3. MACROECONOMICS AND FINANCE

This section explains the TDRs' specific views on macroeconomics, and examines how these have evolved over 30 years. It starts with a discussion of some theoretical aspects of the macroeconomic analyses and policy recommendations (section 3.1). Section 3.2 then reviews the TDR's critique of the reorientation of macroeconomic policies, from demand management, with a focus on growth and employment creation, to a neoliberal and monetarist orientation, with the main focus on inflation control. This is followed by a summary of the TDR's analyses, comments and recommendations in the areas of monetary, financial and fiscal policies, with emphasis on those in developed countries (sections 3.3 to 3.5), but also with regard to their implications for developing countries (section 3.6). Section 3.7 then reviews the analyses and reflections presented in the TDRs on topics related to the conduct of macroeconomic policies, namely imbalances and macroeconomic policy coordination, competitiveness and employment creation.

3.1 Theoretical underpinnings

The policy analysis and recommendations of the TDRs have been shaped by theoretical propositions in the tradition of Keynes, Kalecki/Kaldor and Schumpeter. The underlying theories of saving, investment and the rate of interest, as well as the theories of inflation and employment have distinguished UNCTAD's policy analyses from those of other institutions – and from the majority of economists.

3.1.1 The savings-investment relationship

The TDR's view on the macroeconomic savings-investment identity determined, to very large extent, its analyses and policy recommendation. As discussed in 2008, the neoclassical growth model is *based on the assumption that investment is financed from a savings pool created mainly by household savings. Accordingly, entrepreneurial investment will be maximized by policies aimed at increasing household savings rates* (08: VII). The TDR has questioned this model, positing that the resumption of growth is a necessary condition for increasing domestic savings, rather than its effect, and that an increase in real investment is possible without a prior cut in consumption, *since the investment itself will create the required savings by generating additional income*. Thus it is not savings, but financing of investment that is needed to raise output and incomes and to accelerate structural change. This leads to the conclusion that *it is more pertinent to focus on the factors constraining investment and pushing up interest rates, in particular the organization of the*

financial system and its impact on the cost and supply of finance (91: V).

Addressing this question in connection with the adjustment efforts of developing countries that were hit by the debt crisis in the 1980s, TDR 1986 stated: *It is unrealistic to suppose that it would be possible to push up savings and thereby increase significantly output, investment and exports. Rather, one must look to an improvement in the external environment to trigger a rise in output, investment, income – and hence savings* (86: XII; also 99: 75–76).

In the TDR's view, the financing of investment depends primarily on savings from corporate profits – i.e. the establishment of what the TDR has called since 1997 "*profit-investment nexus"* (97: VII and ch. VI; also 94: 72; 96: ch. I and II; 08: ch. IV) – and on the ability of the banking system to create credit. In the real world, distinct from the assumption of the standard growth model, *profit expectations (rather than the level of savings) determine the level of investment in real productive capital. For example, a fall in the savings ratio does not lead to a fall in investment; on the contrary, since it implies an increase in consumer demand, it will increase profits and stimulate investment* (08: VII).

Strong enterprise profits simultaneously increase the incentive for firms to invest and their capacity to finance new investments from retained earnings (08: VII), and to *the extent that investment can be financed by the banking system, which has the power to create credit depending on the amount of liquidity provided by the central bank, the prior existence of savings balances in the financial system is not a prerequisite for investment* (08: VIII). It follows from this that the level of interest rates is not determined by the scarcity of savings. Rather, it is determined by the central bank through its "policy rate" (i.e. the rate it charges for the provision of liquidity to the banking system) and its supply of such liquidity, as well as competition among banks.

The same applies at the international level, where the standard growth model assumes that in poorer countries insufficient domestic savings have to be complemented by "foreign savings" (i.e. capital imports) to enable an increase in investment (the "savings gap theory"). However, the causality works in the opposite direction: changes in the current account lead to changes in the level of investment and savings (08: VII). Several issues of the TDR pointed to empirical evidence refuting the predictions based on the savings gap model, such as episodes when developing countries, especially in Latin America, had attracted waves of capital inflows in the 1990s but failed to achieve growth in productive investment (08: VII). Similarly, after 2000, an increasing number of developing countries had become net exporters of capital, but at the same time tended to grow faster and to have a higher investment ratio than countries that were net capital importers (08: ch. III). For many observers this was a "puzzle", but in the same vein as in 1991 (91: V) the TDR countered that *net capital exports from fast growing developing countries are no longer puzzling if one recognizes the limitations of the underlying theories: the savings gap model and the neoclassical growth model* (08:VII).

The upshot of these considerations is that attracting capital inflows to replace domestic savings is often unnecessary from a macroeconomic perspective, while the negative side effects of such policies can even harm domestic investment in productive capacity (see section 5 below). Of course, this does not make external financing obsolete; indeed, it is essential for the short-term financing of merchandise trade transactions and for the long-term financing of foreign exchange expenditures on imported capital goods in cases where current export earnings are insufficient to cover these. It is in the latter context (i.e. the foreign-exchange gap faced by most developing countries) that the TDR often called for higher capital flows to developing countries, for two reasons: first, to avoid the need for cutting down on imports during periods of slow export growth or in response to negative external shocks, and, second, to enable higher imports of capital and intermediate goods by the poorest and structurally weak economies.

3.1.2 Wages, employment and inflation

High rates of unemployment are often attributed to labour market rigidities that prevent wages from falling to an equilibrium level at which all excess labour would be absorbed. TDR 1995 pointed out that this is essentially a microeconomic rationale. While an individual enterprise may respond to falling wages by expanding its workforce and output to capture a larger share of the market for its products, boosting employment in the economy as a whole will require

an increase in the level of aggregate demand. But the latter cannot be expected to materialize from labour market deregulation or from wage reduction, which is more likely to reduce demand (95: Part 3, ch. I).

Chapter III of TDR 2010 again discussed this issue at considerable length, rejecting the idea that labour and capital are substituted at a given level of output according to their relative prices. It stressed that at the macroeconomic level, the dual character of labour compensation matters. Since it accounts for the largest proportion of production costs, any changes to it relative to productivity are therefore one of the key determinants of inflation. But labour compensation determines, to a very large extent, the level of demand of private households, which is the main component of aggregate demand.

The TDR therefore underlined the need to analyse employment in connection with output growth and the macroeconomic conditions that influence investment in fixed capital: *Once it is recognized that it is not primarily the relative cost of labour but the pace of output growth that is the key determinant of the level of employment, it follows that investment in real productive capacity and demand expansion that motivates such investment are the main drivers of both income growth and employment creation* (10: 83–84).

Regarding the theoretical basis for monetary policy, especially with regard to its main objective of ensuring price stability, the TDR was frequently – at times strongly – critical of the monetarist approach, which suggests that "too much money chasing too few goods" inevitably creates inflation. It considered this theory – based on a mere identity rather than on a proven functional relationship – as too simplistic a basis for policy decisions. First, even within the framework of that theory, if money supply rises faster than money demand, the velocity of money can adjust. Second, as expressed in TDR 2009: "*too much money" needs a channel through which to inject the virus of inflation into an economy. There are only two channels for this to happen: if demand growth exceeds potential supply growth ('demand-pull inflation'), or if increases in the costs of production, particularly labour costs, exceed productivity growth* (domestic 'cost-push' or 'wage-push' inflation) (09: VII, VIII; also 95: Part III, ch. IV; 00: 1).

Moreover, the response must differ depending on whether the cause of inflation is excessively rising costs or excess demand. In particular, upward pressure on costs and prices resulting from higher import prices needs to be looked at in a different way than price increases caused by domestic factors, because domestic macroeconomic policy can do little, if anything, to treat the source of the problem.

3.1.3 Implications for policy recommendations

In the neoclassical framework, which has governed economic thinking over the past few decades, there is little room for a proactive economic policy, and where it offers economic policy options, they often point in the opposite direction to those suggested by the Keynes-Schumpeter model. This also explains the critical stance the TDR took from the outset on the economic policies that were promoted under structural adjustment programmes, IMF conditionality and the so-called Washington Consensus. But it also led to alternative assessments of the policy orientation of the developed countries, in particular with regard to their monetary and fiscal policies, and the organization of the financial sector.

Based on its theoretical foundation, the TDR has been insisting:

- On an understanding of economic development as a process of structural change driven primarily by fixed capital formation, the pace of which is strongly influenced by monetary, fiscal and financial policies that encourage private investment (and reinvestment of increasing profits);
- On proactive management of the financial sector aimed at ensuring that it serves enterprise in the real sector rather than serving itself;
- That adjustment through deflationary policies is mostly counterproductive; and
- That employment creation results from investment in productive capacity and not from low wages.

3.2 Macroeconomic paradigm shift in the late 1970s and early 1980s

The TDR series was initiated at a time of economic upheaval. In the late 1970s and early 1980s the shift in the macroeconomic policy orientation of the major industrialized countries had led to a sharp rise in international interest rates. At the same time, slow growth in most of these countries had caused trade volumes and primary commodity prices to fall. This shift would mark the course of the world economy and the context for development over the next three decades. Inflation had reached intolerable levels in many countries in the second half of the 1970s, and coincided with slow growth in the early 1980s. In this environment, the TDR expressed concern that the pressure on governments of the major industrialized countries to pursue full employment objectives had drastically weakened (84: 8). The key problem of the new policy orientation was not that macroeconomic policy was giving emphasis to containing inflation, but that this was to the virtual exclusion of other policy objectives, a policy stance that would continue over the subsequent decades.

In addition, *shifts in economic policy since the late 1960s, such as the floating of exchange rates and the adoption of variants of monetarism, combined with progressive financial deregulation and certain other aspects of reliance on free markets, had increased the potential for instability and crisis in the world economy and the vulnerability of employment, trade and development* (84: 8; 88: XII). The new macroeconomic orientation, supported by a majority of economists and international organizations, was thus part of a much more general redefinition of the role of the State in the economy, which favoured significantly reducing the extent of State intervention and public sector involvement in the economy (86: IV).

While agreeing on the need to lower inflation, the TDR became an increasingly lonely voice in the 1980s and 1990s in warning of the risks this shift in the policy regime entailed for the world economy, and especially for developing countries and employment. The TDR maintained its policy recommendations to focus on managing aggregate demand as the main determinant of macroeconomic outcomes. Thus, it rejected the idea that had gained considerable support at the time (and with some variations has remained popular even today), that the slowdown in growth in the developed countries had been caused by a decline in labour productivity as a result of *changing attitudes to work, the proliferation of government regulations, existing tax structures, accelerated inflation, shifts in relative prices, changes in the quality of the labour force, lack of adequate innovation and inadequate research and development* (82: 2). The reorientation of policy was accompanied by a shift in the economic paradigm: from support for capital accumulation as the engine of growth, the emphasis was now on the efficiency of factor allocation. This was reflected, *inter alia,* in the preference for liberalized – as opposed to regulated – markets, for laissez-faire over interventionism, and in a shift from demand management to “supply-side policies”.

3.3 Monetary policy

The shift in the orientation towards finding a balance between containing inflation and promoting growth as the main objective of monetary policy was neither temporary nor limited to the industrialized countries. It soon came to be reflected also in the policy orientation of the international financial institutions, and spread, largely as a result of propagation by the latter, to a majority of developing countries.

While the new policy orientation was successful in bringing down inflation in the industrialized countries, it was accompanied by the steepest and longest recession in the post-war period until then, and a jump in unemployment in OECD countries (86: V). The adverse impact on growth, investment and employment was because the monetary policy implied the use of demand contraction to deal with cost-push inflation, as the TDR had pointed out in 1982 (82: 3). A major problem was that inflation was perceived as a problem of monetary policy rather than one of wage determination and unit labour costs and a resulting wage-price spiral, which could have been better tackled by other means, such as an incomes policy (see also section 3.8).

When inflation had been considerably reduced and recovery set in during the 1980s, the TDR frequently criticized central banks for not bringing down interest rates to the ranges of the 1960s and 1970s (90: IV; 92: IV; 94: IV, 95: VII). The average long-term rate of interest was found to have remained *5-6 times higher than in the previous two cyclical expansions* (90: IV).

In 1996, the TDR pointed out, as it would repeatedly do in later issues, that the rate of unemployment compatible with price stability may be much lower than was generally assumed by monetary authorities, as evidenced by the experience of the United States in the mid-1990s (96: III). The argument then advanced by the TDR was the same as in recent years: inflation can be contained without an excessively restrictive monetary policy stance, and at much lower costs in terms of foregone output, when unit labour costs are kept under control (95: VII; 96: IV; 05: 24; 10: ch. V).

By the mid-1990s the TDR deplored what would remain a central macroeconomic issue until today, namely that

> *The generally restrictive monetary policies implemented in the last two decades have shunted economies into low-growth paths in which low demand growth and low potential output have fed back into one another (95: VII; also 94: V). Upturns have tended to be quickly smothered whereas downturns have been left to work themselves out; the real economy has been disturbed by waves of private debt and credit creation and contraction, in the course of which speculation has naturally thrived; and there have been large imbalances in current account positions and consequent strains in foreign exchange markets and the trading system. These phenomena have been responsible for mounting unemployment and trade imbalances* (94: V).

As the same thinking governed monetary policy in most industrialized countries, the TDR warned of the detrimental effects on the world economy as a whole: *global demand deficiency is a recipe for waste, unemployment, depressed commodity prices, and conflicts among nations* (94: VI).

Since the mid-1990s, the TDR has emphasized the risk of deflation when monetary policy continues to focus on combating inflation, even in situations where inflationary pressures have dissipated and unemployment is rising, and, in particular, when parallel attempts are made to improve fiscal balances (96: IV; 03: IV). It has consistently urged governments to embark on macroeconomic policies designed for *raising the tempo of investment and growth*, the prime need being to *provide business with lower capital costs, on the one hand, and improved prospects for sales, on the other* (95: VIII).

Using the same line of reasoning, the TDRs since 2009 have responded to widespread concerns that the large injections of central bank money in many countries will sooner or later lead to inflation if governments and central banks do not react early to contain that risk: *In the present situation, with capacity utilization at historic lows and unemployment rising at a dramatic rate, economies will take years to restore a level of capacity utilization where supply cannot keep up with demand, or a level of employment that could trigger demand for higher wages. This will allow central banks to gradually withdraw excess liquidity by selling revalued assets and absorbing excess money supply* (09: VII, VIII).

3.4 Financial policy

The TDR recognized that relatively high interest rates and slower growth over three decades were not only due to the generally more restrictive monetary policy stance; another factor was financial deregulation, which also made both interest rates and exchange rates more unstable, causing *greater reluctance among producers to make long-term commitments, and thus to slow the pace of investment in equipment and structures* (88: XII).

Part Two of TDR 1990 entitled, The Internationalization of Finance, was probably a landmark in determining UNCTAD's view of financial liberalization and its implications for trade, investment and growth. The Report denounced *the ascendancy of finance over industry* as the main source *of instability and unpredictability in the world economy* (90: I). This was at a time when policymakers, a large body of public opinion and most of academia subscribed to the merits of financial deregulation and liberalization and the dismantling of government intervention in the allocation of finance and the functioning of financial markets ("financial repression").

It took the global financial crisis of 2008–2009 for a larger number of observers and policymakers to realize that financial policies in the industrialized countries had been misguided for many years. As expressed in TDR 2009, the crisis is a reflection of the predominance that purely financial activities have gained over real productive activities: *Large parts of the financial markets have come to be entirely detached from real sector activities.* In the view of the TDR, this is the outcome of *blind faith in the "efficiency" of deregulated financial markets*, which *led authorities to allow the emergence of a shadow financial system and several global "casinos" with little or no supervision and inadequate capital requirements* (09: III, IX).

From the perspective of the TDR, the current crisis has shown, once again, the *lack of economic logic* of the financial markets:

> *As participants in financial markets often seek speculative gains by moving before others do, these markets are always "ready for take-off", and eventually interpret any "news" from this perspective. Indeed, they often tend to misread a situation as being driven by economic fundamentals when these are just mirages, such as perceived signs of economic recovery in certain economies or fears of forthcoming inflation. As long as prices are strongly influenced by speculative flows – with correlated positions [in different markets] moving in and out of risk – markets cannot function efficiently* (09: III, IV).

This was not the first time that UNCTAD, through the TDR, raised its voice louder than other institutions on the problems resulting from deregulated financial markets. Earlier issues had already emphasized that the recurring financial and currency crises since the end of the Bretton Woods system were a reflection of fundamental flaws in the system itself, rather than occasional accidents in a system that, in principle, functioned well. The judgement of the TDR on the functioning of financial markets and their management became increasingly harsh over the years, not only because each crisis saw a repeat of the same patterns, but also because the strength of speculative influences and the impacts of the crises on the real sector continued to grow each time, while policymakers failed to draw lessons from the previous experiences.

In 1990, already, the TDR stated: *Financial markets have for some time had an independent capacity to destabilize developing countries: there are now increasing indications of the vulnerability of all countries to financial crisis* (90: I). *Financial markets need to be managed if they are to serve the needs of enterprise* (90: XII).

It is notable, that this was written 18 years before financial instability culminated dramatically in the crisis that erupted in 2008. Repeated warnings would follow against the risks emanating from an insufficiently regulated financial industry for the real economy. Even prior to this crisis, a number of TDRs had called for stronger prudential regulation and a strengthened framework for governance of international banking[2] (91: V; 92: V; 95: IV; 01: I). These were based on the insight that *modern financial markets are organized less to create wealth and employment than to extract rent by buying and selling second-hand assets, and the 'discipline' these markets exert on policymakers reinforces the advantages of existing wealth holders* (98: II).

The issue of systemic risk and derivatives, which has become so prominent in the context of the 2008–2009 financial crisis, was addressed in the TDR as early as 1995, following large trading losses and bankruptcies of several banks (95: Part 2, ch. III). The chapter pointed to the potential of the growing use of derivatives *for causing a crisis that would lead to breakdown in the financial system and its three key functions of credit allocation, payments and the pricing of financial assets*. It concluded that a lesson to be learned from various instances of collapse or extreme strain in derivatives markets was the need for strong legal and institutional frameworks. But even with improved prudential standards, the Report maintained, systemic risk *will continue to be present during periods when high volatility in asset markets endangers participants or is accompanied by major insolvencies* (95: IV).

In 2000, the TDR highlighted the unhealthy macroeconomic and financial developments that had caused the dotcom bubble, and which would later prove to be a major cause of the financial and economic crisis in 2008–2009 namely the build-up of financial bubbles, where *self-fulfilling expectations rather than solid earnings prospects are moving the market.* The TDR then commented: *The mania for cross-border mergers and acquisitions has contributed to a large worldwide financial bubble in technology stocks, whose prices have been rising much faster than productivity… A combination of dwindling private savings, rising private debt, mounting current-account deficits and the bubble in technology stocks, has been sustained by the continuing attractiveness of dollar-denominated assets to non-residents. But this situation cannot continue indefinitely* (00: I, III).

After the experience with recurrent financial and currency crises, culminating in the 2008–2009 crisis and the huge bailouts that became necessary, the TDR noted that it would not be sufficient to tighten prudential regulation over financial institutions and to weed out financial instruments with no social returns: *In the interests of greater stability and reliability of the financial system, the balance between private activity and State involvement in the financial sector may need to be revised fundamentally*. *The heavy involvement of governments and central banks justifies a redefinition of the role of central banks and public financial institutions in supporting real economic activity* (09: VIII).

A continuing problem, which was also cited in much earlier TDRs, is the surrender of governments and central banks to the growing power of financial markets, and the *"confidence game"* the former were playing by taking macroeconomic policy measures *"that may not make sense in and of themselves but that policymakers believe will appeal to the prejudices of investors"* (06: 138, quoting Krugman, 1998). Already in 1988 the TDR had hinted at the problem that macroeconomic policy decisions were often taken with a view to how financial markets would react rather than what the authorities believed to be appropriate (88: IV). After the financial crises in some Latin American countries in the first half of the 1990s, the TDR stated: *The right remedies are unlikely to be found by orienting policy towards regaining the confidence of portfolio managers; their mood swings are, in any case, extremely difficult to keep pace with. A further round of rethinking economic policies may be required* (95: III, IV). This contention is equally valid today, particularly in the current phase of macroeconomic disorientation in many OECD countries.

3.5 Fiscal policy

Apart from taking a critical position with regard to the shift in orientation of monetary policy and the laissez-faire attitude of governments to financial markets, the TDR also frequently criticized the increasing focus on balancing the budget as an objective in itself (85: 52; 88: IV; 95: ch. IV; 96: ch. I; 97: 10; 06: ch. IV; 10: VII). Such a focus implied that fiscal policy ceased to be a tool of demand management, whereas the TDR advocated that a proactive fiscal policy would respond to the needs of the macroeconomic situation. It emphasized that when there was a risk of deflation, the effectiveness of monetary policy would be severely constrained so that fiscal expansion – or at least avoiding fiscal retrenchment – would be particularly important. In 1992, the TDR made it very clear that in some situations *the private sector is unable to take the lead in reigniting growth. This is precisely the context in which it is most apt to adopt Keynesian policies of raising government spending.* (92: IV; also 03: IV; 09: VIII: 35). But mostly, as the TDR observed a year later, *the leading industrialized countries are seeking solutions in the motto of that decade: "Leave it to the markets!"* (93: III).

The TDR's support of a proactive fiscal policy, was vindicated in 2004, when it was able to point to *the processes that have led to the recovery of the world economy and the regional growth patterns in the developing world: The economies that provided growth stimuli to the rest of the world were those where monetary and fiscal policy supported domestic demand growth. This is true for both developed and developing countries* (04: V; also 09: II).

During the 2008 and 2009 financial and economic crisis the TDR's approach to macroeconomic management all of a sudden appeared to become "mainstream", as all major economies implemented strong monetary and fiscal measures in response to the crisis. To some extent, the IMF supported this reorientation also for developing countries, at least at the level of rhetoric. It is important to emphasize that the TDR recommended using monetary and fiscal policy for demand management, and not to bail out financial markets and institutions. With regard to the former, the reorientation of macroeconomic policies turned out to be no more than what the Report later called *a short "Keynesian moment"* (11: V).

In 2010, the TDR again cautioned against an error in fiscal management, as fiscal consolidation was being sought by means of a shift towards fiscal retrenchment. This, it believed, could not only *compromise further recovery since, in most developed countries, especially in Western Europe, private demand, so far, has only partially recovered from its trough* (10: II); but fiscal austerity was also likely to fail to achieve its objective of reducing the budget deficit (11: ch. III). In the same sense as in 1992, when it stated that *by promoting growth, higher expenditures would probably reduce rather than increase deficits* (92: IV), TDR 2011 pointed out that in periods when the private sector lacks dynamism, fiscal retrenchment will lead to lower fiscal revenues and therefore fail to reduce the fiscal deficit and lower the debt (11: VII). Moreover, TDR 2009 refuted the idea that growing budget deficits as a consequence of fiscal stimulus packages require a rise in tax rates as soon as the crisis is over, because *in a growing economy government revenue will normally rise sufficiently at constant tax rates to reduce the deficit* (09: VII). On the other hand, the TDR has always expressed serious doubts about the ability of tax cuts to trigger a revival of investment activity, as much in its first issue as in its most recent one (81: 3 and 4; 11: ch. III).

In this context, TDR 2011, ch. III also elaborated on an often neglected aspect which has a bearing on both the effectiveness of fiscal policy in stimulating aggregate demand and its repercussions on the budget balance: the way in which the public sector spends and taxes is not neutral; changes in different types of revenue or expenditure generate different macroeconomic outcomes (11: VII).

However, the importance accorded by the TDR to proactive fiscal policy as a key tool of demand management does not imply that it has ignored the fundamental need for fiscal discipline: *The size of the domestic public debt does matter, since it may compromise budget flexibility in the future. This is why, in order to be truly countercyclical, an expansionary fiscal policy in a recession needs to be combined with fiscal consolidation when recovery sets in and output growth accelerates* (09: VII).

3.6 Effects of macroeconomic policies in the North on the South

The TDR saw the shift in the macroeconomic policy orientation in the major industrialized countries in the early 1980s as a cause of the depth and length of the crises in developing countries in the 1980s. It led to an abrupt rise in interest rates on the outstanding external debt, reduced bank lending and a contraction of exports to the industrialized countries (81: 3; 82: 3; 84: 12; 90: IV; 99: IV). The debt-distressed countries – mainly in Africa and Latin America – consistently experienced poor growth performances, while others – mainly in East Asia – continued to grow rapidly (albeit also more slowly than in the 1970s) (90: II, III). Weak investment *entailed a slow-down in the pace of the technological up-dating of the productive base* (90: III).

As for the cause of the prolonged weakness of commodity prices throughout the 1980s, which led to significant terms-of-trade losses in commodity-exporting developing countries, the TDR acknowledged the role of oversupplies of many commodities as a result of *the investment boom in raw materials resulting from the previous high level of prices.* But it put greater emphasis on the impact of *attempts by producer countries to increase export earnings in response to their debt problems* (90: IV).

In many countries the foreign exchange losses due to the combined effects of recession and interest rates amounted to 10 per cent of GNP [gross national product], in some cases up to one third, the TDR noted in 1985 (85: 3). In addition, many countries were forced to cut down on new borrowing, so that interest payments represented a multiple of new borrowing, and several countries faced a huge negative net transfer of financial resources (87: VII, also 85: 6).[3]

The external shocks *disturbed not only the external accounts but also fiscal balances: The rise in international interest rates raised interest payments by the public sector and the fall in export earnings reduced government revenues* (89: V).

Altogether, this made the 1980s a “lost decade for development”, which, as TDR 1990 showed, was accompanied by a widening of the income and wealth gap, not only between developed and developing countries, but also among the developing countries. As growth in developing countries’ main export markets remained subdued also in the 1990s, TDR 1999 estimated that the slow growth in the industrialized countries during these two decades had widened the trade deficits of developing countries by as much as 1 per cent of gross domestic product (GDP) (99: ch. IV).

The turnaround in macroeconomic thinking in the major developed countries also had indirect impacts on developing countries. It was reflected in the way the multilateral lending institutions, especially the IMF, responded to the debt and development crisis and their policy prescriptions for borrowing countries (see also sections 4 and 5 below). The TDR deplored the loan provisions of official multilateral lending and the conditions attached to such lending, which became increasingly restrictive and procyclical (82: 2; 93: III; 01: IX). Its concerns about the deflationary bias of their lending conditionalities were echoed much later by increasingly discontented governments of borrowing countries in the course of the 1990s.

Even in periods of severe macroeconomic disorder connected with the payments crises in developing countries since the early 1980s and 1990s, the TDR

did not subscribe to the conventional view on which the conditionalities imposed by the international financial institutions were based. These institutions considered budget deficits, excessive money creation and overvalued exchange rates to be errors of domestic macroeconomic policy. While not dismissing the proposition that such "errors" had played a certain role in some cases, the TDR insisted that external shocks had played a much greater role. It maintained that policies aiming at balance-of-payments and fiscal adjustments, as recommended or imposed by the international financial institutions, had made matters worse. They depressed economic activity and tax revenues, while sharp currency devaluations raised the domestic-currency-denominated cost of debt service and imports. This fuelled inflationary pressures and sharply increased domestic interest rates added to the strong deflationary impact (89: ch. IV).

3.7 Imbalances, macroeconomic policy coordination and mercantilism

Both the level of global demand and its distribution across countries have been a frequent concern of the TDR. In 1994, it argued that *the level of global demand is not an accident of fortune,* and that governments can *regulate the level of demand* and macroeconomic stability in the world economy only when acting collectively (94: VI). Other issues of the Report pointed to the desirability of better international policy coordination, *not on an ad-hoc but on a continuing basis* (85: 12, 13; also 01: 66; 03: 20; 04: 84; 06: 64). The main concern in this context has been to avoid a situation where an overall deflationary stance of macroeconomic policies in developed economies depresses global demand and employment. Also to be avoided are inconsistencies between monetary and fiscal policies, and between the macroeconomic policy orientation of different developed economies, which lead to exchange-rate misalignments, imbalances and instability. The TDR observed that such divergences in macroeconomic policies had become more frequent since the end of the Bretton Woods system (94: VI, 97: III; 00: IV). It regretted the lack of multilateral mechanisms that would ensure symmetrical adjustments in surplus as much as in deficit economies, including the largest national economy (the United States), which could exploit its status as the main reserve-currency country to finance its trade deficit.

In the mid-1980s, the TDR reiterated that the incoherence between the fiscal and monetary policy stance of the United States – which supported high interest rates and tax reductions – together with an inconsistency in the overall macroeconomic stance of the United States (expansionary), on the one hand, and Europe and Japan (deflationary), on the other, was the main reason for the strengthening of the dollar and the growing global imbalances. It believed that these increased the risk of financial instability (85: Part One, ch. I): *It is highly unlikely that the present trends in trade imbalances can continue for long; sooner or later financial markets will become reluctant to accumulate dollar-denominated assets* (85: 11). (Two years later, this episode would end with the stock market crash of 1987.) The TDR pointed to the urgency of better international macroeconomic policy coordination, as *imbalances resulting from disparities in demand creation and interest rate differentials cannot be corrected solely by unilateral policy changes or through the operation of private currency and capital markets* (85: 11).

In the 1990s the TDR again pointed to the need for coordinated measures to correct the current- account imbalances that involved a large deficit in the United States and large surpluses in Europe and Japan: *The experience of the 1980s illustrates the difficulties that can be posed by mounting trade imbalances and misalignments in exchange rates for both the international trading system and international monetary stability* (97: III). The Report suggested that an orderly and non-deflationary correction of these imbalances would require a coordinated policy response, with an emphasis on demand expansion in

the surplus economies rather than monetary tightening in the United States (97: III, IV).

In 2000, the TDR observed that the *new current global macroeconomic imbalances bear some disturbing resemblances to those of the 1970s and 1980s, when the absence of cooperation and coordination among the major economic powers led to systemic breakdown and hard landings. And what we have learnt about the global economy over the past few decades tells us that failure to resolve such imbalances in an orderly manner will be most damaging to growth in the developing countries* (00: I). The hard landing this time around took the form of the global financial crisis eight years later.

In 2004, again, the TDR warned: *Large disparities in the strength of domestic demand persist among the major industrial countries, and increasing trade imbalances between the major economic blocks could increase instability in currency and financial markets* (04: I). However, policymakers failed to acknowledge the need for an internationally balanced macroeconomic management of demand. As a *globally coordinated adjustment, whereby surplus countries would expand domestic demand to compensate for slower growth in the deficit countries, was not forthcoming, a hard-landing scenario was thus predictable* (09: III).

Following the period of successful macroeconomic policy coordination at the peak of the crisis, TDR 2010 identified a new risk in the build-up of imbalances as a result of a premature shift to restrictive fiscal policies in some of major economies. It noted that the restrictive policies *make countries overdependent on exports for their growth and could lead to the re-emergence of current-account imbalances of the kind that contributed to the build-up of the financial and economic crisis in the first place* (10: III).

Regarding the problem of adjustment by countries with large current-account surpluses, the TDR was alarmed at the widespread lack of understanding of international macroeconomic relationships, observing that trade *surpluses are again being valued as a prop to economic activity.* It criticized the mercantilist idea that countries should seek growth by improving their overall competitiveness vis-à-vis others, which was becoming accepted as an axiom: *While one country can improve its international competitiveness (and thus, perhaps, its growth performance), it is not possible for all countries to do so at the same time* (94: V).

On examining the macroeconomic aspects of job creation and unemployment in its 2010 issue, the TDR remarked that the increasing reliance on external demand had induced a tendency to keep labour costs as low as possible*: But if exports do not rise as expected, because other countries pursue the same strategy, or if the production dynamics in export industries do not spill over to other parts of the economy, as in many developing countries – especially in Africa and Latin America – these measures can be counterproductive for sustainable employment creation* (10: IX).

3.8 Incomes policies for employment creation and inflation control

Rising unemployment since the 1980s was attributed by most economists and international organizations to "artificial rigidities in labour markets". This reasoning was in line with the shift in orientation of macroeconomic policies.The TDR has repeatedly argued that this explanation is essentially microeconomic and fails to consider the macroeconomic dynamics of employment and investment. According to the TDR, employment performance is related to the pace of demand growth and capital accumulation: *The curse of unemployment will remain as long as demand is insufficient to induce firms to hire more workers* (93: III; also 95: ch. III; 10: ch. III; and section 3.1 above).

In 1995, the TDR pointed to the fact that *labour markets have, in fact, become considerably more flexible over the past decade without bringing a faster pace of employment creation… and that the worsening performance as regards jobs over the past two decades has gone hand-in-hand with a significant*

slowdown in capital formation (95: VII). It attributed this to restrictive monetary policies and financial deregulation, which pushed up interest rates, rather than to high labour costs or low profitability of the existing capital stock.

The TDR also dismissed other popular explanations of increasing unemployment in the industrialized countries, such as the expansion of North-South trade and technological progress. As early as 1984, the TDR saw high employment in the North and development with job creation in the South as two objectives that were perfectly compatible, provided the orientation of macroeconomics policies in the North would not be deflationary. In a detailed analysis in 1995, the TDR showed that competition from developing countries, combined with the introduction of labour-saving technology, may explain job losses in certain sectors but cannot explain the unemployment problem for these economies as a whole (95: V; 10: ch. III). Later it added that the attempts of many companies in the industrialized countries to improve their international competitiveness by cutting wages would *aggravate the weakness of domestic demand* (04: III) and thus compromise employment.

In 1995, the TDR recommended that the only way to reduce unemployment would be by *raising the tempo of investment and growth through lower capital costs, on the one hand, and improved prospects for sales, on the other* (95: VIII). Following this line of reasoning, TDR 2010 suggested that a strategy for reducing unemployment should start with a stronger focus on private investment, while ensuring that *productivity gains resulting from higher investment are distributed between labour and capital in a way that lifts domestic demand. This strategy was successfully pursued in most developed countries during the so-called "golden age of capitalism" between 1950 and 1973, when unemployment was at historically low levels. Labour markets were then generally much more regulated than today*, but monetary and fiscal policies were geared to *ensuring a high level of employment* (10: IX).

Similarly, TDR 2003 noted that in the process of structural change in East and South-East Asia, including China, *a significant and continuous improvement in productivity across a broad range of industrial sectors was compatible with rapidly rising real wages* (03: VIII, IX). By contrast, countries where wage growth was restrained in an attempt to raise international competitiveness did not achieve *sustained improvements in export and value-added performance to the same extent as countries that succeeded in raising productivity and wages in a virtuous process of capital accumulation and employment growth* (03: XI).

In addition, TDR 2010 recommended several other measures of incomes policy, which, while deviating from the paradigm of labour market flexibility, have a direct impact on employment and poverty reduction and an indirect one through the creation of domestic demand. The Report stated that in formulating more proactive employment-creating policies *it will be necessary to take into account institutional frameworks that differ widely, even among countries at similar levels of per capita income* (10: XI), but it also suggested that governments should consider supporting the building of institutions that facilitate productivity-led growth of labour income, which constitutes the largest driver of domestic demand.

It proposed that elements of such a strategy could be the introduction of a minimum wage and its regular adjustment to productivity growth in the economy, and the (re-)activation of collective bargaining mechanisms together with the creation and empowerment of trade unions (10: XI). In many developing countries it would also be necessary to improve earnings as well as working conditions in the informal sectors of the economy. *One way of doing this is to implement public employment schemes that establish an effective floor to the level of earnings and working conditions by making available jobs that offer such minimum employment terms* (10: XII). Some of these measures, it noted, had helped to improve employment in several developing and emerging market economies after 2002.

The experiences of both the "golden age" and the catching-up process of the East Asian economies had also shown that an incomes policy based on the principle of linking wage growth with productivity growth could also help to keep inflation under control. When wage increases do not exceed productivity gains, unit labour costs remain relatively stable and there is no risk of excessive demand growth from rising consumption expenditures. In such an environment, the scope for expansionary monetary policy that fuels a dynamic investment process and productivity growth is much larger than is usually assumed, as evidenced in more recent episodes of monetary expansion (10: 92; also 00: III).