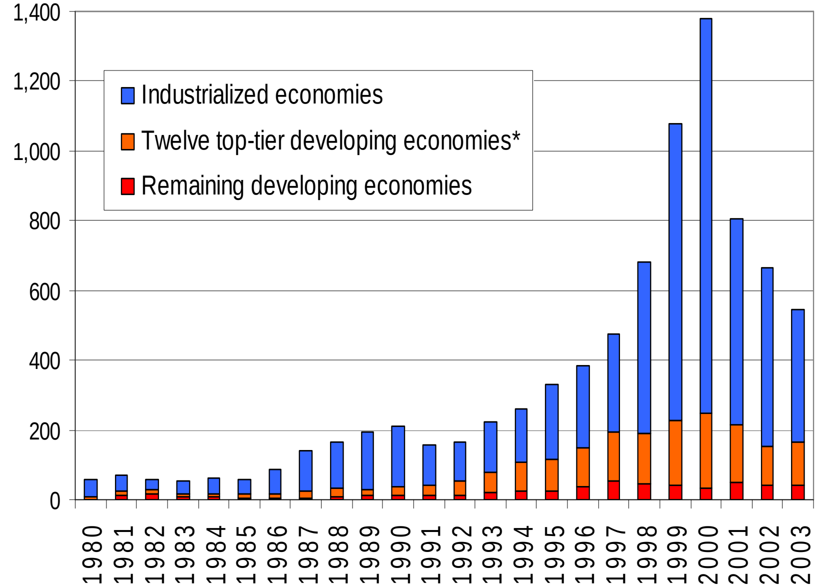


Source: World Bank.

Distribution of private capital flows

- Private capital flows are skewed towards high-income countries, and some middle-income countries.
- A similar trend can be observed for FDI (see graph).

FDI Inflows by Economic Grouping, 1980-2003 (in billion current US$)



Source: UNCTAD.

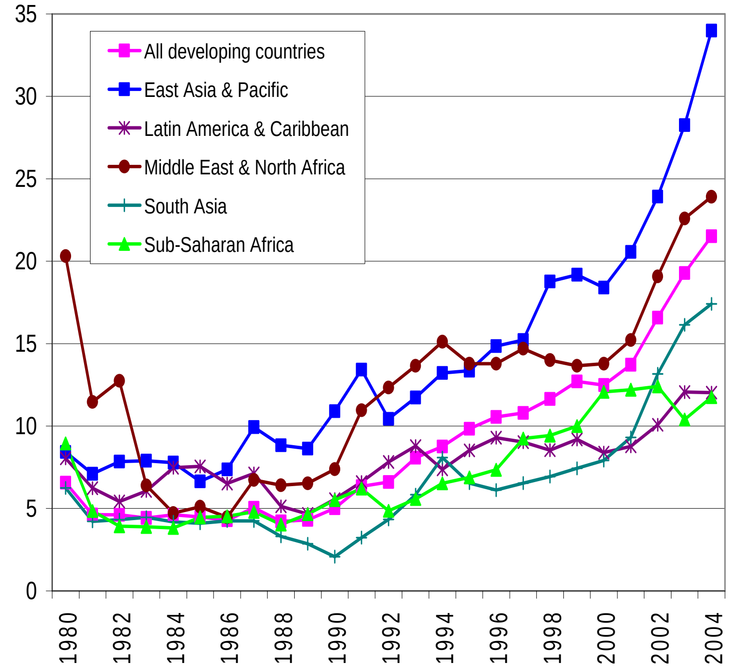
Direct growth effects of financial liberalization

- No solid relationship between capital account liberalization and growth performance can be established (IMF and UNCTAD research).
- Only some middle-income countries appear to have benefited from capital account liberalization.
- Growth performance also depends on other factors, such as good institutions and an adequate policy framework.

Indirect growth effects though increased reserve holdings

- Financial openness makes larger foreign reserve holdings necessary.
- Opportunity cost of reserve holdings is high: Funds can not be used for investments with higher returns.

Reserve Holdings by Developing Countries, 1970-2004 (in % of GNI)



Source: World Bank.

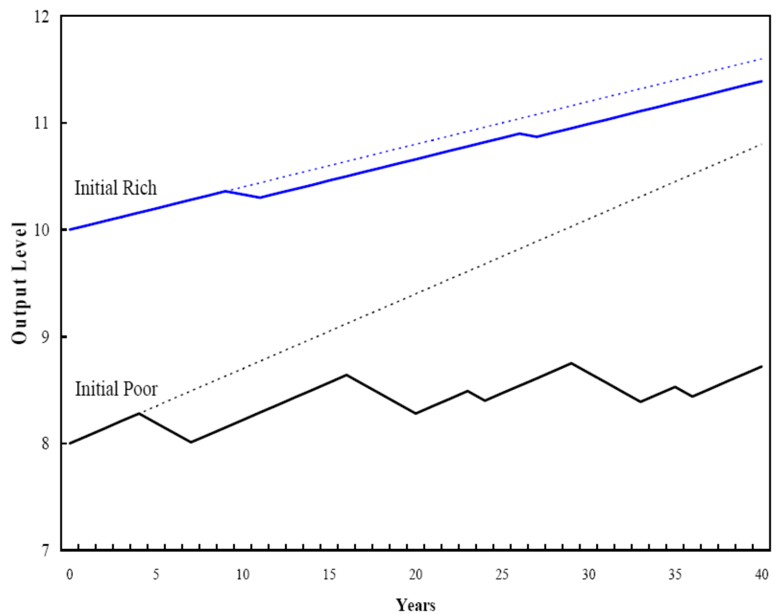
Volatility and financial crises

- Financial flows are generally pro-cyclical; they increase volatility and deepen economic downturns.
- Financial openness has made countries more vulnerable to crises, e.g.:
  - Argentina 1995 and 2001-02
  - Brazil and Chile 1998-99
  - Indonesia, Rep. of Korea, Malaysia, Philippines and Thailand 1997-98
  - Mexico 1994-95
  - Turkey 1994, 1998-99 and 2001

Long-term growth impact of financial crises

- Financial crises have a large, negative impact on GDP.
- Countries typically do <u>not</u> return onto their old growth path (IMF research).
- GDP loss is largest for poor countries.

Typical Growth Path after Financial Crises in Rich and Poor Countries



Source: Cerra and Saxena (2005: 24)

Impact of financial crises on enterprises

- Financial crises have a substantial impact on enterprises, e.g. through:
  - Exchange rate depreciation in conjuncture with exposure to loans in foreign currency;
  - falling domestic demand and lower capacity utilization;
  - higher interest rates (that are intended to defend the exchange rate).

Impact of financial crises on enterprises

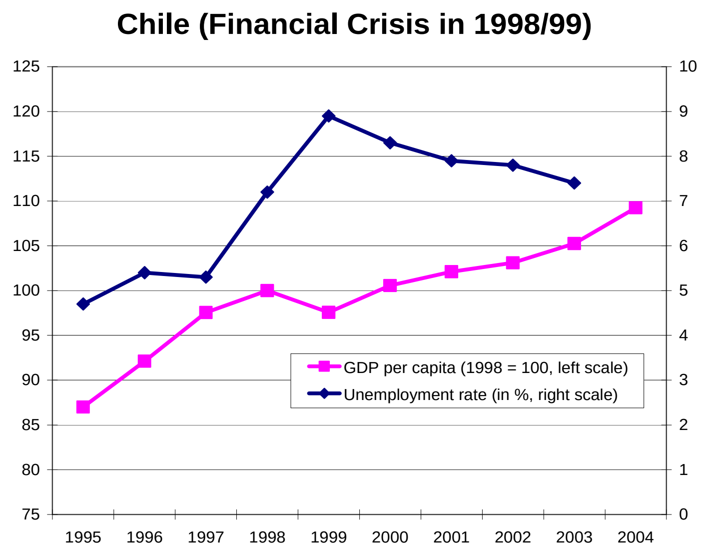
- Experience of affected firms:
  - Deteriorating balance sheet positions forces companies to reduce investments;
  - widespread bankruptcies (in Korea alone, 8,200 SMEs failed during 1997 and a further 10,500 during 1998);
  - enterprises lose firm-specific human capital when workers are retrenched.

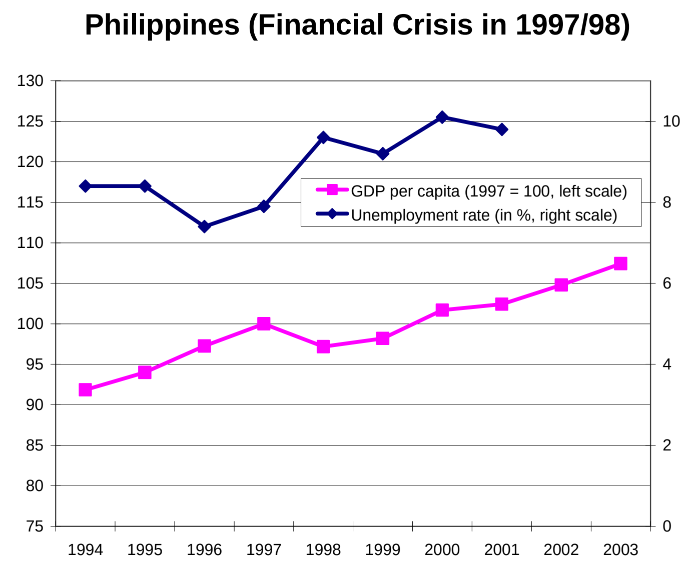
Impact of financial crises on workers

- Social consequences are evident from a number of indicators:
  - Higher unemployment;
  - increase in share of informal employment;
  - falling real wages and falling incomes;
  - higher poverty (e.g. in South-East Asia, the number of working poor rose from 33.7 million before the crisis to 50.6 million in 1998).

Impact of financial crises on workers

- Recovery of social indicators generally lags the economic recovery by several years.





Impact of financial crises on workers

- Financial crises, and exchange rate crises in particular, lead to a decline in the share of wages in national income:
  - On study reports an average drop in the wage share of 5 percentage point per crisis.
  - There is only a modest recovery after a crisis (three years later, the wage share is still 2.6 percentage points below the pre-crisis level).
  - The frequency of financial crises is one factor that contributed to the accelerating decline in wage shares since the early 1990s.

In short: Impact of financial crises on enterprises and workers

- Financial crises reduce long-term GDP growth and have severe negative impacts on enterprises and workers.
- Labour appears to suffer disproportionately:
  - Lagged recovery of employment indicators;
  - long-term decline in the share of GDP that goes into wages.

The international financial system & ILO concerns

- The international financial system should take the needs of enterprises and workers into account:

  "Our goal should be to build a stable financial system that stimulates global growth, provides adequate financing for enterprises, and responds to the needs of working people for decent employment."

  (World Commission on the Social Dimension of Globalization, 2004, para. 404)

Key requirements for the international financial system

- The international financial system should perform three core functions:
  - Provide liquidity to in the international system;
  - provide stability for global markets;
  - leave countries with a large degree of policy autonomy, based on policy consensus.

Areas for policy actions

- Change is needed on different levels:
  - Better co-ordination between the G3 and greater concern for growth and employment creation in industrialized countries;
  - changes in the rules of the international system so that countries have access to emergency financing and are in a position to formulate their own policies towards financial integration;
  - coherent policies in developing countries and a better management of international capital flows.

Policy dilemma at the national level

- National policy space is limited by the impossibility to achieve three policy objectives simultaneously:
  - Open capital account;
  - stable exchange rates;
  - independent monetary policy.
- For example, with an open capital account and fixed exchange rate, an independent monetary policy becomes impossible.

Ways out of the policy dilemma

- Avoiding corner solutions, and using intermediate options.
- Adding new policy tools related to the ILO:
  - Social pacts and coordinated wage bargaining to hold inflation down;
  - greater concern for inequality to reduce inflationary pressure.
- Building democratic institutions for coherent policies.

Discussion

- The Working Party is invited to share its views on:
  - The work of the Office, and a how it can strengthen its capacity;
  - how constituents, and especially those most affected by financial instability, can be involved in building a coherent message for the ILO;
  - how the ILO should voice its concerns for enterprises and workers, and how it should co-operate with other international actors.