Rebalancing global growth: The role of an income-led strategy*

4

Main findings

- To ensure a sustainable recovery from the crisis, it is crucial to rebalance the composition of global growth. As seen in Chapter 3, the United States and other deficit countries must take steps to reduce recourse to debt as an engine for economic growth. This chapter addresses the flip side of the rebalancing story. It focuses on the challenge for surplus developing and emerging economies to reduce dependence upon export production by stimulating domestic sources of growth – notably through an "income-led" strategy, which includes a closer link between labour-incomes' growth and productivity gains, and strengthened social protection systems.
- During the years preceding the crisis, the share of wages in GDP declined by over 7 percentage points, on average, in surplus countries for which data are available. Meanwhile, the wage share stagnated during the same period in deficit countries. This means that real wages grew less than justified by productivity gains in surplus countries. Ensuring a better relation between wages and productivity growth in emerging surplus countries would help exploit domestic sources of growth in those countries while at the same time boosting the world economy and contributing to its rebalancing. The recent experience of Brazil provides an important illustration of how this can be achieved.
- Strengthened social protection systems also play a key role in rebalancing growth in emerging surplus countries, especially in Asia. Building up health-care, education and pension systems could help encourage middle-class households to reduce precautionary savings and increase consumption. This would at the same time reinforce human capital and economic potential. Among poor

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and vulnerable households, a social protection floor involving elements such as income support and cash transfers not only translates readily into consumption, but also paves the way for higher investment in productive assets and creates new business opportunities. However, the design of social protection systems requires careful attention in order to avoid distortions in employment and investment decisions.

- Policy simulations carried out for the purposes of this chapter suggest that measures aimed at ensuring a closer link between wages and productivity, as well as strengthening and extending coverage of social protection systems in Asian surplus countries, including China, would be highly effective in boosting employment and growth prospects within Asia and across other regions. The effectiveness of income policies and social protection policies is further enhanced when they work in tandem. The policy simulations suggest that such income-led policies would be more effective for boosting global growth and job creation than targeting deficit reduction through fiscal consolidation.
- Currency appreciation in surplus countries is often considered to be a crucial policy measure for ensuring global rebalancing. Such measures, however, will tend to depress growth in surplus economies and not raise import demand significantly. For example, according to the policy simulations, a 20 per cent nominal depreciation of the US dollar vis-à-vis the Chinese yuan would produce only a relatively small reduction of the current account surplus of China while exerting upward pressure on unemployment in that country. Instead, an income-led strategy in Asian surplus countries (encompassing improved social security and nominal wage increases of 10 per cent – roughly what is needed to restore the wage–productivity linkages) would produce higher growth and lower unemployment in both the Asian region and other regions.

Introduction

Chapter 3 examined how growth can be rebalanced in debt-ridden countries. The purpose of this chapter is to explore how growth can be made more sustainable in surplus countries, with particular attention to the role of income and social protection policies in stimulating domestic aggregate demand in developing and emerging economies.[1]

The pre-crisis path of global growth based upon an excessive reliance on export-led growth in some countries and debt-driven demand in others is no longer sustainable (Torres, 2010). The current account surpluses accumulated particularly over the last decade by certain developing and emerging economies are mirrored by the growing spiral of debt-driven consumption and housing investment that has characterized economic growth in the United States and some European countries, such as the United Kingdom and Spain (IILS, 2008 and 2009; Rajan, 2010). The vulnerability of excessive dependence on external sources of demand was confirmed by the collapse in world trade that occurred over late 2008 and early 2009, triggered by the crisis of debt-driven growth in the North (Baldwin, 2009; Yi,

1. Hence, OECD surplus countries such as Germany and Japan are not addressed within the scope of this chapter.

2009). In addition to the trade surpluses, corporate and household savings are increasingly contributing to current account surpluses particularly in Asian surplus economies (Prasad, 2009).

To address these imbalances, global leaders and international organizations have called for policy measures that will attain a more balanced pattern of global growth in the post-crisis period (IMF, 2010; UN, 2010a and 2010b). Policy analysis and proposals include measures designed to strengthen domestic demand in surplus economies (G20, 2009 and 2010; UNCTAD, 2010; ILO, 2010a and 2010b; ILO and IMF, 2010).

This chapter is organized in two parts. Section A briefly discusses some of the main factors behind the need for a rebalancing of the export-led growth model. The discussion focuses particularly on the policy challenge to improve income and social protection systems as crucial elements in stimulating domestic demand in surplus countries. Section B then examines different policy options for reducing reliance on export-led growth while maintaining strong growth and employment dynamism in these economies.

A. Surplus economies: The challenge to rebalance sources of growth

The export-led model of growth helped promote development…

The export-led path of development has been a vital source of economic growth for many developing and emerging economies, particularly in Asia. Labour productivity has risen largely due to technological change, business investment and scale economies, as exporters tapped new mass markets which, in turn, fuelled new job growth (ILO, 2010e). Particularly among more recently industrializing countries, this export growth has been predominantly in price-sensitive, labour-intensive consumer goods and services. In these cases, output growth has not always translated into the creation of better-paid, stable or formal sector jobs. While demand for labour has created important new opportunities, it has often involved informal jobs, poor working conditions, hours and wages, particularly in the lower tiers of global supply chains (Barrientos, 2007; ILO, 2009a; OECD, 2009; ILO, 2010e; Posthuma and Nathan, 2010).

Over the past three decades, the share of low- and middle-income countries in world exports for goods rose from 16 per cent in 1986 to over 30 per cent in 2008 and from 13 per cent in 1986 to 20 per cent in 2007 for services (Milberg and Winkler, 2010). The export drive in China has been particularly pronounced, with exports growing from 3 per cent of GDP in 1970 to nearly 43 per cent in 2007, a trend mirrored in Argentina, India, Mexico and the Republic of Korea among others (ibid.).[2] Exports of goods and services as a share of GDP in Asia and Africa rose particularly over the 2000s, while Latin America experienced its strongest export growth over the 1990s. This export orientation has increased the reliance of developing countries on export revenues.

2. However, it must be borne in mind that export contribution to growth can be overestimated in countries such as China, where exports contain a large import quotient (see for example the CPB method: www.cpb.nl).

…but created excessive export dependency upon countries driven by debt-led demand.

The Asian region has long relied upon exports as a driver of growth. However, it was only after the Asian crisis that many countries in the region shored up greater foreign exchange reserves and larger current account surpluses as a buffer against future instability (ADB, 2009; Mendoza, 2010).[3] East Asian countries overall increased their current account surpluses from US$16.3 billion in 1997 to US$294 billion in 2006.[4] Meanwhile, Latin American countries turned their aggregate regional deficit of US$48 billion in 1997 into a surplus of US$48 billion by 2006.

As a counterpoint to strengthened external surpluses in developing and emerging economies, the growth path adopted in the United States and several other large advanced economies, including the United Kingdom and Spain, was driven by a rising spiral of debt-fuelled consumption and housing investment. As imbalances deepened, the United States became the world's consumer of last resort. With less than 5 per cent of the world's population, the United States came to consume over 20 per cent of world output. Conversely, with about 20 per cent of the world's population, China was consuming just 2–3 per cent of world output prior to the crisis. These diverging growth paths of surplus and deficit countries constitute a set of "fault lines" underlying the current crisis (Rajan, 2010).

Attaining sustained global growth will require rebalancing the composition of global sources of growth. For deficit countries, this means reducing debt-led demand and current account deficits, while also raising the saving rate and avoiding protectionist measures. Meanwhile, the challenge for surplus countries will be to stimulate domestic sources of growth.

Export-led growth will continue to be an important source of growth and job creation for many developing and emerging economies. Export-oriented growth can be compatible with balanced growth, but this requires a shift from the pre-crisis model that was dependent upon exports as the key engine of growth and the accumulation of massive current account surpluses (ADB, 2009; Chandrasekhar and Ghosh, 2010). Instead, the crucial policy challenge is to put in place measures to attain a sustainable balance between external and domestic sources of demand (Rodrik, 2008; ILO, 2010e).

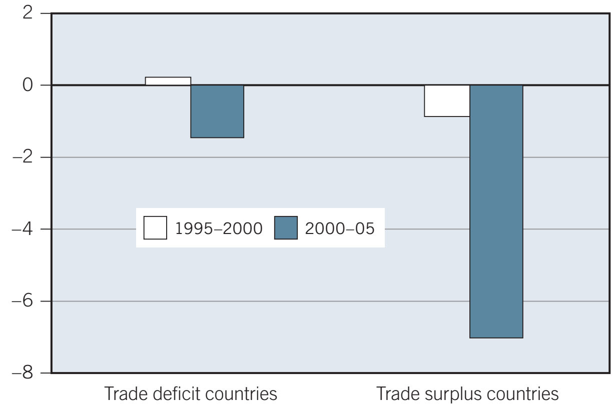
The following discussion explores some of the factors behind two policy dimensions that will be crucial in stimulating domestic sources of growth in surplus countries: adjustments in wage shares; and a reduction of excessively high savings rates.

A more balanced model of global growth, which stimulates domestic demand in surplus countries, will need to address wage gaps…

Many surplus countries have built export competitiveness on a comparative advantage of low labour costs. Price competition has created pressure to control

3. It is estimated that two-thirds of global foreign exchange reserves are now in the hands of central banks in developing and emerging economies (OECD, 2010a).
4. This discussion focuses on the surplus economies; it does not address all developing and emerging economies, among which great heterogeneity exists. For example, no single pattern emerges for current account balances across Asian economies; there are both surplus and deficit countries. Rather, four broad types of behaviour have been identified: (a) middle-income countries that have raised current account surpluses since the Asian financial crisis; (b) high-income surplus countries and areas (Hong Kong, China; Singapore; and Taiwan, China); (c) low-income surplus economies (China); and low-income deficit economies (India and Viet Nam) (Adams and Park, 2009).

Figure 4.1 Change in wage share in trade surplus and deficit countries (1995–2000 and 2000–05)



Note: The figure shows changes in the share of wages in GDP, in percentage points, in (i) countries that had a trade deficit, on average, during 1995–2000 and 2000–05 and (ii) countries that had a trade surplus during the same periods. See Appendix A for the list of deficit and surplus countries.

Source: IILS estimates based on data from World Development Indicators, 2010, IILS, 2008 and UN System of National Accounts.

production costs, which often has involved strong wage moderation. Thus, productivity growth has not always translated into commensurate wage gains (Akyüz, 2010). Instead, rising income inequalities and lagging wage shares have characterized much of the process of global economic growth over the past two decades (ILO, 2008a and 2008b).

Declining wage shares bear a relationship with the trade balance for a set of 69 advanced, emerging and developing economies. Among the 37 deficit countries for which data are available, the share of wages in GDP stagnated during the period 2000–05. Significantly, the wage share declined over both periods in *surplus economies*. In particular, during 2000–05, the share of wages in GDP declined by over 7 percentage points, on average, in the 32 surplus economies for which data are available (figure 4.1). These findings suggest that the gains from export-led growth have not been shared equally between profits and wages in the majority of the countries examined.

This trend of declining wage shares underscores the policy challenge for the post-crisis period to follow a more balanced and socially inclusive approach. It has been possible for export-oriented growth to increase the absolute level of domestic consumption, even under conditions of declining wage shares, as seen in China. However, more balanced and inclusive growth in the future must involve greater attention to the role of incomes in stimulating domestic growth through the positive effect of increased earnings on domestic effective demand and household consumption levels. For example, rebalancing toward greater domestic-led consumption growth in Asia will rely largely upon its emerging middle class, which represents an enormous potential consumer market, but which remains fragile as the majority lies in the US$2 to US$4 range (ADB, 2010). Resources already exist to rectify this imbalance, at least among the surplus countries. The recent experience of Brazil suggests that, if carefully conducted, such a policy can be successful.

This pattern is under growing pressure to change. Wage pressures are rising in China, and also in other Asian export manufacturing economies, due to a combination of social, demographic and economic factors (box 4.1).

…strengthen social protection…

Social protection also has an important role to play in stabilizing consumption over the cycle and strengthening human capital. Low household consumption

Box 4.1 Wage pressures in Asia's global factories

Wage pressures have built up in Asian factories that fuelled the boom of export production. In mid-2010, industrial action in Cambodia halted production in ready-made garment factories, leading to intense discussions on changing the level of the existing minimum wage in this export-dependent sector. Industrial action at a number of factories in China has also led to pressure for wage adjustment.

Prior to the crisis, wage pressures were already manifest. In 2008, a record number of 762 strikes erupted throughout Vietnamese export factories, due primarily to double-digit inflation (particularly in food and oil prices). This social pressure contributed toward the setting of a new minimum monthly wage for workers in foreign-owned companies of US$52 in early 2010. In the case of China, a combination of structural factors is at play. These include tighter labour markets for skilled workers, demographic shifts, changes in labour relations, rising expectations among the industrial labour force (including migrant workers) in the coastal export zones and new labour regulations (Chan, 2010; OECD, 2010a). For example, the Labour Contract Law, which came into force on 1 January 2008, expanded employee rights and protections. Ambiguity over the legality of strike action by workers over wages was an important factor making recent labour disputes difficult to control.

and high precautionary savings among middle-class households in many surplus economies are explained largely by poor social protection systems and an underdeveloped financial system (Woo, 2008), which consequently create a private burden of expenditure on housing, education and healthcare (Chamon and Prasad, 2008). Weak domestic demand was further reinforced by industrialization policies that favoured output for exports at the expense of domestic consumption.

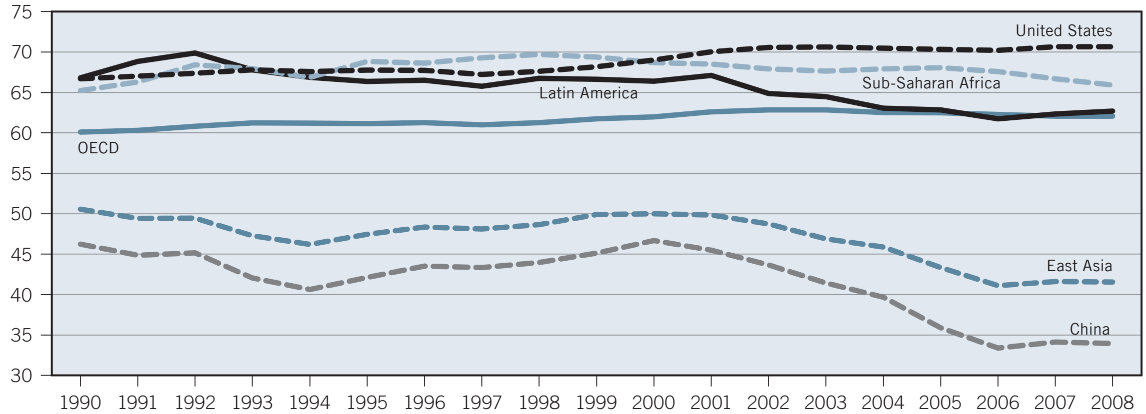
Throughout the 1990s and 2000s, household consumption as a share of GDP in East Asia fluctuated between 40 and 50 per cent of GDP. In China over the past decade, as economic growth and net exports rose at a substantial rate, household consumption declined from around 46 per cent of GDP in 2000 to below 36 per cent in 2008[5] (figure 4.2). In contrast, household consumption in the United States rose to around 70 per cent of GDP over the 2000s. For the OECD economies and Latin America, household consumption remained between 60 and 70 per cent over the period. High household consumption in Africa reflects low earnings and poverty that mean a large proportion of household income is spent on basic necessities.[6] Building up social protection, quality public healthcare and education and solid pension funds could encourage middle-class households to reduce precautionary savings. Social protection and education also can contribute to enhancing growth prospects by maintaining human capital.

…and provide income support for poor and vulnerable households.

Strengthened social protection is equally important for raising consumption by poor and vulnerable households, which save little and have a high marginal propensity to consume. Greater social expenditure, such as income support and cash

5. Not only are household savings large in China, but the largest increase in savings in the build-up to the crisis came from the corporate sector (rising to 20 per cent of GDP) (OECD, 2010a).
6. Low savings rates in Africa have also been associated with the costs involved with formal financial markets, strategies for risk management as well as investments in household-level productive activities (Aryeetey and Udry, 2000).

Figure 4.2 Household consumption, 1990–2008 (percentage of GDP)



Source: World Development Indicators, 2010.

transfers, translates effectively into consumption. Such resources are often used for investment in productive assets, such as improvements in agriculture or the family dwelling, as well as urban micro- and small enterprises, which contribute to raising domestic output and job creation.

The ILO estimates that 80 per cent of the world population lacks adequate social protection coverage (ILO, 2010c and 2010d). Policy responses to the crisis involved various types of support to strengthen social protection mechanisms, revealing the recognition among policy-makers of the role of social protection as a socio-economic stabilizer, as well as its role in accelerating economic recovery. Looking toward post-crisis growth policies, an enhanced role of social protection and poverty reduction policies in developing countries is now seen as a necessary component to obtain sustainable global growth (Canuto, 2010). A broader, systemic approach that embeds social protection within development policy would be effective in unleashing greater domestic consumption, as well as addressing the new forms of vulnerability that have emerged as a result of engagement in the global economy (Cook and Kabeer, 2010; Prasad and Gerecke, 2010).

Attaining a growth model in surplus economies that maintains a better balance between export production and income-led domestic demand will necessarily involve raising the wage share to a more equitable level, in line with productivity gains. In addition, strengthened provision of social protection and other public social goods will play a crucial role in helping to reduce precautionary savings by the middle class, while providing income support to raise the disposable earnings of low-income and vulnerable groups.

This policy approach is in line with the Global Jobs Pact. The Pact emphasizes the macroeconomic interaction of employment policies, minimum wage mechanisms and social protection policies with fiscal and monetary policies as a central focus of strategies for stable, sustained and balanced growth (ILO, 2009b; ILO and IMF, 2010).

The next section explores different policy options for reducing reliance on export-led growth, while maintaining strong growth and employment dynamism.

B. Policy options for addressing global imbalances and recovery of growth

To address the imbalances described in the previous section, two types of policy responses have been advocated: (a) reducing growth led by private debt in deficit countries – mainly through tighter fiscal policy; and/or (b) boosting growth led by domestic demand in surplus countries, through some combination of currency adjustments, supportive wage and social protection policies and development of internal sources of growth. The employment impacts of tighter fiscal policy have been analysed in Chapter 3. The purpose of this section is to assess the employment effects of the second set of policy measures. This is done by examining three scenarios derived from a model of the world economy developed for this report (see Appendix B). Importantly, the model investigates the short-term effects of different policy options for rebalancing the world economy. It therefore does not consider the longer term impacts that policies may have on the structure of the economy. In addition, the model does not take into account the possible reaction of financial markets to policy changes. Despite these important caveats, the model helps illustrate the immediate post-crisis paths arising from different rebalancing policies. The main outcomes of these simulations are presented in table 4.1 and a detailed analysis can be found in Von Arnim (2010).

Currency changes yield conflicting employment effects and limited reductions in external deficits…

It is often argued that currency realignments will be sufficient for rebalancing economic growth. This would involve appreciation of the exchange rate in surplus countries vis-à-vis deficit countries. However, evidence suggests that currency realignments on their own are insufficient to achieve the transition to a balanced growth mode[7], not the least as the causes underlying current account surpluses and high savings rates are partly socio-structural in nature. Therefore, when undertaken, in combination with other policy measures, a credible realignment of exchange rates could be part of the rebalancing process (UNCTAD, 2010; Ma and Yi, 2010; OECD, 2010b; McKinnon and Schnabl, 2009).

As an illustration, the effects of an appreciation of the yuan against the US dollar have been estimated on the basis of the above-mentioned model. More specifically, the model is used to simulate the short-term effects of a 20 per cent nominal depreciation of the US dollar vis-à-vis the Chinese yuan. The size of this shock comes close to what is conventionally discussed. In this first policy scenario, Chinese exports become more expensive, while imports into China are more competitive. The result is a contraction of China's current account surplus of almost 7 per cent (Von Arnim, 2010), which is relatively small in view of the current size of the global imbalance. Importantly, relative to China's GDP, the current account surplus does not shrink noticeably. Moreover, domestic demand does not shift strongly enough towards non-Chinese products. The unemployment rate in China rises by more than 1.8 percentage points, and it remains broadly unchanged in the United States and other advanced economies.

7. Exchange rate appreciation of the yen in the mid-1980s failed to boost domestic demand and, instead, led to stock-market and real-estate bubbles and a shift of investment by Japanese companies to lower-wage Asian countries (Rajan, 2010).

Table 4.1 Changes in unemployment rates as a result of three policy options for rebalancing the world economy (in percentage points)

	World	Advanced economies	United States	Europe	Japan	Emerging& developing economies	Asia	Latin America	Africa	Brazil	Russian Federation	India	China	South Africa	Energy exporters
Yuan appreciation	**0.1**	**0.0**	0.1	–0.1	0.0	**0.4**	–0.3	0.1	0.0	–0.1	–0.1	–0.1	1.8	–0.2	–0.1
Asia rebalancing	**–0.3**	**–0.1**	–0.1	–0.1	–0.3	**–0.6**	–0.6	–0.2	–0.1	–0.1	–0.2	–0.2	–1.4	–0.1	–0.4
US deficit cut	**1.2**	**1.3**	3.1	0.3	0.6	**0.9**	0.8	2.2	0.2	0.3	0.5	0.4	0.7	0.3	1.2
Memorandum item: Unemployment rate, 2008	**6.2**	**6.1**	5.7	6.9	3.9	**6.4**	6.2	5.2	16.3	8.1	6.3	7.3	4.2	21.4	6.8

Note: The table provides differences in percentage points between estimated unemployment rates arising from each policy shock and actual unemployment rates. For example, a shock associated with Asian rebalancing would reduce the world unemployment rate by 0.3 percentage points (second figure in the first column). The three policy options considered in the Table are: (i) a 20 per cent nominal depreciation of the US dollar vis-à-vis the Chinese yuan (first row); (ii) improved social protection and a 10% wage increase in Asia (so-called "Asia rebalancing"; second row); and (iii) a 2 percentage-point cut in the US fiscal deficit relative to GDP (third row).

Source: IILS, based on Von Arnim (2010).

Over the longer term, a stronger positive effect can be expected from improved competitiveness in the US and other advanced economies. Likewise, the yuan appreciation may gradually boost the non-tradable sector of China, thereby dampening the negative impacts of output and employment associated with the currency appreciation. As mentioned, these longer-term effects cannot be captured in the model which is short term in nature. However, the immediate socio-economic implications associated with the currency appreciation make this a difficult option to pursue politically in China.

The weak impact of currency appreciation on growth patterns tends to corroborate the view of some authors that the root cause of global imbalances lies in national imbalances (ILO, 2008b). According to this view, savings and investment patterns dominate external borrowing requirements (Von Arnim, 2009).

…in contrast, boosting demand in surplus countries would support jobs and cut imbalances worldwide…

There is evidence that policy measures aimed at ensuring that labour income grows in line with productivity, in addition to strengthening and extending coverage of social protection systems, can be highly effective in boosting overall growth prospects (UNCTAD, 2010).[8] The effects of these policies are especially beneficial in emerging economies where higher income among low- and middle-income groups can lead to a virtuous cycle of greater consumption and investment, nurturing business opportunities and product innovation to meet new demand, and in turn leading to higher employment and income.

For instance, policies adopted by the Brazilian government prior to the crisis were aimed at addressing income inequalities, raising the minimum wage and

8. In the case of China, calculations suggest that the decline in disposable household income as a share of GDP is largely responsible for the relative decline of household consumption in aggregate demand (UNCTAD, 2010; Aziz and Cui, 2007).

strengthening the social protection system. This not only sustained consumption, but also stimulated business investment and the creation of new products that meet new demand – a key factor behind the successful crisis recovery of Brazil (Barbosa, 2010). Likewise, the impacts of the Chinese stimulus package appear to support the thesis that boosting domestic demand can support internal – hitherto unexploited – sources of economic growth and job creation.[9] The OECD attributes one-third of global growth in 2010 to China's double-digit expansion that was fuelled by monetary and fiscal stimulus (OECD, 2010a).

Policy instruments that can ensure appropriate rates of income growth include setting and adjusting regularly minimum wages (as discussed in box 4.2) in addition to broader measures to reinforce social dialogue and wage bargaining (ILO, 2008a).

Market forces themselves have exerted upward pressure on wages in some Asian countries. In cases where wage increases have been attained, these are often the result of company-level decisions, rather than arising from broad-based wage bargaining within a domestic industrial relations system.[10] Hence, in order to become a sustainable and regularly adjusted component of an income-led growth strategy, such wage adjustments must be structurally embedded within labour market institutions and agreed wage-setting mechanisms.

More generally, the effectiveness of wage policies and social protection policies is further enhanced when they work in tandem (ILO, 2010d). Thus, both income and social protection policies have an important role to play in post-crisis rebalancing, through their effect in distributing the benefits of growth more widely domestically and contributing to more sustainable and inclusive global growth.

To illustrate this, the second policy scenario simulates the effects of improved social security and higher wages in Asia on global rebalancing and recovery. The policy changes are implemented in the Asian surplus region, including China, as (a) a decrease in the net tax rate by 10 per cent (to capture higher social transfers) and a decrease in the propensity of wage earning households to save by 10 per cent (to capture reduced precautionary savings associated with strengthened social protection), and (b) an increase in nominal wages by 10 per cent. The results are clearly positive for employment in all regions (second row in table 4.1). Higher growth in Asia represents increased external demand for the rest of the world and leads to a cut in China's current account surplus relative to GDP (Von Arnim, 2010).[11]

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9. Chinese stimulus expenditures in 2009 accounted for the equivalent of 2.1 per cent and in 2010 totaled 2.3 per cent of the country's 2008 GDP (Prasad and Sorkin, 2009). Some studies forecast that the Chinese fiscal stimulus package had the potential to boost domestic demand sufficiently to raise internal job creation by as much as 17 to 20 million new jobs in non-farming sectors (He, Zhang and Zhang, 2009).

10. Some companies express concern that granting higher wages may affect their profits and the final retail price of their goods on global markets. In some cases, companies experiencing rising wage pressures have reportedly decided to shift all or part of production to lower-wage areas in China and other Asian countries, such as Bangladesh, India, Indonesia, the Philippines, Thailand and Viet Nam. These practices pose a challenge for ensuring a closer link between labour income and productivity, which if undertaken in the majority of the enterprises and sectors would be beneficial to Asian economies as a whole.

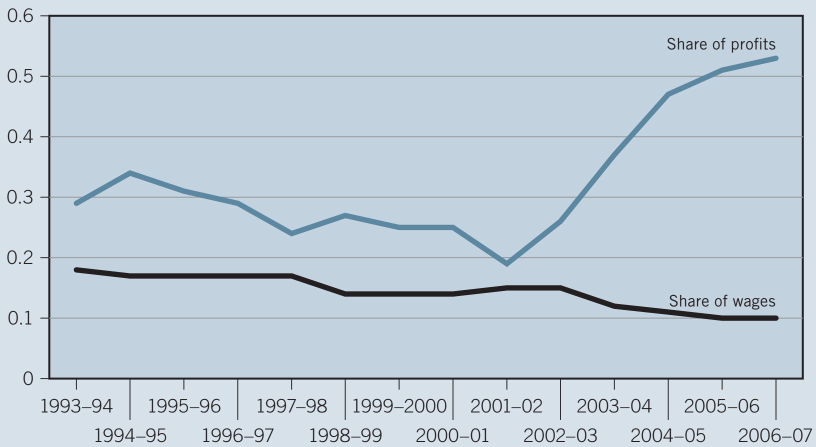
11. As shown in the detailed results (Von Arnim, 2010), the Asian aggregate region grows by 1 percentage point, but its aggregate external deficit increases slightly. That is largely due to the fairly strong in-region growth; the Asian deficit region's current account relative to GDP worsens by 0.5 percentage points, outweighing the Asian surplus region's reduction. Income inequality – as measured by the functional distribution of income – decreases. However, increases in the wage share should be interpreted carefully. Principally, wage share changes in this model are cyclical, and it is not necessarily obvious that they will last. Still, if higher real wages become structurally embedded institutionally, they can translate into improvements in the personal distribution of income, even if productivity growth catches up. Fiscal balances across Asia remain sound.

Box 4.2 Improving wage share through implementing and enforcing minimum wage legislation

Redistribution via increased wage share can contribute towards raising aggregate demand because the marginal propensity to consume out of wages is higher than the marginal propensity to invest out of profits (Lavoie, 2009; Stockhammer, Onaran and Ederer, 2007).

In India, for example, the share of profits in output has risen sharply since 2001–02, reducing wage share and depressing purchasing power (figure 4.3). An important mechanism through which wage share can be adjusted is minimum wage legislation. In India, the Minimum Wage Act of 1948 is an important piece of labour legislation. However, the minimum wage is set only "in certain employments or occupations" and therefore not all wage earners (especially casual wage earners) are covered. A major step towards improving the coverage was made when the Central Government introduced the concept of an indicative national minimum wage floor in 1996, currently set at 100 rupees or about US$2 per day. This was in response to the observation that high levels of poverty and inequality persist despite high rates of economic growth in recent years.

Figure 4.3 Declining wage share in India, 1993–2007



Source: Annual Survey of Industries, various years.

However, the national minimum wage floor is not binding on the States. If the existing minimum wage laws were adopted and implemented more effectively, it would help to increase purchasing power and improve domestic demand. Data simulations show that the effects of either making the national minimum wage floor compulsory or extending the coverage of State-level minimum wages would be considerable (Belser and Rani, 2010). Approximately 73 million out of 173 million wage earners throughout India do not receive minimum wages. About 30–40 per cent of these low-paid wage earners belong to poor families. Extending the minimum wage to all of them could lift their wages and would contribute to reducing both inequalities (9 per cent) and poverty incidence (8 per cent) in India. This example demonstrates the role of minimum wages as an effective redistributive tool.

Of course, an income-led strategy should go hand in hand with continued efforts to raise labour productivity and improve the responsiveness of enterprises to new demand (ILO, 2010e).[12] For example, China has been particularly effective in tapping foreign direct investment as a source of technology acquisition and productivity enhancement, in addition to domestic investments in science and

12. Towards this aim, policy measures in other domains are also necessary, such as ensuring availability of credit and provision of incentives to invest in technological change and upgrading installed capacity, including for smaller and medium-sized firms. Productive upgrading also calls for raising the quality and supply of training and skills development, to build requisite skills among the workforce. Industrial policies can focus attention where greatest potential exists to boost the sectoral composition of growth.

technology. This has played an important role in raising economic growth and labour productivity in China. Other countries wishing to follow an income-led growth path should at the same time make efforts to improve access to new technology and enhance productivity.

…which would clearly be better for employment than rebalancing world growth by reducing demand in deficit countries.

Evidence presented in Chapter 3 suggests that fiscal austerity measures tend to depress world growth. The third policy scenario confirms this, and it also shows that these measures would do little to reduce global imbalances, but would entail considerable cost in terms of higher unemployment (third row in table 4.1). For instance, a cut in US public borrowing as a share of GDP by 2 percentage points – which is the size of the cut that is often advocated – would lead to a sizeable contraction of GDP in the United States. According to the model, the US unemployment rate would increase by over 3 percentage points and the US external balance relative to GDP would improve by about 1 percentage point relative to GDP, mainly arising from falling imports (Von Arnim, 2010). The latter, in turn, would lead to a downturn in all the regions, especially in the US main trading partners – Canada and Latin America.

Policy considerations

There is widespread agreement that rebalancing of global growth will require policies in surplus economies to obtain a more sustainable balance between export-oriented production and domestic sources of growth. Raising labour income commensurate with gains in productivity has been shown in this chapter to be a necessary policy shift for surplus countries, and as such should be an integral component within a broader income-led growth strategy. Likewise, strengthened social protection systems (including well-designed policies for health care, education and pensions) can impact favourably upon reducing precautionary savings. Such policies would also exert a positive supply effect by boosting human capital and creating new business opportunities associated with the enlargement of the market to include low-income groups. Policy measures introduced during the crisis that involved income support and enhanced social protection provide positive lessons in this regard, as they have proved effective in sustaining both domestic demand and domestic sources of growth (ILO, 2010a and 2010d).

The driving question behind this chapter has concerned how domestic growth can be stimulated in surplus countries through policy measures that give primacy to income-led growth paths. What are the elements for this necessary policy shift?

The strengthening of mechanisms for wage setting, involving bargaining between employers and workers representatives, is crucial in this respect. Wage-setting mechanisms can help reduce wage inequalities, particularly as experienced in rapidly growing economies. Social dialogue and extension of collective bargaining coverage can ensure that wages are more responsive to productivity gains (ILO, 2008). Such policy mechanisms affect earnings in the formal economy, but can also be designed to influence wage patterns in the informal economy. Wage-setting in the public sector also can serve as a wage anchor.

Minimum wages are particularly important in setting a wage floor and redressing inequalities at the bottom of the wage scale, for categories of workers not covered by collective bargaining mechanisms, such as low-skilled workers, the self-employed, informal and vulnerable workers.[13] Minimum wage mechanisms work best when kept simple and manageable, with adjustments conducted on a regular basis. Credible enforcement mechanisms also help improve effective implementation of minimum wage legislation (ILO, 2008a). Various countries are implementing relevant policy responses in this regard. For example, in order to enhance the effectiveness of minimum wage policies, a series of reforms are being introduced in the Philippines and Viet Nam. In the case of China, new laws on wage regulations are being developed, particularly in response to increases in wage disputes and widening income inequality. Many other countries in Asia (e.g., Mongolia) are following suit through initiating various reforms in wage policies (ILO, 2010f).

Putting in place a stronger and more extensive system of social protection (including provision of basic services such as quality health and education and strengthened public and private pension systems) can promote the well-being of society. Social protection systems also contribute to the sustainability of economic growth by building human capital and thereby boosting future labour productivity. Social protection policies constitute important countercyclical policies that can help sustain aggregate demand in times of crisis. For poor and vulnerable households, mechanisms that introduce, strengthen and extend the social protection floor (such as income support and conditional cash transfers) can prevent extreme poverty and open new market opportunities, while also contributing to boost aggregate demand.

Since the 1990s, Latin American countries have made efforts to put in place an effective social security system (Maurizio, 2010; Mesa-Lago, 2008). This has helped exploit domestic sources of growth and has contributed to make Latin America more resilient to crises – as the relatively good performance of these countries in the wake of the 2008 crisis shows (Barbosa, 2010; Maurizio, 2010). Other recent social protection policy initiatives include the extension of pensions and minimum health insurance coverage to rural China. Also, China has launched social security reforms that have improved coverage of the social safety net (with the exception of unofficial migrants) (OECD, 2010a).

Wage adjustments and social protection policies alone are not a silver bullet. Nor can they be implemented in isolation. The policy agenda to attain more balanced growth will require greater coherence between different policy domains. This will involve policies to boost investment, technological development, labour productivity and human capital formation, along with income-led strategies as key components to lay down the structural conditions for sustainable growth.

13. In the formal sector, minimum wages should not be considered a substitute for collective bargaining, which can ensure more accurate wage adjustments.

Appendix A

List of deficit and surplus countries

1995–2000		2000–05	
Surplus	**Deficit**	**Surplus**	**Deficit**
Algeria	Argentina	Algeria	Australia
Armenia	Bahamas	Argentina	Bahamas
Australia	Belgium	Armenia	Bahrain*
Austria	Brazil	Austria	Bulgaria
Bahrain*	Bulgaria	Belarus*	Canada
Belarus*	Chile	Belgium	Colombia
Canada	Egypt	Brazil	Costa Rica
Colombia	France	Chile	Croatia
Costa Rica	Germany	Egypt	Cyprus
Croatia	Greece	Germany	Denmark
Cyprus	Hungary	Greece	Estonia
Denmark	Iceland	Hungary	Finland
Estonia	Italy	Kenya*	France
Finland	Jordan*	Kuwait*	Iceland
India*	Kenya*	Lesotho	India*
Ireland	Latvia	Luxembourg	Ireland
Japan	Luxembourg	Malta	Japan
Korea, Rep. of	Mexico	Mexico	Italy
Kuwait*	Mongolia	Mongolia	Jordan*
Lesotho	Netherlands	Namibia	Korea, Rep. of
Lithuania	Nicaragua	Netherlands	Latvia
Malta	Niger*	Paraguay	Lithuania
Namibia	Poland	Poland	New Zealand
New Zealand	Portugal	Portugal	Nicaragua
Nigeria*	Singapore	Saudi Arabia*	Niger*
Norway	Slovenia	Singapore	Nigeria*
Oman	Spain	Slovenia	Norway
Paraguay	Sri Lanka	Sri Lanka	Oman
Philippines	Sweden	Sweden	Philippines
Qatar	United Kingdom	Switzerland	Qatar
Romania	United States	Tunisia	Romania
Saudi Arabia*		Venezuela, Bolivarian Rep. of	South Africa
South Africa			Spain
Switzerland			Thailand
Thailand			Turkey
Tunisia			United Kingdom
Turkey			United States
Venezuela, Bolivarian Rep. of			

Note: Wage shares are calculated as the share of labour incomes in per cent of GDP, adjusted for the incidence of self-employment in total employment. * Wage shares not adjusted for the incidence of self-employment in total employment, owing to lack of data.

Appendix B

Assessing rebalancing policies: A modelling exercise

The model applied here allows investigation of a variety of scenarios. It falls within the general category of computable general equilibrium (CGE) models. A CGE model is based on a social accounting matrix, which depicts detailed data on relations of production and distribution between the main socio-economic agents in an economy. The model adds behavioural relationships to the accounting, with econometric evidence being used to calibrate relevant parameters. The model can then be used to simulate responses to assumed shocks and policies. For simplicity, and given the analysis in Chapter 5, the model does not cover the financial side of the economy.

The model covers 160 countries. It is aggregated into 16 countries and regions: the countries are the United States, Japan, Canada, and the BRICS (Brazil, Russian Federation, India, China and South Africa); the regions are Africa, Asia, the Eurozone, the rest of Europe, and Latin America and the Caribbean.[1] Additionally, countries with more than half of their exports concentrated in oil and gas products are grouped together. Further, Asia and the Eurozone are disaggregated into surplus and deficit regions.

The model covers product and labour markets in simple but comprehensive fashion. For example, consider price and quantity setting in both markets. Product markets feature a "macroeconomic firm" that uses domestic factors and imported intermediates from all other regions to produce domestic value added. The firm marks up on domestic labour costs; the supply price is then a weighted average of domestic factor and import cost. Foreign cost pass-through is limited by the cost structure. The size of the markup depends on the degree of competition in product markets. If the firm faces little competition and as a result has high pricing power, its markup rate is high. High markups, of course, imply high profit shares.

The level of aggregate demand for the firm's product is a function of expenditure levels, the multiplier and the real exchange rate. Expenditure levels – real private investment and real public expenditures – are exogenous in this model. The multiplier, however, increases with redistribution towards wage earners, due to their lower propensity to save. It also changes with prices: all else being equal, higher domestic prices imply a real appreciation and higher imports – which lowers the multiplier.

A fall in the real exchange rate – a real appreciation – has also a negative impact on the level of external demand. Therefore, expenditures, prices and distribution all affect value added of the domestic firm, which is of course equal to the country's household income.

The country's "macroeconomic household" has two elements: one that owns the firm and employs labour in it, and one that works in the firm and receives wages from it. The two bargain in labour markets over nominal wages, which are ultimately determined by the rate of unemployment. The lower the rate of unemployment, the higher the nominal wages, and vice versa. Neither owners nor workers know all prices at the time of wage bargaining, and the real wage deviates

1. The composite developing regions (Africa, Asia and Latin America) exclude the BRICS in the respective regions.

from the rate bargained. Further, labour productivity depends on demand conditions, due to labour hoarding as well as overhead labour. Labour hoarding refers to the fact that the firm retains skilled employees throughout a downturn because retraining new employees in the upturn would be costlier; overhead labour refers to the fact that firms usually have some back-office and managerial staff who are not easily expendable. The ratio of the real wage to labour productivity indicates the real unit labour cost, or, in other words, the wage share. The higher the workers' real wage relative to their productivity, the higher is the wage share – and the lower are the profit share and the markup.

The model data set includes: (a) national accounts data for GDP by expenditure and government revenue as well as private savings; (b) a bilateral trade matrix; (c) labour market data on labour force, employment and the relevant rates as well as the functional distribution of income (wage shares); and (d) a set of elasticities. Labour market data are summarized by the unemployment rate. The data set is based on population, labour force, employment and unemployment data from national statistics offices, regional development banks and ILO's LABORSTA and EAPEP databases. Reported unemployment rates are used where available, otherwise estimates based on the highest quality underlying data are used. All unemployment rates are for 2008, as are the rest of the data. See Von Arnim (2010) for a more complete discussion of the model and data issues.

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