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The global economic crisis and developing countries: transmission channels, fiscal and policy space and the design of national responses

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Preface

The primary goal of the ILO is to contribute, with member States, to achieve full and productive employment and decent work for all, including women and young people, a goal embedded in the ILO Declaration 2008 on *Social Justice for a Fair Globalization, and*[1] which has now been widely adopted by the international community.

In order to support member States and the social partners to reach the goal, the ILO pursues a Decent Work Agenda which comprises four interrelated areas: Respect for fundamental worker's rights and international labour standards, employment promotion, social protection and social dialogue. Explanations of this integrated approach and related challenges are contained in a number of key documents: in those explaining and elaborating the concept of decent work[2], in the Employment Policy Convention, 1964 (No. 122), and in the Global Employment Agenda.

The Global Employment Agenda was developed by the ILO through tripartite consensus of its Governing Body's Employment and Social Policy Committee. Since its adoption in 2003 it has been further articulated and made more operational and today it constitutes the basic framework through which the ILO pursues the objective of placing employment at the centre of economic and social policies.[3]

The Employment Sector is fully engaged in the implementation of the Global Employment Agenda, and is doing so through a large range of technical support and capacity building activities, advisory services and policy research. As part of its research and publications programme, the Employment Sector promotes knowledge-generation around key policy issues and topics conforming to the core elements of the Global Employment Agenda and the Decent Work Agenda. The Sector's publications consist of books, monographs, working papers, employment reports and policy briefs.[4]

The *Employment Working Papers* series is designed to disseminate the main findings of research initiatives undertaken by the various departments and programmes of the Sector. The working papers are intended to encourage exchange of ideas and to stimulate debate. The views expressed are the responsibility of the author(s) and do not necessarily represent those of the ILO.

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[1] See http://www.ilo.org/public/english/bureau/dgo/download/dg_announce_en.pdf
[2] See the successive Reports of the Director-General to the International Labour Conference: *Decent work* (1999); *Reducing the decent work deficit: A global challenge* (2001); *Working out of poverty* (2003).
[3] See http://www.ilo.org/gea. And in particular: *Implementing the Global Employment Agenda: Employment strategies in support of decent work, "Vision" document*, ILO, 2006.
[4] See http://www.ilo.org/employment.

Foreword

The paper focuses on the impact of the global economic crisis on developing countries and their capacity to respond to it. The crisis started in the US and spread fast to the industrialised countries. Since then, the debate and discussion have principally focused on industrialised countries. This paper analyzes the impact on developing countries. Both are rapidly unfolding and changing. The paper shows the differentiated impact and transmission mechanisms, mainly through declines in trade, private capital flows, changes in commodity prices and remittances. It also argues that many developing countries find themselves in an invidious position because lack of 'fiscal and policy space' constrains their capacity to engage in countercyclical interventions to cope with the most severe global economic downturn since the Great Depression.

In proposing this argument, the paper covers a wide terrain. It briefly reviews the pre-crisis period (2002-2007) during which many developing countries grew at historically unprecedented rates, even though such growth often did not translate into robust employment outcomes. This short-lived, but rapid, growth experience perhaps explains why there was an initially hesitant acknowledgement of the scale and severity of the crisis. The paper shows that the financial crisis in the United States that first emerged in August, 2007 eventually spread to the developing world through a variety of transmission channels. Not all developing countries are equally affected. Initial conditions vary significantly across developing countries, with some countries having a greater degree of resilience than others in coping with external shocks.

Cross-country evaluations reveal that fiscal expansions undertaken so far by the G20 countries are not sufficient to remove the global output gap. Furthermore, developing economies cannot rely on the 'trickle down' benefits from globally coordinated fiscal actions. They need policy space to enact fiscal stimulus packages. This reveals a structural issue of the capacity of developing economies to engage in counter-cyclical policies. It tackles the two issues of short term mitigation capacity and a long term approach to crisis management. It is possible to enhance both fiscal and policy space in sustainable ways. This means a renewed commitment to domestic resource mobilisation, reorientation of policies and better preparedness to cope with global downturns. In particular, developing countries with access to global capital markets should be wary of the dangers of 'liability dollarisation' that can severely hamper national policy choices. It is also necessary to move beyond short-term crisis management and develop a long-term national employment strategy by drawing on the values and principles that are embedded in the ILO's Decent Work Agenda. Finally, developing countries need global and regional cooperation in order to harness new resources on a significant scale to assist them to cope with the crisis. The recently concluded G20 made a promising start, but one also has to acknowledge that many challenges lie ahead. These include lack of a clear template to tackle the reform of global economic and financial governance, failure to agree to a new round of fiscal expansion to cope with the steep decline in global demand, and the insufficient appreciation of the scope for regional solutions to strengthen fiscal and policy space in developing countries. The paper suggests that developing countries can also learn from each other, most notably, from successful cases of crisis management as well as successful operations of national recovery measures.

This paper is a contribution to the unfolding and evolving debate on crisis impact and response in developing countries.

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1. Introduction

The severity of the current global recession, the worst in 60 years, was largely unforeseen by governments across the world and by key multilateral agencies that routinely produce global and regional growth forecasts. In mid-2007, a widely held view among key multilateral agencies was that a financial crisis that was brewing in the United States would largely bypass the developing world and the world economy as a whole will quickly recover from any economic downturn.[5] Such optimism seems to have evaporated. The latest forecasts (April, 2009) released by several agencies suggest a very grim scenario, with global growth in 2009 expected to contract by as much as 2.8% and world trade in 'free fall'. A global jobs crisis, led by the OECD economies, appears to be unfolding. The return of growth in the first quarter of 2010 is anticipated, but even here the forecasts are hedged by a good deal of uncertainty.[6]

It is against such a grim prognosis of global growth prospects that this paper builds on a burgeoning literature to reflect on the experiences of, and prospects for, developing countries during the course of the current economic crisis.[7] It discusses several interrelated themes that, taken together, form a central narrative. The paper argues that the creation of fiscal and policy space for developing countries on a sustainable basis needs to be a central feature of the global development agenda. This in essence means fortifying the capacity of developing countries to engage in counter-cyclical interventions to respond to global economic downturns using a combination of macroeconomic, labour market and social protection policies. In the long-term, there is a case for a comprehensive national employment strategy derived from values and principles embedded in the ILO's Decent Work Agenda (DWA). Such a strategy – combined with appropriate forms of global and regional cooperation - is essential in securing sustainable recovery.

The paper is structured as follows: *Section 2* briefly revisits the period prior to the crisis and highlights the global boom, its unsustainable nature and the role that it could have played in injecting a sense of undue optimism about the future. In *Section 3*, the paper suggests an organising framework for identifying the vulnerability of developing economies to the global economic crisis.[8] *Section 4* of the paper reviews national policy responses to the global economic crisis. It distinguishes responses undertaken in developed countries from their peers in the developing world. *Section 5* explores the twin notions of fiscal and policy space in developing countries by drawing on a sizeable literature. It highlights different interpretations of fiscal and policy space and suggests how developing countries can enhance their fiscal and policy space to cope with economic downturns. *Section 6* of the paper argues that the global community is understandably in short-term crisis management mode. What is needed is a long-term strategic agenda that looks beyond

[5] See the August 2007 Outlook prepared by the OECD and the forecasts produced by the IMF in July 2008.

[6] For the most recent projections, see OECD (2009), IMF (2009a) and World Bank (2009a)

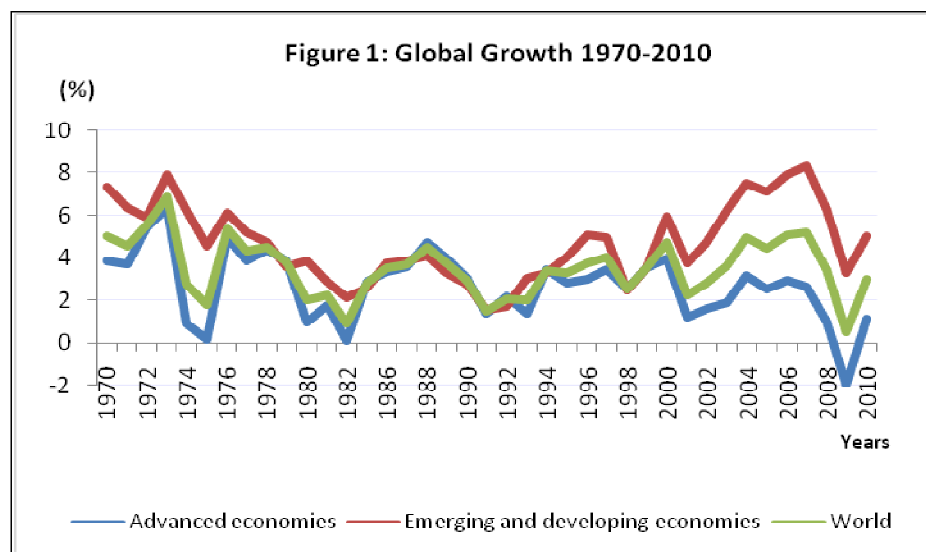
[7] The term 'developing countries' is used to include both low income and middle-income countries in Africa, Asia, Latin America and the Middle East. The paper eschews the use of the term 'emerging markets' or 'emerging economies' because it is also used to describe countries in Eastern Europe and the Baltics that are part of the Eurozone. Some economies in Eastern Europe and the Baltics have been very badly hit by the global economic crisis, but there is only passing reference to their experiences.

[8] There is now a burgeoning literature on the impact of the global economic crisis on developing countries. See, for example, te Velde (2008), Massa and Velde (2008), AfDB (2009), ECLAC (2008, 2009), James *et al* (2008), ADB (2009), Naude (2009), ILO and Institute of Labour Studies (IILS, 2009), IMF (2009), World Bank (2008a), The Global Monitoring Report (2009, chapter 1).

the crisis and seeks to secure sustainable recovery. *Section 7* of the paper discusses the role of global and regional cooperation as a complement to national policy responses to cope with the global economic crisis. The final section offers a summary of key findings.

2. The 2002-2007 global boom: buoyant growth, but weak labour market performance

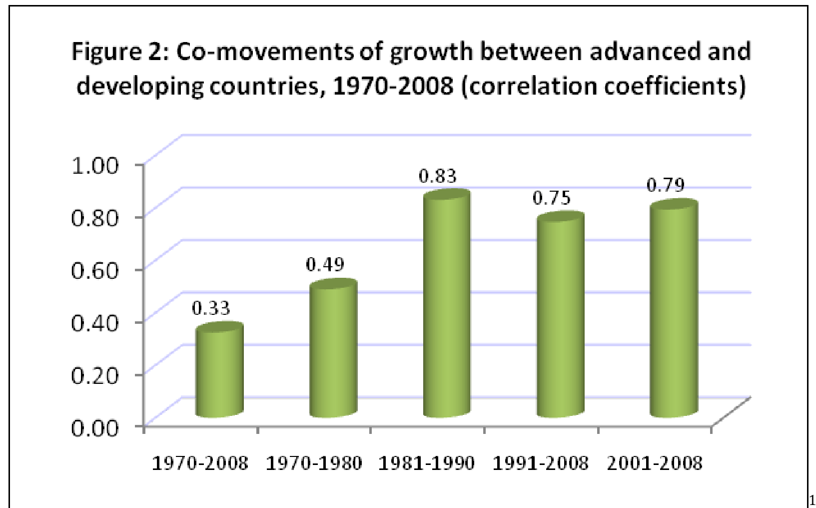
There was a relatively mild global downturn in 2001. This was followed by a synchronised boom that lasted until 2007. Many developing countries grew at rates not seen since the 1970s (**Figure 1**).



Sources and notes: Derived from IMF World Economic Outlook Database

One can detect several episodes of global downturns (early 1970s, early 1980s, early 1990s and at the beginning of the 21st century). After taking on board the severe global recession of today, it is possible to suggest that between 1970 and 2009, global downturns have occurred, on average, every ten years. One can also detect that, over time, the co-movement (as measured by correlation coefficient between growth in the advanced economies and growth in the developing and emerging economies) intensified, reflecting the deeper integration of the global economy.[9] (**Figure 2**)

[9] The IMF(2009a:17) observes that 'output fluctuations in emerging and developing economies have been fairly synchronized with output fluctuations in the G-7 countries over the past 15 years…a 1% change in real GDP growth is associated with a 0.4 percent change in growth in emerging and developing countries'.



[10]

Sources and notes: Authors' calculations based on IMF World Economic Outlook

The 2002-2007 period stands out as a case of an unsustainable boom. There was a surge in various forms of external finance (export revenues, remittances, private capital flows) that fed an investment boom in the developing world led by China and other emerging economies.[11] Such a growth experience bred a sense of robust optimism about the future. This state of mind perhaps contributed to the collective complacency of policymakers, development practitioners and multilateral agencies that were evident even at a time when the seeds of a rather severe global economic recession were being sown in the US heartland. More importantly, it meant that insufficient attention was being given to the stresses and strains that afflicted labour markets across the world even during the high-growth era.

Quantitative expansions in employment in many parts of the world were juxtaposed with sluggish real wage growth, persistence of the informal economy, 'casualisation' of the work-force, declining wage shares in national output and rising inequality. This is a familiar theme in recent ILO reports,[12] but other organisations, such as the OECD and the World Bank, have also highlighted the problems of growing economic insecurity and inequality in regional and global labour markets.[13] In addition, one should not overlook the very important point that, during 2007 and the early part of 2008, many developing countries were buffeted by food and energy price shocks that impaired the fiscal and current balances of the affected economies, led to food riots and protests in many countries and pushed millions into poverty.[14]

In sum, the 2002-2007 global boom appeared to provide a justification for a model of globalisation that relied on a mix of macroeconomic prudence, privatisation, deregulation, trade and financial integration. Of course, there were voices expressing concern about an impending bust, but they were not enough to galvanise policy-makers and multilateral

[10] Tim Geithner, US Secretary of the Treasury in the Obama Administration, makes the following observation: 'A major lesson of the crisis is that the remarkable overall performance of the global economy between 2003 and 2007 contained within it the seeds of its own undoing'. As cited in Guha, K (2009) 'Geithner calls for no let-up in action on crisis', *Financial Times*, April 23

[11] See Lin (2008) who highlights the surge in external financing of the global growth in the 2002-2007 period, but does not emphasise its lack of sustainability.

[12] See, for example, ILO and IILS (2008a and 2008b), ILO (2009a) Ghose *et al* (2008)

[13] See the 2007 editorial by the OECD on the 'globalisation paradox' and the statement by Holzmann (2006) on behalf of the World Bank.

[14] See Islam, R and Buckley (2009)

agencies to tackle the problems of growing global disparities and the manifold employment challenges facing the world with a well-thought and carefully executed pre-emptive strategy.[15] All the signs are that, despite large-scale interventions by governments in the 'G3' (United States, Eurozone and Japan) and some emerging economies, the global recession that is underway is likely to be deep and durable. To make matters worse, the historical evidence suggests that even if the world economy graduates from a recession in a technical sense by 2010, the living conditions of workers and their families are unlikely to recover before 2014.[16] Hence, it is necessary to highlight the degree of uncertainty about growth prospects for 2009 and 2010 and, more importantly, to highlight the long-lived effects of the global recession on real wages and employment.

At the global level, estimates for growth have been sharply revised by the IMF on several occasions within the space of eight months (July, 2008 to March, 2009).[17] At the country level too, major revisions about growth prospects for 2009 have taken place. In China, for example, the official target for growth in 2009 is 8.0%. Yet, the IMF has reduced its 2009 growth forecasts for China to 6.5%, while some private sector economists contend that, on a seasonally adjusted basis, growth in the third quarter of 2008 was probably zero.[18] Hence, it is necessary to put in place policy packages with provisions for dealing with 'worst-case' scenarios.

3. Vulnerability of developing economies to the global economic crisis

The financial crisis that started in the United States in August 2007 eventually spread to the developing world. It is necessary to understand the transmission channels through which this happens, but it is also necessary to comprehend that not all developing countries will be equally affected. Initial conditions vary significantly across developing countries, with some countries having a greater degree of resilience than others in coping with external shocks. Hence, this section identifies the vulnerability of developing economies to the global economic crisis by analysing the interaction between transmission channels and initial conditions.

3.1 Vulnerability analysis: the nature and pattern of growth preceding a crisis

The nature and pattern of growth prior to the onset of a crisis deserve particular attention. If growth, for example is largely based on debt-driven consumption or sustained by speculative investments in real estate, then the risk is that equity price bubbles might emerge and eventually burst with devastating consequences on the real economy. It now

[15] See *Foreign Policy* (2009) 'The Worst is Yet to Come', Jan-Feb. The editors of *Foreign Policy* highlight the work of four US-based economists (Robert Schiller, Nouriel Roubini, David Scmick and Dean Baker) who had the prescience to warn of a US-led global bust. In the UK, Fred Harrison used long-run data on boom-bust cycles in the property sector to predict a recession in 2010. See Harrison (2007).

[16] This conjecture is based on historical data compiled by Reinhart and Rogoff (2008).

[17] See various issues of the World Economic Outlook (WEO) produced by the IMF.

[18] Patterson (2009)

appears that this was the case in the United States, UK and elsewhere – see **Box A.1** on Dubai and **Box A.2** on Latvia in the appendix.

In the case of some emerging economies, most notably China, the nature and pattern of growth became excessively dependent on external demand. Private domestic consumption as a share of GDP fell from more than 60 % of GDP in 1980 to less than 50% in 2007 in developing Asia.[19] Indeed, some influential observers maintain that 'most of the slowdown in regional economic growth (in East Asia) stems not from a fall in net exports but from weaker domestic demand'.[20] A more accurate interpretation is that East Asia is suffering from an export slump that has been compounded by weak domestic demand. It is ironic that calls are now being made by many that China and other export-oriented East Asian economies – hailed for so many years as success stories - will have to rely a lot more on domestic consumption and internal markets to drive future growth.

3.2 Vulnerability analysis: from fiscal and current account balances to labour market institutions

Two World Bank policy notes (2008a and 2009b) and the IMF (2009b) have suggested a framework for assessing the vulnerability of developing economies to the global economic crisis. The first World Bank policy note (World Bank 2008a) and the IMF (2009b)[21] focus on fiscal and current account balances and financial sector stress. The second World Bank Policy note (World Bank 2009b) is broader in scope and creates an ordinal index with which to classify more than 100 developing economies into 'high exposure', 'medium exposure' and 'low exposure' cases. A 'high exposure' country has (a) high initial levels of poverty and (b) decelerating growth. Using the 2008 benchmarks, 25 % of the countries in the sample have both high fiscal and current account deficits. Using the 2009 criteria, 39% of the countries have 'high exposure'. In addition, about 75% of the 'high exposure' countries have either low institutional or fiscal capacity.

The 2009 approach by the World Bank is an improvement on its 2008 version in the sense that it goes beyond a consideration of macroeconomic balances. Yet, it decided to exclude from its terms of reference any analysis of the nature and composition of external linkages and its implications for the vulnerability of nations. While there is a clear emphasis on institutional capacity, there is no explicit recognition of the central role that labour market institutions and policies play in this process. Bearing these concerns in mind, the framework suggested here enlists a wide range of 'initial conditions'. These pertain to: (a) the nature and pattern of pre-crisis growth and the state of the labour market, (b) labour market information system that can provide timely monitoring of the impact of the crisis, (c) labour market institutions and social safety nets that can serve as a shock absorber to external crises (e.g. active and passive labour market policies, mechanisms for social protection etc), (d) the robustness of the domestic financial system, (e) fiscal and current account positions.

Fiscal and current account imbalances are critical constraints on the policy-making capacities of national governments, but an exclusive focus on these constraints can elevate the status of the macroeconomic policy framework to a level that precludes any serious

[19] David Pilling (2009) 'Unlucky Numbers', *Financial Times*, February 10. See also Deutshe Bank (2008).
[20] *The Economist* (2009) 'Asia's suffering', January 29
[21] In the case of the IMF, the sample (70) consists exclusively of low-income countries. They are classified into 'high risk', 'medium risk' and 'low risk' countries. The key criterion is 'reserve cover falling below three months of imports' (p.4). 26 countries in the sample are considered to be in the 'high risk' category.

consideration of the complementary role of labour market and social policies in coping with a crisis and sustaining a recovery. It is essential to emphasise the role that labour market information systems and labour market institutions play in dealing with external shocks.

The paradox is that, even if national governments maintain healthy fiscal and current account balances, they will prove to be an insufficient arsenal to cope with an economic downturn if complementary labour market and social policies are not in place. If national governments are not endowed with adequate labour market information systems, they will not be able to monitor the impact of the crisis in a reliable and timely fashion. In the case of China, for example, its unemployment statistics only include urban areas. This means that if rural migrants are laid-off and return to their homeland, they will not be reflected in the official statistics. Yet, recent media reports suggest that 15% of China's rural migrants have been laid off and have returned to their homeland.[22]

It is well known that inadequate social safety nets, insufficient labour market risk mitigation schemes and poor provisions for maintaining investments in health, education and infrastructure in the event of an economic downturn will attenuate the capacity of individuals, households, firms and governments to sustain consumption and to sustain long-run growth potential. There is growing evidence that, even in some developed economies, social safety nets and unemployment compensation programmes fell into a state of benign neglect.[23] The 1997 Asian financial crisis has also shown how economies in the region that were widely praised for their successful growth models had to struggle and improvise social safety nets and labour market institutions to cope with the social consequences of the crisis.[24]

In sum, the state of the labour market in the pre-crisis period deserves particular scrutiny. Unless determined efforts are made to track changes in the composition of employment and trends in real wages across vulnerable groups in the work-force, quantitative expansions in employment and declines in the unemployment rate during high-growth periods can mask deleterious developments in the labour market. Thus, when an economy is exposed to a downturn in conjunction with weak labour market institutions and inadequate social safety nets, the distributional consequences and the adjustment costs can be quite acute. This is an issue that needs to be at the centre of current policy discourse.

3.3 Vulnerability analysis: the role of the financial system

The health of the domestic financial system was at the centre of debates on the causes, consequences and cures in the wake of the 1997 Asian financial crisis. It was felt that lack of appropriate prudential regulations left many East Asian financial systems vulnerable to sudden shifts in capital inflows. During the long economic boom that preceded the 1997 crisis, East financial institutions borrowed heavily in global capital markets and engaged in imprudent lending that fed an investment boom, especially in real estate and construction. Once investor sentiments turned sour, the economies in the region paid a heavy price. Hence, the conduit for the 1997 crisis, according to this narrative, turned out to be a weak and weakly regulated domestic financial system.

[22] Jamil Anderlini (2009) ' Data hide scale of job woe', *Financial Times*, February 11

[23] Focusing on the case of the US, *The Economist* notes: 'Unemployment insurance is one of the economy's most important automatic stabilisers, helping to maintain household purchasing power when the economy weakens. But that role is impaired by the short duration of benefits and their skimpy level.' See *The Economist* (2008) 'A Safety Net in Need of Repair', December 28

[24] See Lee (1998)

In the case of the current global recession, there is general agreement that it was bred by the US financial system that grew imprudent under a lax regulatory regime and in a global environment that was awash with excess liquidity. Profit-maximising financial entrepreneurs in the US responded to the era of cheap credit and rising asset prices by creating novel, but ultimately risky, financial products in an effort to extract higher yields. A deregulated environment – an incentive structure that rewarded excessive risk-taking and financial globalisation – enabled the pursuit of higher yields in the financial services industry. Unfortunately, boom conditions have a tendency to create overly optimistic expectations about the future and temper the willingness of policy-makers, households and firms to take prudential and pre-emptive action. The seeds of a subsequent bust were sown.

The implosion of national financial systems ranging from United States to Iceland testifies that such problems are no longer the preserve of emerging economies. A much-needed debate is now underway on designing a reform agenda for national financial systems in an era of capital mobility. Some would like it to be a primarily national endeavour, while others see it as a case for global collective action.[25] How the debate will be resolved remains to be seen, but the central role that domestic financial systems play in propagating a crisis that has widespread ramifications has yet again been tragically demonstrated.

3.4 Vulnerability analysis: the role of external linkages

Once an audit of the country-specific initial conditions are undertaken, it is necessary to comprehend the nature of the transmission mechanism that has led a US-centric financial crisis to become a contagious global economic crisis. The transmission mechanism pertains to various forms of external linkages manifested in: (a) trade flows (b) private capital flows (c) migration and remittances (d) terms of trade (e) aid flows. The potency of the transmission mechanism will vary from country to country and sectors/regions within the same country. The aggregate magnitude of external dependence (say, as measured by trade-to-GDP ratio) is less important than the composition of this dependence. In other words, particular countries could, for example, have a relatively low trade-to-GDP ratio, but this could mask a high degree of dependence on particular export markets (say, 'G3' export markets) and particular products and services (say, electronics and tourism). Furthermore, some external linkages in particular countries could be more important than others (e.g. migration and remittances, tourism rather than trade in goods or financial services).

It is equally important to distinguish between external linkages mediated largely through the private sector (trade in goods and services, private capital flows, migration and remittances) and those that are mediated through the public sector. In the case of the latter, the most prominent example is foreign aid. Some developing economies are heavily dependent on aid flows- such as Tanzania and Rwanda.[26]Some developing economies are heavily reliant on multilateral aid, others on bilateral donors.

What are the projections on the various trade and financial flows at the global level in the wake of the crisis? The sharpest decelerations are in trade, private capital flows and terms of trade. Remittances seem to be holding up, but it is unlikely the growth in international migration and the income transfers associated with it will be sustained at pre-crisis rates.[27] The projections on aid inflows are also not clear-cut. Concerns have been

[25] Brunnermeir *et al* (2009).
[26] See Massa and Te Velde (2008).
[27] See World Bank, Global Economic Prospects 2009, chapter 1. See also Abella and Ducanes (2009) on remittances from the perspective of developing Asia.

expressed that donor nations might renege on their pledge to maintain aid volumes. If the past is any guide, the composition of aid is likely to change to the possible detriment of the countries that need it most.[28]

3.5 Vulnerability analysis: summary

Table 1 summarises the vulnerability of developing countries to the global economic crisis as the product of interaction between country-specific initial conditions and various components of the external linkages outlined above. This table can be thought of as a matrix that captures 'vulnerability-to-crisis-attributes' (VTCA). It can be applied to various countries to work out the impact of the crisis, both at an aggregate and disaggregate level. As an example, the case of Egypt is highlighted – see **Box 1**. This is followed by **Box 2** on the plight of the toy industry in China to demonstrate how important it is to monitor the impact of the crisis from the perspective of particular sectors/industries within a country. As can be seen, Egypt's vulnerability derives not just from its lack of fiscal space, but also from a range of factors: limited productive job creation even in the high growth era, inadequate labour market institutions and policies and dependence on a narrow range of exports and export markets. In the case of China, the sharp downsizing of a highly export-oriented industry (production and sale of toys to global markets) in the wake of the global economic crisis might not mean much in terms of its impact on the overall economy, but it bears a great deal of significance for jobs and livelihoods for a particular region and for millions of rural migrants that were attracted to that region. More importantly, this case study highlights the critical role that pre-emptive labour market and social policies can play in mitigating the effects of external shocks.

Table 1: Vulnerability-to-crisis attributes (VTCA): a suggested framework

Attributes: initial conditions	Attributes: external linkages
Nature and pattern of growth and state of the labour market	Dependence on key external markets (e.g.'G3' and oil-rich Gulf states)
Capacity of labour market information system to monitor crisis impact	Dependence on key exports (e.g. electronics, primary commodities, tourism) and sensitivity to changes in terms of trade
Capacity of social protection system to mitigate impact of external shocks on poor and vulnerable households	Dependence on overseas migration and remittances
State of domestic financial system (esp. exposure to liabilities denominated in foreign currency)	Dependence on private capital flows
State of fiscal and external balances	Dependence on aid flows

Note: This is a variation of a framework suggested in Muqtada and Islam (2009)

[28] See Mold (2008). The irony is that public support for aid even during a recession in rich nations is usually quite high. See Zimmer (2008).

Box 1: Vulnerability to the global economic crisis: the case of Egypt

Egypt is classified as carrying a risk of 'medium exposure' to the global economic crisis by the World Bank (2009). It has reduced growth prospects and a reasonable degree of institutional capacity, but low fiscal space. There is a moderate degree of risk of an increase in poverty as a consequence of the global economic crisis. The analysis offered here relies on a broader depiction of initial conditions and their interaction with external linkages and seeks to provide additional insights.

As in the case of many countries, growth in Egypt in the pre-crisis period was robust, reaching a historically unprecedented 7.2% in 2007/2008. In 1996-99, for example, growth averaged 5.%. The official position is that growth will decline to less than 5.2% in 2009, which is very close to the long-term growth rate of 4.8% achieved over 1970-2005.

In order to appreciate the vulnerability of the Egyptian economy to current global developments, it is necessary to form an appreciation of the pattern of growth and the state of the labour market in the pre-crisis period. This information then needs to be combined with the limited nature of labour market and social policies, the lack of fiscal space and the evolution of external linkages.

Dr Raggui Assad, currently a Professor at the University of Minnesota and a former Regional Director for West Asia and North Africa at the Population Council in Egypt, makes the point that, in recent years, 'a lot of the growth … has been felt by those who own assets and property'. Private sector growth in employment has certainly been 'quite rapid', but it was concentrated in the informal part of the private sector. As a 2007 World Bank analysis (p.41) points outs, quantitative expansions in employment 'say nothing about important qualitative aspects: whether workers are productively employed, have acceptable working conditions, and receive decent wages'. If, as noted, a large part of the growth in employment was in the informal segment of the private sector, one would expect a trade-off between employment growth and productivity growth. This is indeed a characteristic feature of the process of job creation in Egypt.

Labour institutions in Egypt are weak. There is limited scope for risk mitigation schemes, even in the formal sector. The labour market information system is inadequate, with different sources providing divergent measures of changes in basic labour market indicators, such as employment and unemployment rates.

The fiscal balance has deteriorated sharply, rising from -1.8% of GDP in 1996-1999 to -7.7% in 2007. The current official position is that the fiscal balance stands at -8.3% of GDP. The government is committed to a process of fiscal consolidation that will bring down the fiscal balance to - 4.5% of GDP by 2010.

It is against this background that one needs to assess the nature and composition of external linkages. The export-to-GDP ratio has gone up sharply in recent years: it was 17.3 % in the 1996-99 and rose to 34% in 2007. The FDI-to-GDP ratio went up dramatically, rising from less than 1% of GDP in 1996-1999 to 8.0% by 2007. These external developments allowed the Egyptian government to build up a current account surplus of 2.2% of GDP and foreign exchange reserves worth 9 months of import coverage.

What strikes one is the highly concentrated nature of the growing openness of the Egyptian economy. Tourism, remittances from overseas migrants and earnings from the Suez Canal make up the bulk of foreign exchange earnings. In 2007, for example, tourism and remittances accounted for 49 % of gross foreign exchange earnings and 11.3% of GDP. More importantly, 50% of Egypt's annual remittances come from its two million plus citizens working in the Persian Gulf area. The latter also accounts for about 60% of tourist arrivals to Egypt. In sum, the increasing degree of integration in the case of Egypt has been juxtaposed with a high degree of dependence on a narrow range of export of services and on the regional economy.

The Egyptian government is clearly concerned. Recent data suggest that, in January of this year, hotel bookings were down 30% vis-à-vis the same period last year. FDI is likely to decelerate sharply, earnings from the Suez Canal has fallen as shipping services decline in response to the reduction of global trade flows. There is the grim prospect of an eventual decline in remittances, given the slowdown in the Persian Gulf area. The government has announced an economic stimulus package of extra spending on infrastructure project worth USD 2.72 billion. It has also announced a series of measures to boost tourism. Not much is known, however, of the government's strategic thinking on how it intends to respond to the 'worst-case' scenario of a jobs crisis with an appropriate mix of labour market and social policies.

<u>Sources:</u> Egypt News (2009) 'Egypt reveals measures to boost tourism', January 4; Egypt News (2009) 'Deficit may grow', January 8; Egypt News (2009) 'Egypt to cut growth forecast below 5.2%, January 12; World Bank (2007) *Middle East and North Africa: Economic Developments and Prospects, Job Creation in an Era of High Growth,* Washington DC; World Bank (2009) 'The Global Economic Crisis: Assessing Vulnerability with a Poverty Lens', mimeo, February; Navtej Dhillon (2008) 'Global Economic Crisis: Short and Long-term Prospects for Egypt, Interview with Ragui Assad, October 29, *The Brookings Institutions*; Michael Slackman, (2008) 'Slowdown in Persian Gulf Reverberates in Middle East', October 29, *New York Times*

Box 2: China's toy industry and the global economic crisis

The plight of China's toy industry illustrates vividly the need to engage in a disaggregated analysis to capture the industry and location-specific consequences of the global economic crisis. Although representing a minuscule portion of China's aggregate exports, output and employment, the toy industry plays a key role in the regional economy of Guangdong province. It represents the centre of China's highly export-oriented toy industry. More than 60% of China's toy manufacturers are located in Guangdong. These manufacturers, together with others, accounted for 70% of the world's toy exports in recent years. The bulk of these exports (70%) also went to US and EU markets. At one point, there were 8610 firms linked to 2000 suppliers and employing 20 million migrants. When the US economy went into recession towards the end of 2007, followed by the EU economies in 2008, the Chinese toy industry succumbed to an export slump that became evident in November, 2008. Today (February, 2009), there are only 4388 toy manufacturers left. The industry has undergone a massive downsizing in a very short period of time.

The export slump, unleashed by the global economic crisis, merely magnified the toy industry's woes that have been festering for some time. The industry suffered from a reputation deficit, driven by international concerns about the quality and safety of the toys that have been exported, unsafe and poor working conditions and the impact of production processes on the local environment. These concerns culminated in world-wide product recalls over the past 18 months. The latest saga in these developments that severely tarnished the image of China's toy industry occurred on January 23, 2009, when the Indian government, citing safety concerns, imposed a ban of six months on the import of Chinese toys. China's competitiveness in toy exports was also impaired by rising labour and land costs that were cutting into operating margins.

An important message that emerges from this case study is that labour market and social policies are critical in understanding the vulnerability of particular industries within national economies to the global economic crisis. If policy makers had, for example, paid more attention to working conditions in the industry and if they had pre-emptively put in place measures to boost the productivity of toy manufacturers, the vulnerability of the industry to the global slowdown would perhaps have been mitigated.

Sources: Raja Murty, 'Playtime is over for China's toy industry', *Asia Times* June, 26, 2006; April Mei, 'India ban worsens China's toy woes', January 30, 2009 *Asia Times*; Jane McCartney, 'Half of China's Toy Factories Close after Export Slump', *The Times*, February 10, 2009

4. Policy responses to the crisis: developed versus developing economies

How have developing countries reacted to the rapidly evolving global economic crisis? What can they learn about 'best practice' approaches to counter-cyclical policy packages? This section discusses these issues in a number of steps.

First, it highlights once again how multilateral agencies and national policy makers initially underestimated the seriousness of the crisis. This meant that some developing countries either did not take action or engaged in pro-cyclical policy at a time when the US-centric financial crisis was spiralling out of control. *Second*, it draws on datasets created by the Institute of Labour Studies (IILS), the Bangkok office of ILO and ECLAC to provide an overview of the policy responses that have been undertaken by a range of countries - both developed and developing - in the realm of monetary, financial, fiscal and labour market policy. *Third*, it briefly evaluates the nature of such policy responses. To what extent have they been driven by projected growth decelerations and compromised by various constraints pertaining to the balance of payments, the government's fiscal position and institutional impediments? How effective are the interventions likely to be in arresting the inexorable decline in output and employment across various parts of the world?

4.1 Responding to the global economic crisis: a slow beginning

As noted, the global community was probably lulled into a collective sense of complacency by the boom conditions that prevailed in 2002-2007, and, in particular, by the historically unprecedented growth rates observed for developing and emerging economies. Even highly experienced development experts succumbed to this optimism. Thus, a September 2008 report led by Francois Bourguignon, the former World Bank Chief Economist, argued:

> …The global economic environment has been buoyant over recent years, with very positive effects on economic growth in a large number of developing countries, reversing the trend in divergence between high-income and low-income countries for the first time since the 1970s. …Will the favourable trend continue? In the short-term, there can be little doubt that the slow-down in developed economies will spill over into developing countries. However, the question is whether this will hinder their long-term growth…There seems to be a consensus that emerging economies will continue to grow quickly, though not as quickly as before, and this will have a positive effect on the world economy and other developing economies.[29]

This optimism was also reflected in the Global Economic Prospects 2009 (GEP 2009), one of the flagship publications of the World Bank.[30] GEP 2009 argued, along the lines of Bourguignon *et al*, that the long-term, growth prospects of the developing countries will not be affected in any significant way and the developing world as a whole will not only meet the Millennium Development Goals (MDGs), but 'overshoot' them by 2015. Such robust optimism was maintained even though their own calculations suggested that the recent surge in food and energy prices probably pushed 130-155 million into poverty (evaluated at 1.25 dollars a day - which is the latest PPP standard adopted by the Bank) in 2008. GEP 2009 essentially argued that developing countries would recover quickly from what was shaping up to be a synchronised global downturn that was preceded by supply shocks in the form of an unanticipated surge in food and energy prices. It proceeded to note that developing countries will have to rely on the well-known policy package (monetary restraint, fiscal prudence, and structural reforms) that, it claims, was the basis for engendering rapid growth in the 2002-2007 period. This implied that the current global recession would have a transient effect on the long-term growth trajectory of the developing countries. It thus called for policy-makers in the developing world to be ‘especially wary of reacting too aggressively to the global slowdown’.[31]

To its enormous credit, the World Bank has now moved away from that optimistic perspective. In a Press Release (February 12, 2009), it said:

> New estimates for 2009 suggest that lower economic growth rates will trap 46 million more people on less than USD1.25 a day than was expected prior to the crisis. An extra 53 million people will be trapped on less than USD 2 a day. This is on top of the 130-155 million people pushed into poverty in 2008 because of soaring food fuel prices.
>
> These new forecasts highlight the serious threat to the achievement of the MDGs.[32]

Such a sombre prognosis reinforces projections by the ILO of a global jobs crisis. Under a worst-case scenario, unemployment, vulnerable employment and working poverty are expected to go up significantly in 2009 in all parts of the developing world. Indeed, the

[29] Bourguignon *et al* (2008:17)
[30] It would be wrong to imply that the World Bank was the only organisation that underestimated the consequences of the crisis on growth prospects in the developing world. Consider, for example, the following observations by Economic Commission for Africa (ECA) which, in its *Economic Report for Africa 2008,* noted (ECA:21): ‘Some positive developments in the world economy are likely to sustain growth in African countries, especially through the high demand for African export commodities and the relatively low costs of external borrowing.’
[31] World Bank, Global Economic Prospects 2009, p.19
[32] World Bank (2009), ‘Crisis hitting poor hard in developing world’, Press Release, February 12. There is some confusion on the projected increase in poverty. In an ‘op-ed’ written for the New York Times, Robert Zoellick, the President of the World Bank, states ‘…the economic crisis has already pushed an estimated 100 million people back into poverty’. See Robert Zoellick (2009) ‘A Stimulus Package for the World’, *New York Times*, January 22. If this is correct, then nearly 29% of the gains in global poverty reduction have been wiped out. This estimate is based on claims that since 1997, 350 million people graduated out of poverty (measured at USD 1.25 a day). See Lin (2008).

global jobs crisis has led to protests and riots in various countries and threatens to jeopardise international peace and stability.[33]

It is also important to emphasise that there is now a good deal of evidence that volatility of growth – not just an episodic growth deceleration – is prejudicial to the living standards of the poor. One study summarises the evidence in the following way:

> The poor have less human capital to adapt to downturns in labour markets. They have less assets and access to credit to facilitate consumption smoothing. There may be irreversible losses in nutrition and educational levels if there are no appropriate safety nets….(One) finds an asymmetric behaviour of poverty levels during deep cycles: poverty levels increase sharply in deep recessions and do not come back to previous levels as output recovers.[34]

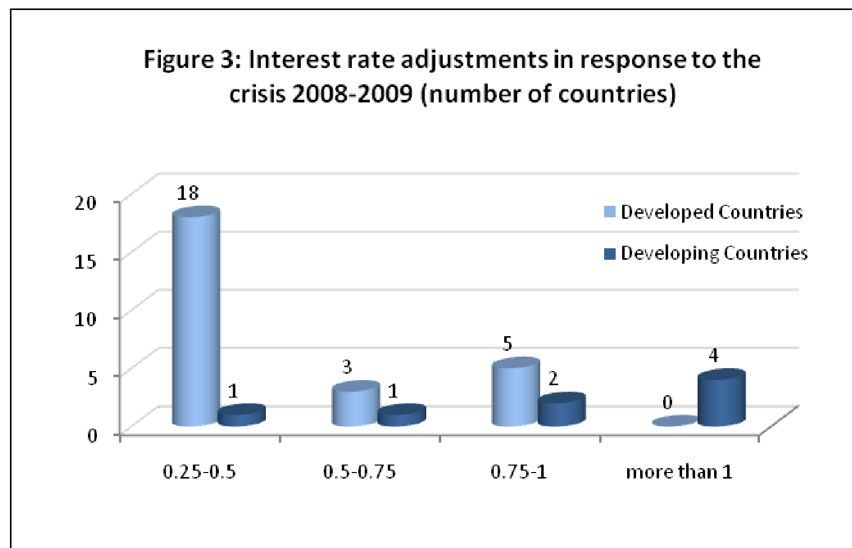
In light of such evidence, how have policy-makers in developing countries responded to the evolution of the global economic crisis? One should not take aim only at multilateral agencies and redoubtable development experts for being slow to recognise the consequences of the global economic crisis on developing countries. Several large and populous emerging economies either took little action or engaged in pro-cyclical policy between July and November 2008, precisely the period during which the US-centric financial crisis was spiralling out of control. Brazil, Indonesia and South Africa *increased* their interest rates at a time when the US was aggressively cutting interest rates to stave off a recession.[35] This was largely driven by the belief that one would need to control inflation induced by food and energy price shocks. There has been a subsequent softening, but the point is that monetary policy operates with a long and variable lag. Hence, the consequences of a monetary policy tightening cannot be easily reversed. More importantly, policy-makers, having now realised the gravity of the global economic crisis, have to play 'catch-up'. They have perhaps lost the lead time that is necessary to make investments in financial, intellectual and administrative capital that are needed to restructure the policy-making architecture to deal with the short-term and medium-term consequences of the crisis.

4.2 Policy responses to the crisis: an overview

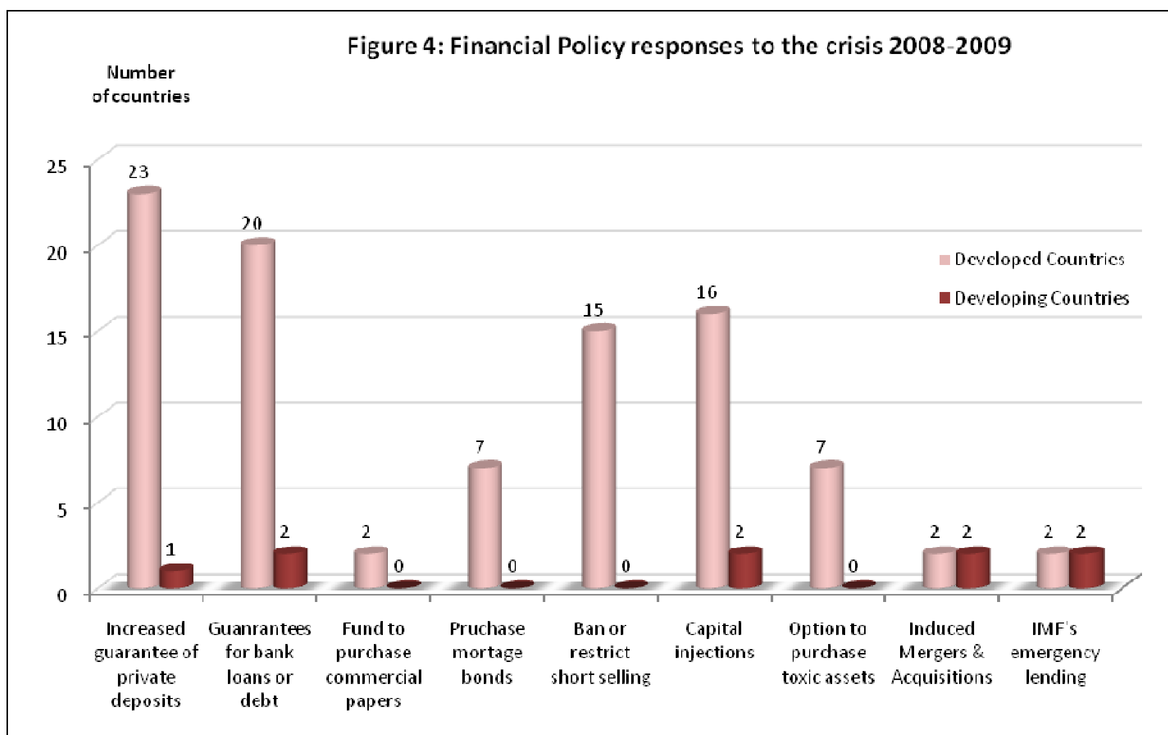
By end of February, 2009 more than 30 countries have announced a range of measures cutting across monetary, financial, fiscal and labour market policy. Media reports suggest that 34 countries have announced USD 2.25 trillion dollars worth of fiscal stimulus packages.[36] Developed countries dominate this cohort, but it also includes some developing countries. These policy responses have been analysed by a number of recent studies. A brief overview is offered here.

As expected, the majority of the countries that have adopted expansionary monetary policy (as reflected in interest rate adjustments until end-2008) belong to the developed world (**Figure 3**). As expected too, efforts to fix the financial system have been led by developed countries (**Figure 4**).

[33] Nelson Schwartz (2009) 'Rise in Jobless Poses a Threat to Stability Worldwide', *New York Times*, February 15
[34] Chowdhury (2006)
[35] On Brazil and South Africa, see UNCTAD (2008). On Indonesia, see IIF (2009)
[36] As cited in Ban-Ki Moon and Al Gore (2009) 'Green Growth is Essential to any Stimulus', *Financial Times*, February 16



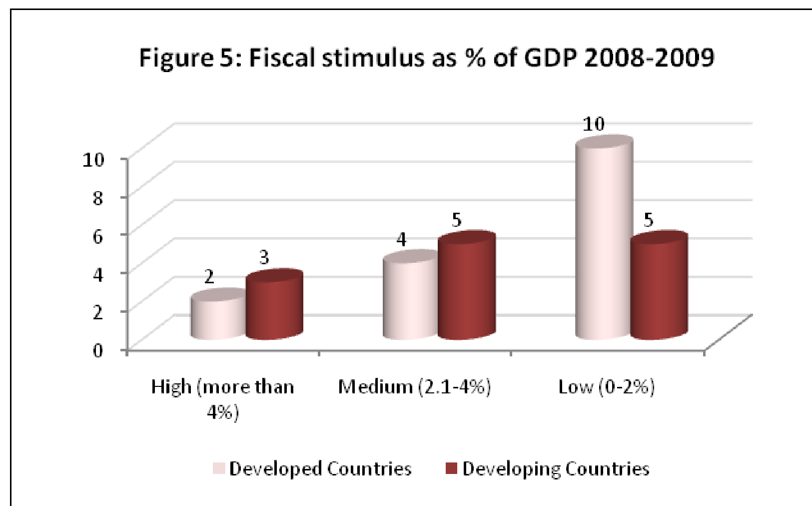
Sources and notes: Derived from ILO and IILS (2009) and supplementary sources



Sources and notes: Derived from ILO and IILS (2009)

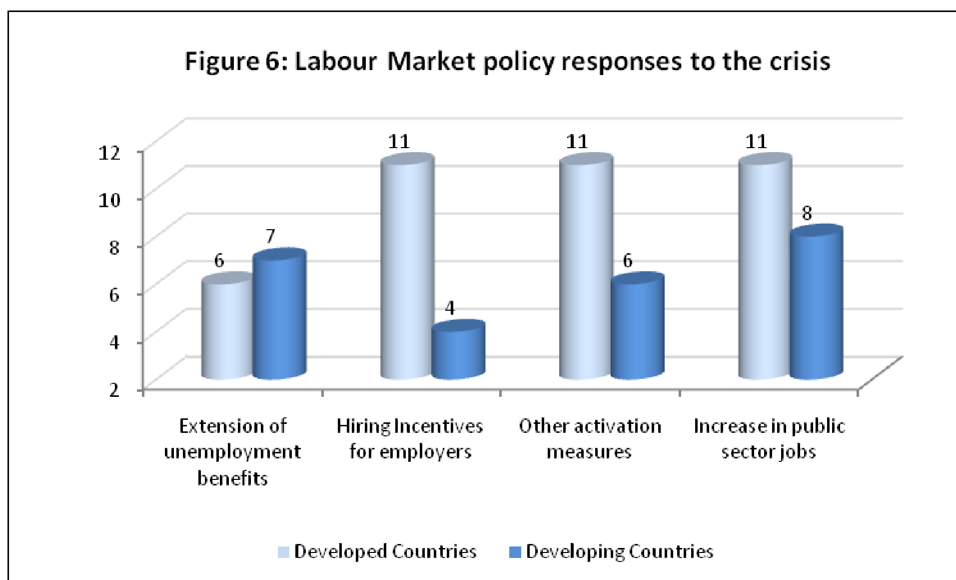
By the end of 2008, it was clear that the global economic crisis could not be fought by expansionary monetary policy alone, nor could it be reversed by efforts to fix the financial system. At this juncture, many countries switched to a Keynesian mode and embraced fiscal stimulus packages. Out of the more than 30 countries with publicly available information on such packages, 12 can be regarded as developing and emerging economies. Most of the packages are less than 4% of GDP (**Figure 5**).[37] All of these packages entail a combination of spending programs on infrastructure, income transfers and tax cuts.

[37] See ADB (2009) for an update on fiscal stimulus packages for developing Asian economies.

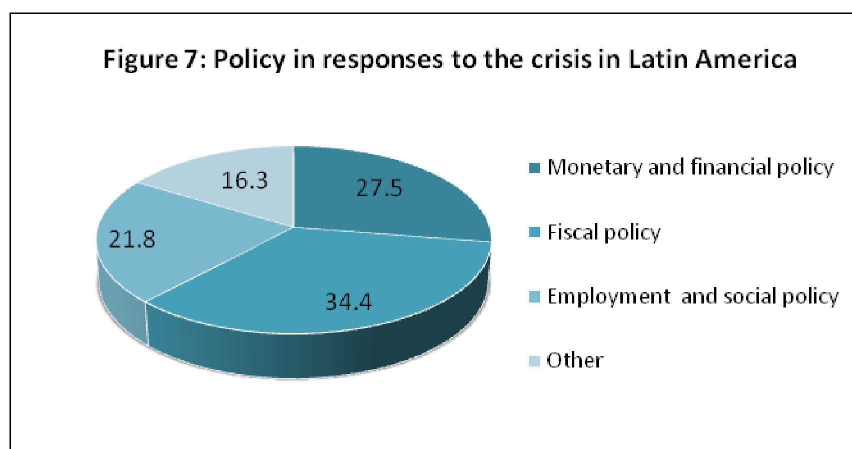


Sources and notes: Derived from ILO and IILS (2009) and ILO (2009a)

Labour market policies have received relatively little attention vis-à-vis monetary, financial and fiscal policies. Some information on the type of labour market initiatives in response to the crisis that have been used by both developed and developing countries are shown in **Figure 6**. These initiatives include extension of unemployment benefits, various activation measures, hiring incentives for employers and increase in public sector employment to compensate for the decline in private sector jobs. The available evidence shows that, in general, developing economies have made less use of labour market policies than developed countries. A clearer picture of this pattern emerges in the case of Latin America. As can be seen in **Figure 7**, only 22 % of the policy responses to the crisis in Latin American governments can be classified under the rubric of 'employment and social policies'.



Sources and notes: same as in Figure 5



Sources and notes: ECLAC (2009)

4.3 Policy responses to the crisis: an evaluation

How effective are the policy measures (announced so far by more than 30 countries) going to be in tempering the effects of the crisis on output and employment? There is a consensus that the effectiveness of monetary policy has reached its limits – raising the spectre of a classic 'liquidity trap'. In some advanced economies, interest rates that are pertinent to policy-making are already below 1%. Even in some export-oriented Asian economies, policy interest rates are barely above 1 %.[38] These are thresholds that have not been seen for many decades. Yet, there is little evidence that such a low interest rate environment is ushering in economic recovery. The point is that USA and some countries in the 'G3' are suffering from a 'balance sheet recession' caused by the precipitous decline in equity prices. Windfall gains in interest rate cuts are not leading to demand for new borrowing for consumption and investment as firms and households are engaged in repairing their balance sheet through the mechanism of debt consolidation.[39]

In light of this impaired nexus between monetary policy and economic activity, the resumption of growth in the short-term will have to depend on fiscal stimulus packages. One recommendation – issued by the Managing Director of IMF in November, 2008 – is that, to be effective, fiscal stimulus packages across systematically important countries should be globally coordinated and should amount to about 2% of their collective GDP. Furthermore, there is broad agreement that spending programs, rather than tax cuts, are more likely to be effective. The size of the fiscal stimulus varies, depending how it is measured – a point that is revisited at a later stage. There is lack of clear evidence on global coordination in terms of both the content and magnitude of the various policy packages.

There is not much information on how the size or composition of various policy packages was determined. A simple correlation analysis between projected growth decelerations across countries and variations in the relative size of fiscal interventions does not suggest a particularly strong relationship. In other words, it is by no means clear that policy makers in different countries arrived at the size or composition of fiscal policy

[38] The (unweighted) average interest rate is 1.2 % (as recorded in February, 2009) for the following sample of Asian economies: Hong Kong, Singapore, Taiwan, Thailand, South Korea and Malaysia. The outliers (interest rates that are 5% and above) are: Indonesia (8.5%), Vietnam (7.0%), Philippines (5.5%), India (5.0). See ANZ (2009) *Emerging Asia Economic Monthly*, February
[39] Koo (2008)

interventions on the basis of an ex-ante assessment of the projected slowdown in economic activity and on the basis of a clearly articulated framework.[40]

Of course, even if they aspire to engage in ambitious fiscal policy interventions, policymakers, especially in developing countries, might be constrained by weak balance of payments position, high initial levels of budget deficits and inadequate institutional capacity. A simple correlation analysis could not unearth any significant association between balance of payments deficits and the magnitude of fiscal interventions. This implies that countries with large balance of payments deficits are as likely as countries with a balance of payments surplus or modest deficits to engage in fiscal stimulus.

A broader approach to an assessment of the constraints on counter-cyclical fiscal interventions depicted in **Tables 2** and **3** which draw on World Bank data on developing economies. The first table here shows distribution of countries by fiscal space and institutional capacities based on three thresholds (low, medium, high).

Table 2 suggests that about 11% of the countries have both low institutional capacity and low fiscal space, while 18% of the countries have low fiscal space regardless of their institutional capacity. These are promising findings suggesting that the typical developing country can, with the necessary political will and a suitable combination of technical and financial assistance from the donor community, cope with the crisis and move forward with an agenda of sustainable and equitable growth.

Table 2: Distribution of countries by fiscal space and institutional capacities

		Fiscal Space		
		Low (36)	Medium(40)	High (27)
INSTITUTIONAL CAPACITY	Low	11	5	13
	Medium	20	27	9
	High	5	8	5

Table 2. Source: Derived from World Bank (2009b)

Table 3 draws on a sample of Asian economies to work out where they fit in terms of this framework (*where size of fiscal deficit as a proportion of GDP is shown in parentheses*). The sample is unfortunately too small to detect any significant pattern. It appears that some countries with high fiscal space (China) have engaged in much more ambitious counter-cyclical interventions than countries with low fiscal space (India), but there are exceptions.

[40] See Spillimbergo *et al* (2008) 'Fiscal Policy for the Crisis', December 29, IMF Staff Position Note for such a framework

Table 3: Distribution of selected Asian economies by fiscal space and institutional capacities

		Fiscal Space		
		Low (36)	Medium(40)	High (27)
INSTITUTIONAL CAPACITY	Low			
	Medium	India (0.7)	Philippines (4); Indonesia (1.1); Viet Nam (1.1); Brazil (0.3)	China (6.9)
	High		Mexico (4.7)	Malaysia (1); Thailand (3.3); Chile (2.2)

Table 3. Source: same as in Table 2. Numbers in parentheses are the value of fiscal stimulus packages as a proportion of GDP.

4.4 Country-specific experiences versus cross-country evaluations

There is relative dearth of information on ex-ante analyses of the effectiveness of fiscal stimulus packages in specific countries. Are they adequate enough to arrest the decline in output and employment? One illustration of such an analysis is offered in **Box 3**. It depicts the official evaluation of the so-called 'Obama Plan', that is, the fiscal stimulus package implemented by the Obama administration in USA. Unfortunately, the outcomes are modest. The package will mitigate the magnitude of the recession (in terms of stemming the rise in unemployment), but not its duration. Some prominent critics, such as Nobel Laureate Paul Krugman, contend that both the composition and size of the package are inadequate relative to what is needed. In any case, political horse-trading has whittled down the original size of the fiscal stimulus package by about 12%, while the proportion of tax cuts is higher than it should be.[41]

[41] See Paul Krugman (2009)'What the Centrists Have Wrought', *New York Times*, February 7. One commentator on European policymakers maintains that they '…still appear to believe that the economy will miraculously recover in the second or third quarter, which is when their stimulus packages will kick in. But these plans are nowhere near big or good enough to stop such a massive decline (in output) so quickly'. See Wolf Munchau (2009), 'Global policy shortcomings will cost us dear', *Financial Times*, March 2. Others who are concerned about the inadequate size of the fiscal stimulus of the systemically important countries include include Bergsten (2009) and Feldstein (2009)

Box 3: The American Recovery and Reinvestment Plan: will it work?

The general consensus seems to be that the current US recession is 'likely to be more severe than the last two'. One study notes: 'According to most projections, unemployment won't peak until mid-2010 when, absent substantial public investment, the rate is likely to reach 10.2 %. It could remain as high as 7.6% at the end of 2012, four years from now'. If these grim projections are borne out, the current recession will bear the unenviable mantle of being the most severe since 1973. Not surprisingly, a lot of hope is being placed on rapid and comprehensive implementation of the much-debated fiscal stimulus package that has just been successfully negotiated by the Obama administration. Yet, what will the Obama Plan achieve even if fully, and quickly, implemented? One can draw on an official evaluation to offer a clue. First, the fiscal stimulus package will mitigate the magnitude of the impact of the recession on the labour market. In absence of the stimulus package, the unemployment rate is expected to reach 8.8% by 2010, but it is still projected to reach 7.0% with the assistance of the 'large prototypical package'. Second, the duration of the job market recovery will not be affected. The unemployment rate is projected to reach 5% (which is very close to the 2007 benchmark) by the first quarter of 2014, *but this will also happen even in the absence of intervention.* In other words, the much-discussed Obama plan will soften the impact of the recession on the labour market, but the duration of the recovery is unlikely to be altered. This implies that one would need a range of active and passive labour market policies to supplement the potency of the fiscal stimulus package.

Sources: Irons, J (2009) 'How long would a job-market recovery take?' January 7, *Economic Policy Institute;* Mishel, L *et al* (2009) 'Without adequate public spending, a catastrophic recession for some', Issue Brief No.248, January 13, *Economic Policy Institute;*
Romer, C and Bernstein, J (2009) 'The job impact of the American recovery and reinvestment plan', *Council of Economic Advisers and Office of the Vice President*, 9 January

While in-depth knowledge of the efficacy of country-specific fiscal expansions is missing, one could argue that it does not matter a great deal in the case of the typical developing country. The emphasis should be on the overall size and composition of the fiscal expansion for the systemically important countries. Thus, if the G20 nations as a whole can boost global demand and close the output gap (the difference between potential global GDP and actual GDP as it now prevails) through their fiscal actions, then developing countries outside the G20 can 'free ride' from the positive externalities of such collective action. This implies that the typical developing country should not be unduly concerned.

What does the evidence show in terms of the collective ability of the G20 to close the output gap? Table 4 summarises the findings from a number of evaluations. As can be seen, the relative size of the fiscal expansion undertaken by various countries depends on how it is measured. If expressed as a proportion of either the combined GDP of the OECD countries or the nine largest countries, the relative size of the fiscal expansion is impressive (a little over 3% of GDP), but it drops appreciably when assessed as a proportion of the collective GDP of the G20. The verdict is even more disappointing when one considers the fact that the current fiscal stimulus packages, taken together, cannot remove the output gap at the global level. Some analysts have argued that the required fiscal expansions of the G20 will need to be even higher than the benchmark recommended by the IMF in late 2008 because the global output gap has grown significantly since then.[42]

The verdict on the composition of fiscal packages announced by the G20 is equally disappointing. There is a consensus that spending multipliers have higher values than tax multipliers. Moreover, public investment in infrastructure has very high impact on output and employment.[43] Yet, most countries went for a 'diversified' approach, that is, the fiscal packages have entailed a combination of tax cuts and public spending programs, a proportion of which was devoted to investment in infrastructure. While this is understandable because public infrastructure investment suffers from implementation lags,

[42] See Bergsten (2009). He suggests a relative size of discretionary fiscal expansion equal to 3% of the combined GDP of the G20 that will have to be maintained for 2009 and 2010.
[43] OECD (2009) reviews of the evidence reveal the following. An increase of 1% of government expenditure leads to a 1.3% increase in output. A 1% tax cut leads to increase in output that varies from 0.8% (personal income) to 0.4% (indirect taxes).

the current composition of the typical fiscal stimulus package announced so far has not been designed to maximise their impact on output and employment. Furthermore, a lot of the fiscal interventions are front-loaded, that is they concentrate on 2009 rather than 2010. Some analysts suggest that this front-loading also dilutes the effectiveness of fiscal expansions.[44]

The implications of the above findings for developing nations that fall outside the G20 is that they cannot rely on the 'trickle down' benefits from a globally coordinated fiscal stimulus undertaken by the G20. If the present is any guide, the indirect benefits of collective fiscal action by systemically important nations are unlikely to accrue on a timely and a large enough scale to make a difference to the economic circumstances of the developing world. In any case, many developing countries lack the necessary repertoire of labour market and social protection policies to protect the poor and vulnerable from the deleterious consequences of the global recession.

It thus appears that developing countries need direct support in enacting fiscal stimulus packages. One exercise, drawing on the experience of sub-Saharan Africa, points out that an aid-financed fiscal expansion of USD 50 billion will be needed for the region to remove an estimated output gap of USD 40 to 50 billion. The composition of the fiscal intervention is important. An aid-financed public investment in infrastructure is the best option, provided it is well-designed and well-managed. This strategy contributes to the long-run growth potential of the region and also confers benefits to the donor countries by increasing demand for their goods and services[45].

Table 4: Summary of key findings on fiscal stimulus packages

Agency	Sample coverage	Estimated size of fiscal expansion (as % of GDP)	Key findings
ILO and IILS	G20 + 12 countries	1.7	*Overall size inadequate relative to what is needed *Composition does not maximise employment impact *Model-based simulation suggests that biggest employment impact from labour-intensive public expenditure programs *Model-based simulation suggests that delay in implementation reduces ability to close 'jobs gap'
Brookings	G20	1.4	*Size falls short of benchmark set by IMF *Composition varies significantly and not geared towards maximising size of fiscal multipliers *'Frontloading in many cases, that is, fiscal expansion mostly in 2009
IMF (1)	Nine 'largest economies'	3.4	*Although size appears large, impact not significant enough to offset output gap *'Diversified approach (mix of tax cuts and spending) *There is a +ve relationship between output gap and size of fiscal expansion (higher output gap leading to higher fiscal expansion) *Initial conditions constrain size of fiscal expansion
IMF (2)	G20	1.5	*Although sizeable increase in output and employment, overall impact still not significant enough to offset output gap *Diversified approach, but evidence that infrastructure spending has biggest impact on growth

[44] Bergsten (op.cit).
[45] Barrell *et al* (2009)

			*There is a +ve relationship between output gap and size of fiscal expansion (higher output gap leading to higher fiscal expansion) *Initial conditions constrain size of fiscal expansion
OECD	OECD economies	3.4	*Although size appears large, impact not significant enough to offset output gap *Diversified approach, but evidence is that 'spending multipliers' bigger than 'tax multipliers' * -ve relationship between 'automatic stabilizers' and size of fiscal expansion

4.5 Summary

The review of the policy measures undertaken, so far, suggests the following salient patterns.

- The crisis response strategies are being led by the developed world. This is understandable, as the recession was bred in the rich nations. Yet, they also have both the institutional capacity and the resources to mount counter-cyclical interventions.
- The available evidence on policy responses among developing countries is relatively sparse. Out of the more than 100 countries that can be classified as developing economies, there is probably usable for a handful of countries spread across Asia and Latin America. Africa is clearly underrepresented in the available datasets that have been used in this study. Future work should make a determined effort to rectify this lacuna.
- The available evidence, based on Latin America, suggests that policymakers have not, as yet, made sufficient use of labour market and social policies to complement interventions via conventional macroeconomic and financial policies.
- One evaluation of the highly publicised fiscal stimulus package in the United States suggests modest outcomes.
- Cross-country evaluations reveal that fiscal expansions undertaken so far by the G20 are inadequate to remove the global output gap and are not designed in a way that maximises the effectiveness of policy interventions.
- Developing economies cannot rely on the 'trickle down' benefits from globally coordinated fiscal actions. They need direct support to enact fiscal stimulus packages. The benefits of this direct support have been documented in one study on sub-Saharan Africa.

5. Revisiting the notions of policy and fiscal space in developing countries[46]

A widely accepted view is that developing countries lack fiscal and policy space and thus cannot respond effectively to the global economic crisis. This leads, according to one perspective, to '…large asymmetries in global economic policies – counter-cyclical policies are pursued by developed countries, while most developing countries pursue pro-cyclical

[46] This discussion draws on a burgeoning literature on the twin notions of policy and fiscal space. On policy space, see UNCTAD (2002, 2004, 2006), Woodrow Wilson Center (2006), Ranieri (2009), ODI (2007), Chang (2005), Akyuz (2007). On fiscal space, see Heller (2005a, 2005b, 2006a), Heller *et al* (2006), Perotti (2008), Roy *et al* (2006), Schik (2008), Culpeper and Kappagoda (2007).

policies'.[47] Others concur that this is indeed a matter of concern. As the Global Monitoring Report for 2009 jointly produced by the World Bank and IMF notes:[48]

> ...most developing countries faced with sharply declining growth and consequent major social disruptions lack the resources to mount any fiscal response, and will in fact experience a further erosion of their fiscal space as public revenues fall and external financing dries up.

Despite this renewed interest on the limited capacities of developing countries to cope with the global downturn, some practitioners have complained that the dual, and interrelated, notions of policy and fiscal space are 'fuzzy'.[49] They need to be clarified in the interest of informed policy discourse. This clarification is critical in deepening our comprehension of contemporary discussions on how best to enable developing countries to respond to the global economic crisis.

5.1 Policy space: two interpretations

The discussion commences with the idea of policy space. Here, there are two broad strands. One advances the thesis that multilateral rules under the WTO-based international trading system have constrained the capacity of developing country governments to pursue industry and trade policies that are compatible with national aspirations. This thesis is associated with the work of UNCTAD and first emerged about 2002 and received, as an ODI Briefing Paper put it, 'official status' in the Sao Paulo Consensus of 2004. Whether or not the WTO-based international trading system constrains policy space is a matter of some debate and its resolution requires careful country-specific studies.

This paper is concerned primarily with a second strand of thinking on policy space that predates the first and evolved from open economy macroeconomics.[50] The latter was in turn rooted in the institutional context of OECD economies. Widely attributed to the work of Fleming and Mundell, the core idea is that national governments cannot exercise independent monetary policy to influence domestic output and employment in the presence of perfect capital mobility. This important finding evolved into the thesis of the so-called 'impossible trinity'. In other words, national governments cannot expect to run an autonomous monetary policy, control the exchange rate *and* maintain an open capital account. While all three are potentially feasible, only two are possible at a point in time. In this interpretation, lack of 'policy space' or 'policy autonomy' stems from capital mobility.

While lack of policy space engendered by capital mobility is, in principle, a thesis that is equally valid for both developing and developed countries, it is the former that the literature seems to have focused on. This is because banking and financial crises have, in the past, been typically associated with middle-income developing countries with access to global capital markets. Hence, debates on financial crises in the developing world have sought to deal with the unintended consequences of capital account liberalisation.

A conspicuous feature of capital account liberalisation in developing countries is that of so-called 'liability dollarisation'. In essence, this means that the private sector acquires liabilities in foreign currency, although assets are denominated in local currency. This makes the balance sheet of the private sector highly sensitive to shifts in the exchange rate. Significant exchange rate depreciations can lead to large and negative wealth effects as

[47] Members of the Commission of Experts of the President of the UN General Assembly on reforms of the international monetary and financial system, January 6, 2009
[48] Global Monitoring Report (2009: 5)
[49] See Heller (2005a) and Perotti (2007).
[50] The rest of the discussion draws on Akyuz (2007) and Cavallo and Izquierdo (2009)

liabilities increase in value relative to assets. Such wealth effects often cannot offset the positive impact on competitiveness engendered by exchange rate depreciations. This is not an academic point. Developing countries often experience sharp changes in capital flows. The most conspicuous – and the most damaging in terms of its impact on real output, employment and wages – are so-called ‘sudden stops’, when there is an unanticipated cessation of capital flows that are not linked to any systematic policy errors committed by developing country governments. These sudden stops reflect failures and shortcomings in international capital markets. Under normal circumstances, governments would seek to mitigate the impact of a capital account crisis on the real economy by engaging in countercyclical policies. Unfortunately, the presence of liability dollarisation – as well as the lack of preparedness - acts as a binding constraint on policy space. Monetary authorities develop a ‘fear of floating’ and thus are reluctant to allow the depreciation of the exchange rate and engage in expansionary policies because of the rather large negative wealth effect stemming from liability dollarisation.

The 1997 Asian financial crisis has shown how liability dollarisation engendered by capital account liberalisation severely constrains policy options available to governments. In addition, when they turned to the IMF to seek external assistance, these constraints were reinforced when the IMF, in a bid to restore capital flows by seeking to restore investor confidence, advised governments in the region to engage in monetary restraint by sharply increasing interest rates. They were also advised to implement a fiscal austerity program and a comprehensive program of structural reforms to make them even more integrated with the global economy. In retrospect, this exercise in pro-cyclical policies and a comprehensive structural reform agenda failed to restore investor confidence, while the large exchange rate depreciations could not overcome the negative wealth effects by inducing an increase in competitiveness. The program of monetary restraint and fiscal adjustments made matters worse. The result was a severe region-wide recession, with Indonesia becoming the worst affected country.

Not all countries in the region accepted the policy constraints imposed by sudden stops and reinforced by IMF agreements to deal with sudden stops. Malaysia represented a conspicuous exception. It eschewed IMF agreements and imposed temporary capital controls[51]. It recovered faster than Indonesia that sought to follow IMF prescriptions. In addition, a recent study of some Latin American countries show that better preparedness can allow governments to deal with a capital account crisis by engaging in countercyclical policies[52]. These governments accumulated either fiscal resources or foreign exchange reserves during ‘boom’ times and used them to mitigate the impact of capital outflows on the real economy. This leads one to a discussion of ‘fiscal space’ and how harnessing it can enhance the policy options available to governments. Enlarging policy choices in the fiscal domain need to be seriously considered in light of the evidence that fiscal policy in developing countries is usually pro-cyclical even in the absence of IMF interventions.[53]

5.2 Fiscal space: two interpretations

One author defines fiscal space as ‘the room in a government’s budget that allows it to provide resources for a desired purpose without jeopardizing the sustainability of its financial position or the stability of the economy’.[54] This might be characterised as the IMF view of fiscal space.

[51] Islam and Chowdhury (2000, ch.7)
[52] Cavallo and Izquierdo (2009)
[53] The evidence is reviewed in Akyuz (2007) and Perotti (2008).
[54] Heller (2005a:1)

How does a developing economy enhance fiscal space in a way that does not threaten 'the sustainability of its financial position or the stability of the economy'? There are, in principal, several avenues. An obvious approach is to raise the revenue share in GDP in the case of countries with low tax burdens. The IMF advice is that low-income countries should raise the revenue share to 'at least 15% of GDP.'[55] Yet another way of enhancing fiscal space in a sustainable fashion is to re-allocate government expenditure programs from low priority areas to high priority areas, such as cutbacks on defence and internal security to health, education and infrastructure. A closely related initiative is to increase the efficiency with which public expenditure programs are delivered. Other options to enhance fiscal space that meets the sustainability criteria include the use of proceeds from privatisation to fund particular initiatives, private sector-public sector partnerships to augment government expenditure programs, especially in infrastructure and the use of external grants. Of course, all of these options are subject to various complications. Raising the revenue share in GDP is a long-term agenda and requires resolute commitment to tax reform. Reallocation of public expenditure and efficient utilisation of existing resources are easier said than done, in view of institutional and political impediments. The use of external grants as a predictable and long-term source of development finance has not materialised in practice (on which more later).

The use of deficit financing is an area where the IMF approach to fiscal space has demonstrated a great deal of circumspection. Fiscal deficits can be financed by borrowing from domestic and external sources and by seignorage or money creation. The risk of the former is that it can lead to unsustainable debt service obligations, while the risk of the latter is that it can lead to high inflation.

Some analysts closely associated with the UNDP have sought to proffer an approach to fiscal space that serves as an alternative to the IMF view.[56] They contend that the IMF – and the Bretton Woods - approach to fiscal space is dominated by fiduciary concerns about sustainability at the expense of development objectives. This has led in practice to policy advice that focuses on the attainment of short-run fiscal targets (usually using such indicators as debt/GDP ratios and fiscal deficit/GDP ratios). The primary goal of fiscal policy in this alternative interpretation is to mobilise resources to finance public investment to support long run growth and attain the Millennium Development Goals (MDGs). The available evidence suggests that public investment as a share of GDP has fallen, in some cases precipitously, across both low and middle-income developing countries. This has been detrimental to both long-run growth and the attainment of the MDGs.

Why has public investment declined in developing countries? The answer, according to this literature, lies in the first generation 'structural adjustment programs' pioneered by the Bretton Woods Institutions (BWIs). In the quest to attain fiscal consolidation, the IMF, within the framework of structural adjustment, has exhorted developing country governments to focus on attaining overall fiscal targets. Little attempt was made to distinguish between the composition of the public budget, or current vs. capital expenditure, and its overall size. The consequence was that capital expenditure pertaining to spending on infrastructure was cut to meet overall fiscal targets as it is politically difficult to cut current, non-discretionary expenditure pertaining to wages and salaries of civil servants as well as income transfer programs. The expectation of the BWIs was that private investment would increase to compensate for the shortfall in public investment, but this not happened.

[55] Heller (2006:75).
[56] Roy *et al* (2006)

There has been a belated recognition by the IMF that the decline in public investment, most notably in the area of infrastructure, has not been compensated by the rise in private investment. This has led to attempts to sustain 'pro-poor' social expenditure in developing countries even within the framework of fiscal consolidation and in the current generation of poverty reduction strategies (PRS). Whether this has worked is still an open question. In Africa, for example, social expenditures on health and education have been sustained, but at the expense of a significant fall in infrastructure spending.[57] One might add that new, survey-based research on sub-Saharan Africa suggests that firms regard poor-quality infrastructure (such as poor roads, unpredictable supply of electricity) as a major constraint on business opportunities.[58]

The critique of the IMF approach has considerable merit, but the critics have to contend with ways of increasing fiscal space in a sustainable fashion. If some – or even many – developing countries are hampered by poor initial conditions leading to high fiscal deficits and debt service obligations, what is the way out? As the critics of the IMF approach to fiscal space readily admit, foreign-aid financed interventions to scale up public investment has some inherent limits, because the 'the external and volatile nature of aid can undermine country ownership and increase vulnerability to shocks…' [59] The available evidence substantiates these concerns. As one study concludes: '(The) evidence strongly suggests that aid is highly unpredictable.' It is as volatile as private capital flows to emerging markets and its volatility increases with aid dependence... There is also evidence that multilateral flows are relatively more volatile than their bilateral counterparts'.[60]

It seems that there has to be a renewed commitment to domestic resource mobilisation in developing countries to increase fiscal space. Here, the evidence is disappointing. One study finds that the share of revenue in GDP for all low-income countries fell between 1990 and 2004 and is below the 15% benchmark proposed by the IMF.[61] This development can be attributed to several factors. Trade liberalisation, by reducing tariffs, has eroded a traditional and major source of revenue in developing countries. This 'fiscal shock', amounting to 2% of GDP according to some estimates, has not been adequately compensated by other sources of tax revenue, most notably value-added and income taxes, partly because of limited institutional capacity and partly because of lack of political will of governments. High aid dependence in some countries seems to have reduced tax efforts in some developing countries. The global agenda on downsizing the public sector, the need to provide tax incentives to attract foreign direct investment and the rise of international tax havens have all worked against the idea that increasing the share of revenue in GDP through the taxation system is a politically attractive option. High tax burden can reduce incentives to work and to invest, but the problem is that many low income countries, and even some middle income ones, face a so-called 'tax gap' in which their actual tax collection efforts fall well below their potential. This is a major development agenda that deserves renewed attention in light of continuing debates on lack of fiscal space in developing countries.

[57] Roy *et al* (2006:5). The sample size is 11 countries and the period of coverage is 1980 to 2001.
[58] See Ramachandran *et al* (2009). The data is based on 5000 firms across 29 countries.
[59] Roy *et al* (2006:25).
[60] Akyuz (2007)
[61] Culpeper and Kappagoda (2007:12).

5.3 Policy and fiscal space in developing countries and the current economic crisis

As is now clear, no country is likely to be immune from the severe global recession that is underway. One can, and ought to, bemoan the fact that many developing country probably lack the policy and fiscal space to engage in counter cyclical interventions to cope with the consequences of the global recession. What the current literature on policy and fiscal space demonstrates is that financial globalisation can severely constrain policy options in middle-income developing countries with access to global capital markets, especially if it leads to liability dollarisation.

The brief review of the literature has also shown that the fiscal consolidation exercise that has been undertaken under the first generation 'structural adjustment programs' in the developing world has been associated with declines in public investment, especially in infrastructure. Such declines have not been offset by an adequate increase in private investment. In addition, one observes a fall in the revenue share of GDP in low-income countries to the point where it is now below the 15% benchmark recommended for such countries. This has constrained the fiscal capacity of governments to pursue growth and poverty reduction objectives. Foreign aid inflows, despite increases in recent years, have not compensated for the lack of domestic resource mobilisation because they have been volatile and unpredictable, with such volatility costing, according to some estimates, up to two per cent of GDP annually.[62]

Yet, developing countries can, in principle develop the resilience to cope with external shocks. As noted, better preparedness can go some way towards fortifying the capacity of developing countries to cope with cyclical downturns. As the experience of some successful examples of crisis management in Latin American countries have shown, it is possible to engage in some degree of 'self-insurance' by accumulating fiscal resources during 'boom' periods and using such resources to finance expansionary policies or targeted interventions during a downturn.[63] Despite this, many Latin American economies have not engaged in such a prudential strategy during the recent period of robust growth that preceded the current global recession.

An alternative way in which such 'self-insurance' mechanisms have been put in place pertains to accumulation of foreign exchange reserves. This became particularly evident after the 1997 Asian crisis when countries in the region, scarred by such experience, decided to build up a buffer against capital account crises.

It needs to be recognised that 'self-insurance' mechanisms, most notably when exercised in the form of holding large foreign exchange reserves to act as a buffer against external shocks, can impose high opportunity costs. This is because such reserves, typically held in low-interest bearing US Treasury bonds, could have been utilised for productive purposes rather than sitting 'idle'. Some estimates suggest that the opportunity cost of this particular form of 'self-insurance' can be quite substantial[64].

There are manifold implications that follow from the analysis undertaken so far. First, it takes time to improve preparedness to deal with a crisis. Similarly, it takes time to improve the share of tax revenues in GDP. This cannot be accomplished overnight.

[62] Kharas (2008)
[63] These successful cases are Brazil, Chile and Peru. See Cavallo and Izgueirdo (2009).
[64] Baker and Walentin (2001)

Reducing costly and inefficient forms of 'self-insurance' to deal with external crisis requires regional and global cooperation in undertaking reforms to tackle shortcomings in global capital markets. This, however, is a long-term agenda and will take some time to bear fruit. What one needs now is an external financing facility that developing countries facing the brunt of the global recession can readily access to support countercyclical interventions. This is an idea that been proposed in the past, but that has resurfaced in the wake of the current crisis. Several proposals have now been made to set up an external financing facility at the global level, but others have proposed that such a facility is best located at a regional level. The merits of these proposals are discussed more fully at a subsequent section of this paper.

One point that deserves to be highlighted – and that was discussed more fully in the section on 'vulnerability analysis' – is that neither the literature on fiscal space nor the literature on policy space pays any significant attention to the role that labour market and social protection policies play in the design of countercyclical interventions. The discussion is limited to the macroeconomic sphere. Yet, even if a typical developing country can pursue expansionary monetary and fiscal policies, its ability to shield poor and vulnerable households from the consequences of a severe global economic recession depends heavily on the scope, size and efficiency of the existing array of labour market and social protection policies. Hence, one needs to reiterate the message that the discourse on fiscal and policy space in developing countries cannot afford to ignore the ability of the typical developing country to use a wide range of labour market and social protection policies to attenuate the effects of a global recession on its citizens.

6. Looking beyond the crisis: from short-term management to a long-term, strategic approach

In the quest to secure sustainable growth, policymakers in developing countries face two challenges. First, they need to move away from short-term crisis management mode to a long-term, strategic approach. Second, they need to temper the intellectual influence of a particular paradigm that has dominated the global development agenda for at least two decades. This pre-crisis development paradigm, characterised by such epithets as 'the Washington Consensus', 'market fundamentalism' and the 'neoliberal globalisation model', allowed a particular formulation of economic policy to dominate global policy discourse.[65] Both these challenges are intertwined. If one believes in the pre-crisis paradigm, then short-term management is a rational strategy, as one can go back to a 'business-as-usual' mindset once the crisis is over and thus disengage from the need to reflect on, and enunciate, alternative pathways to a post-crisis future. Yet, there is a popular aspiration, as reflected in statements by political leaders across the world, that 'more of the same' is no longer an appealing and even a credible option.[66]

It should be acknowledged that The 'Washington Consensus' policy package (and its variants) made a number of important contributions. It highlighted the importance of macroeconomic stability, warned against the dangers of protectionism and advocated the virtues of global economic integration. It demonstrated a capacity to modify its original

[65] The pre-crisis development paradigm is associated with the Bretton Woods institutions, but its core ideas were spawned by intellectuals in the developed world.

[66] As Martin Wolf puts it, 'The world economy cannot go back to where it was before the crisis, because that was demonstrably unsustainable'. See Wolf, M (2009) 'Why the green shoots of recovery could yet wither', *Financial Times*, April 22

stance by making a renewed commitment to poverty reduction within an MDG framework. Yet, it erred in a number of important directions.

Globalisation was promoted as if it was an end in itself rather than a means to an end. The focus on macroeconomic stability led to a narrow emphasis on nominal targets. More importantly, the need for counter-cyclical policies was discounted. This stemmed from an analytical perspective in which the quality of the investment climate became a primary driver of growth. The policy message was that governments needed to follow a particular set of policies – macroeconomic prudence, privatisation, deregulation, trade and financial liberalisation, labour market flexibility – that would boost the investment climate by boosting investor confidence and thus foster growth. This policy package was considered to be valid regardless of the state of the business cycle.

6.1 Elements of a national employment strategy

What is the way forward? Elements of alternative pathways to a post-crisis future can be found in the ILO's Decent Work Agenda. Other organisations, such as the World Bank's MILES approach, have followed suit and share significant similarities with the ILO approach.[67] In addition, the goals and targets for policymaking and monitoring that follow from the ILO's Decent Work Agenda share similarities with the OECD's approach to analysing and monitoring labour market trends.[68]

A national employment strategy drawing on the above ideas should have the following components:

- Goals and targets that reflect popular aspirations for sustainable and equitable growth
- A diagnostic framework that seeks to identify binding constraints on growth and employment creation
- Policies and programs derived from the diagnostic framework
- Mechanisms for consultations with social partners on policy design and delivery
- Monitoring and evaluation entailing a transparent, accountable and rigorous validation process that relies on systematic use of evidence to verify and/or modify the diagnostic framework leading to policy innovations
- A periodic 'stress test' (say, every three to five years) to assess evidence of vulnerability to external shocks and global economic downturns (e.g. asset price bubbles, excessive reliance on particular sectors) and to ascertain how quickly and effectively policy responses can be crafted to such high-impact, low frequency events.

These components add up to an evidence-based approach to policy-making. The primary strength of this approach is that it guards one against myopic policy responses driven by populist pressures and ideological proclivities.

The national employment strategy that is suggested here seeks to enlarge the policy choices available to governments in the developing world. **Table A.1** in the appendix suggests how this strategy compares and contrasts with the conventional approach. There

[67] See Holzmann (2006) on the World Bank's MILES approach to development policy. The key point is that labour market and social policies should be seen as part of a holistic development framework. Hence, the MILES approach (the epithet stands for 'macro', 'investment climate', 'labour', 'education' and 'social safety nets'). The philosophical premise is similar to the ILO's Decent Work Agenda that was unveiled in 1999. How the MILES approach will be operationalised remains to be seen.
[68] See the OECD database on employment available at www.oecd.org

are similarities, but also significant differences. The following normative propositions may be made.

6.2 Goals and targets

There should be fundamental re-orientation of macroeconomic policy goals. They need to be anchored in MDG1 (target Ib) that calls for 'full and decent employment for all, including young men and women'. This goal should be pursued while maintaining macroeconomic stability. This reorientation offers a much-needed corrective to a narrow focus on nominal targets and aligns the macroeconomic policy framework with the global development agenda. There is a diverse range of 'decent work ' indicators that can be used to monitor the attainment of MDG1b beyond quantitative expansions in employment and should be part of the labour market information system in all countries.

6.3 Monetary and financial policies

Until the outbreak of the global economic crisis, the monetary authorities of many developing countries were pursuing inflation targeting. The aim was to attain low, single-digit inflation (usually less than 5%), even though the empirical evidence was not robust enough to support the diligent practice of inflation targeting.[69] The aim of monetary policy should now be to support the attainment of MDG1b while maintaining a moderate (but necessarily low single digit) and stable rate of inflation.

Current proposals for fixing the financial system should take account of the need to provide access to finance to SMEs. This view can be endorsed by findings from business environment surveys (covering more than 10,000 firms in 80 countries) that consistently show lack of bank finance as one of the most important constraints on the growth of SMEs.[70]

6.4 Fiscal policy and public investment

A key message of this paper is that lack of public investment in infrastructure can act as a binding constraint on growth in developing countries. How to facilitate such public investment in a fiscally sustainable fashion is thus a major policy challenge that transcends the imperatives of the current global recession. The ILO's well–established 'employment intensive investment program' (EIIP) has also demonstrated under a variety of developing country circumstances how one can use public investment in infrastructure as a significant source of employment creation, including the creation of 'green jobs'.[71] In light of the deficiencies that have stemmed from the practice of focusing on short-run fiscal targets in the past, a long-term agenda that uses public investment in infrastructure as a major tool of fiscal policy can potentially pay rich dividends.

6.5 Capital account management and FDI liberalisation

The discussion in *Section 5* of the paper made it amply clear that capital mobility can constrain policy options for middle-income developing countries with access to global capital markets. Active capital account management should be seen as an important way to enhance the capacity of policy-makers to pursue discretionary monetary, fiscal policy and exchange rate policy without having to worry about the destabilizing influence of short-

[69] Epstein (2008)
[70] de Ferranti and Ody (2007)
[71] ILO (2004)

term capital flows. In particular, it is necessary to maintain a competitive and stable real exchange rate – a goal that becomes rather difficult to attain in the presence of a high degree of capital mobility. There is a well-established empirical literature that substantiates this view.[72] Furthermore, FDI liberalisation should be subject to a 'national benefit test' in which its relevance to national development needs includes the potential to create productive and sustainable employment.

6.6 The role of labour market institutions

Influential voices are calling for a renewed commitment to labour market flexibility as a long run strategy for dealing with the global jobs crisis.[73] The rationale is that labour market regulations act as a binding constraint on growth and employment creation. Such voices should not be heeded. The uncritical embrace of labour market flexibility should be replaced by an agenda that seeks to uphold core labour standards and empower labour market institutions. This position can be substantiated by several state-of-the-art studies that question the notion that labour market regulations represent a binding constraint on growth and employment creation.[74]

6.7 Social protection and economic security

The focus on time-bound and targeted social safety nets needs to be transcended by an emphasis on the need to provide economic security for all citizens, regardless of where they work and live and regardless of the state of the business cycle. The aim is to have a holistic approach to social protection that uses complementary instruments to cater to the particular needs of different groups in the formal economy, the informal economy and rural areas. ILO and other studies show that incentive-compatible unemployment compensation programs for formal sector workers are technically feasible and fiscally affordable (financed through 1 to 2% of payroll taxes) for developing economies.[75]

There is now a menu of 'best practice' social safety nets that have been used in countries ranging from South Asia to Latin America entailing such instruments as conditional cash transfers, microfinance and rural employment guarantee schemes to cater to workers outside the formal economy.[76] A basic social security package for all is also technically feasible and fiscally affordable for developing economies and requires investment of around 4% of GDP in many cases.[77] Furthermore, greater effort at domestic resource mobilisation, in conjunction with transitional assistance from the donor community, can make such a basic social security package an attainable goal for all

[72] See, for example, Rodrik and Subramanian (2009)
[73] The Economist (2009) 'The Jobs Crisis', March 12
[74] Howell *et al* (2007), Freeman (2007), Berg and Kucera (2008), Ghose *et al* (2008), Lee and Eyraud (2008), McCann and Lee (2008).
[75] Lee (1998), Vroman (1999) and Vroman and Brustentev (2005)
[76] See Ravallion (2008). See also Lustig (2000) who notes that the well-known Mexican *Progresa* conditional cash transfer scheme costs about 0.2 % of GDP and two million households are beneficiaries. The *Trajabar* program in Argentina reaches 350,000 persons and costs a 0.25% of GDP. The Brazilian Bolsa program costs about 0.4% of GDP and covered 11.1 million families in 2006. In Indonesia, the social safety net operations during the height of the 1997 financial crisis cost about 2% of the central government's budget and probably prevented several million from sliding into transient poverty. See Dhanani and Islam (2002).
[77] ILO (2009d). A simulation exercise for Nepal, for example, shows that nearly 100% of the basic social security package can be financed from domestic resources, provided the Nepalese government can partly reallocate social expenditure, increase the goods and services tax rate marginally, improve income tax collection and introduces modest health insurance contributions.

developing countries. Once a social security protection system is in place, it is much easier to pursue enterprise-level flexibility and to cope with global economic downturns.

6.8 Active labour market policies

A comprehensive social protection system needs to be complemented by active labour market policies that focus on training programs and employment services for displaced workers. An analysis based on 345 studies of well-designed training programs in more than 90 countries show that they can have a significant impact on the livelihoods of displaced workers.[78] In the long-term, active labour market policies should aim to develop an education and training system that enhances the productive potential and employability of the work-force.

6.9 Inclusive approach to policy-making: the role of social dialogue

An ILO review reveals that many, if not millions of workers, across the world have to cope with downward adjustments to wages and working conditions as firms struggle to save jobs and maintain operations in the wake of a fall in demand.[79] This so-called 'concession bargaining' at the enterprise level cannot really act as a substitute for tripartite dialogue at the national level. Some governments, notably South Korea and South Africa, have enacted national plans to respond to the crisis by engaging in social dialogue with both employers and workers. One hopes that other governments will adapt this practice more extensively to their particular circumstances.

6.10 Monitoring and evaluation

The monitoring and evaluation framework appears at times to rely too much on statistical exercises using cross-country data to validate competing hypothesis on labour market performance and too little on 'field experiments' to ascertain effectiveness of policies and programs.[80] Hence, policy and program evaluations based on country-specific field experiments to supplement the currently dominant cross-country methodology are highly desirable.

There is an important innovation that policy makers could consider. The monitoring and evaluation framework should include periodic 'stress tests' (say, every three to five years) to identify emerging vulnerabilities and to assess whether policy responses to external shocks and global economic downturns can occur quickly and effectively.[81]

7. The role of global and regional cooperation in strengthening fiscal and policy space in developing countries

The previous section highlighted elements that form part of a national policy framework that drew on the values and principles embedded in the ILO's Decent Work Agenda (DWA). As is well known, the ILO regards the implementation of the DWA as a

[78] See World Bank (2009c)
[79] Ludek (2009)
[80] Duflo (2005)
[81] This point is emphasised by Cavallo and Izquierdo (2009: chapter 1). They call it the need to engage in 'fire drills'.

national enterprise, but a crucial complement to the success of country-level DWA is the nature and degree of global and regional cooperation. The aim is to promote 'fair globalisation' by resolving, through collective action, a range of common challenges and concerns that cannot be handled by individual nations acting on their own. These include (but are not limited to): (a) reform of the international financial architecture to temper the excesses of financial globalisation; (b) the need to deepen voice and representation of developing countries in global economic governance; (c) the need to attenuate global asymmetry in national policy-making, with developed countries pursuing counter-cyclical policies and many developing countries either unwilling or unable to pursue counter-cyclical policies when faced with externally generated economic downturns.

Proposition (c) is most germane to the issue of fortifying the capacity of the developing economies to respond to the current global economic downturn. The G20 Communiqué of April 2, 2009 represents the first major attempt by the global community to tackle the issue. As the Communiqué notes:

'We have …agreed today to make available an *additional* (USD) 850 billion of resources through the global financial institutions to support growth in emerging market and developing countries by helping to finance counter-cyclical spending, bank recapitalization, infrastructure, trade finance, balance of payments support, debt rollover, and social support'.[82]

The G20 communiqué of April 2, 2009 promises an injection of USD 1.1trillion into the global economy. This headline grabbing number appears to be the sum of USD 750 billion to augment existing IMF resources, USD 100 billion for multilateral development banks (MDBs) and USD 250 billion to support trade finance.

This proposal was foreshadowed by a number of suggestions made by multilateral agencies and development practitioners. Some of these suggestions are summarised in Table 5. [83] As can be seen, Nancy Birdsall's suggestion was rather close to the mark.

Table 5: Suggestions for an enhanced global financing facility for developing countries: Some examples

Proposed by:	Title	Objectives	Amount
ILO and IILS (2009)	Global Jobs Fund	To provide stabilization credit separate from traditional IMF package	Unspecified
Commission of Experts, UN General Assembly (2009)	*Immediate: untitled *Long term: New Credit Facility	*To support developing countries so that they can engage in counter-cyclical policies *New and sustainable sources of development finance	*1% of fiscal stimulus packages of G20 (approx. USD 22 billion) + existing aid commitments *Amount for new credit facility unspecified
World Bank (2009)	Vulnerability Fund	To provide funds to the most vulnerable countries to finance expenditure on social safety nets, infrastructure, SMEs	0.7% of fiscal stimulus packages of G20 (approx. USD 15 billion)
ancy Birdsall (2009)	Untitled	To roll over sovereign	USD 1 trillion

[82] *London Summit – Leaders' Statement,* 2 April, 2008

[83] See Bergsten (2009) and Goldstein (2009) both of whom emphasise a substantial replenishment of IMF resources. For proposals on enhanced global financing facilities for developing countries that pre-date current versions, see Dervis and Birdsall (2006) and Akyuz (2007).

	debt, existing bank and corporate debt, to finance fiscal deficits, emergency job and food programs	(USD 829 billion of which will go towards emerging, middle-income economies in Asia, Latin America and Eastern Europe; balance for low income countries.)

Is the G20 initiative a 'new deal' that will bring the global economy out of the recession and assist developing economies to cope with the crisis? The leaders of the G20 understandably claim that a global solution to a global crisis has been found. The G20 Summit declaration has also received the endorsement of some leading development practitioners.[84] The planned USD 1.1 trillion programme (billed as 'support to rescue credit, growth and jobs in the world economy') is added to the existing fiscal stimulus and financial rescue packages announced by the members of the G20 to proclaim that it will raise world output by 4%, which is roughly the estimated output gap at the global level.

An obvious point to be made is that it is misleading to add the USD 1.1 trillion to the existing fiscal stimulus and financial rescue packages. Close to 70% of the former represent additional resources for the IMF. This will only have an impact on the ability of developing countries to enhance their resources if they use IMF financial assistance. The irony, as *The Economist* and others emphasise, is that the IMF is finding it difficult to attract middle-income economies in East Asia and Latin America to even use their existing facilities.[85] This is largely the result of a so-called 'reputational' effect. Given that the IMF has played a controversial role in past crisis management episodes, and given onerous conditionalities that are attached to IMF assistance programs, this reluctance by member states is understandable. Furthermore, such member states can observe that countries (13 in all) that are under current IMF agreements are being subjected a typical IMF macroeconomic stabilisation-cum-adjustment program, entailing monetary restraint, fiscal austerity and structural reforms.

Once the funds allocated to the IMF and trade finance are taken out, the current G20 initiative appears much more modest- amounting to about USD 100 billion new monies proposed for the MDBs to finance a variety of initiatives with both short term and long term effects. They fall well short of USD 500 billion suggested by Nancy Birdsall (see Table 5). As noted in *Section 5*, one study on sub-Saharan Africa suggests that aid-financed, public investment in infrastructure is essential to compensate for the output loss and sustain long-term growth in the region. This is tantamount to USD 50 billion in sub-Saharan Africa. In other words, 50% of the proposed allocations for the MDBs would need to be spent in one region of the developing world alone. To set this number in a broader context, the estimated output loss so far in the developing world is over USD 800 billion.[86]

Critics of the G20 initiative make two important points. First, the leaders of G20 failed to come up with fresh and practical ideas to fix the financial system that is at the core of the current global economic crisis. Second, they failed to commit themselves to `spend the hundreds of billions of dollars in additional fiscal stimulus that the world economy needs to pull out of its frighteningly steep dive'.[87]

[84] See Sachs (2009)
[85] The Economist (2009)'The IMF: Battling Stigma', March 26. See also Pomerleano (2009)
[86] te Velde (2009)
[87] New York Times (2009) 'The Economic Summit' April 2

There is the unresolved issue of the necessary institutional reforms that need to accompany a substantially expanded role for the IMF. The G20 communiqué makes it clear that this is an agenda that will be tackled later (in 2011). Advocates of the reform of the IFIs are understandably disappointed, fearful of the risk that increased resources in an institutionally unchanged IMF might mean 'business as usual'.

Critics of the G20 initiative contend that insufficient attention has been given to the role that regional and local solutions can play in fortifying the capacity of developing countries to cope with the global economic crisis.[88] Some even make the stronger point that regional approaches are desirable, partly because cooperation is easier to engender and partly because geopolitical considerations can afflict the quality of global solutions to a global economic crisis.[89]

What kind of regional initiatives are underway that have relevance in dealing with today's crisis? In Latin America, there is a Venezuela-led 'Bank of the South' initiative that seeks to develop regionally rooted facilities that can respond to both short-term financing needs and long-term development finance. In East Asia, there are continuing attempts, since the Chiang Mai Initiative of 2000, to develop regional cooperation to enable participating countries to tide over temporary economic setbacks engendered by external shocks. These regional innovations can be seen as attempt to offer opportunities to participating countries to seek access to fast-disbursing, low-conditionality external sources of finance without having to go through the IFIs.[90]

Finally, there is considerable scope for 'peer group' learning in the developing world. Developing countries can learn from their peers in nurturing national initiatives to enhance fiscal and policy space. They can seek lessons from successful cases of crisis management without compromising on policy autonomy (such as Malaysia during the 1997 financial crisis).[91] They can learn from successful operations of national stabilisation funds (as in the case of Chile).[92] What is, important, however, is not to be tempted to regard such national funds as a time-bound operation that is wound up once the global recession is over. This approach is costly and inefficient. The goal of a stabilisation fund is to create the necessary 'fiscal space' to sustain investments in human capital and basic infrastructure across business cycles and to scale up programs pertaining to passive and active labour market policies to cope with external shocks. Such a fund can be financed from excess revenues collected by the government during normal and boom periods. This illustrates once again the critical role that a renewed commitment to domestic resource mobilisation can play in enhancing fiscal and policy space on a sustainable basis. The donor community can provide seed funding and technical assistance, but the success of a national stabilisation fund in developing countries ultimately depends on national commitment.

[88] Baker (2009) "G20: Why support the IMF?" *The Guardian,* April 2

[89] Woo (2008)

[90] See Wesibrot (2009) on both the Latin American and East Asian experiments in developing regional sources of development finance. See Woo (2008) for further details on the East Asian experience.

[91] Islam and Chowdhury (2000, chapter7)

[92] Islam (2005)

8. Conclusion: summary of key findings

This paper has navigated a wide terrain and reflected on a broad range of issues. It would be useful at this juncture to offer a summary of the key findings that are embedded in the various sections.

Section 2 of the paper briefly reviewed the pre-crisis period and noted that a synchronised global boom probably injected a sense of robust optimism about future growth prospects both for the world at large and the developing world. Such optimism perhaps allowed policy makers around the world to overlook the stresses and strains that afflicted the global economy and various regions within it. The discussion at this juncture highlighted the point that, based on long-run data (1970-2008), one can state with a reasonable degree of confidence that global downturns tend to happen, on average, every ten years. Furthermore, based on long-run data (1887-2008), one can identify many major episodes of banking and financial crises that engender recessions of considerable severity. The recovery period from such recessions is typically higher in the case of wages and employment than in the case of aggregate output. The co-movements between growth in the advanced economies and growth in the developing and emerging economies appears to have strengthened, rather than weakened, if one uses decadal averages for the 1970-2008 period. Given that the attenuation of global boom-bust cycles and the resolution of systemic banking/financial crises depend on collective action at the international level that has so far not been forthcoming, developing country policymakers should assume worst-case scenarios and prepare for the periodic occurrence of global economic downturns.

Section 3 of the paper discussed the transmission mechanisms manifested in trade and non-trade flows and used them to explain how the financial crisis that was bred in the United States eventually cast its adverse influence on the rest of the world. Despite this, much depends on initial conditions in affecting the vulnerability of developing countries to the current global recession. These initial conditions in turn reflect a complex range of factors. Such factors include the nature and pattern of pre-crisis growth and how it influences labour market outcomes; the ability of the labour market information system to track the impact of the crisis on employment, real wages and working conditions; the ability of labour market and social protection policies to shield the poor and vulnerable from the global recession; the state of the financial system; the state of fiscal and external balances. Developing countries with impaired initial conditions and external linkages that are insufficiently diversified will be vulnerable to the current global economic crisis. The distributional aspects of the impact of the crisis are as important as its aggregate magnitude. Even if the impact of the crisis might seem relatively moderate at the national level, particular sectors and regions are likely to be significantly affected.

Section 4 of the paper noted that the national policy responses to the global recession are dominated by the following initiatives: (1) sharp reductions in interest rates; (2) efforts to fix the financial system; (3) fiscal stimulus packages. Given that developed nations have been particularly badly hit by the crisis, it is not surprising that they have led the rescue effort in all three areas, but several developing economies ranging from East Asia to Latin America have featured prominently in the announcement and enactment of fiscal stimulus packages.

There is a consensus that expansionary monetary policy has reached its limits, with interest rates reaching 1% even in a number of developing countries. While huge fiscal resources have been expended in fixing the financial system, the initiatives undertaken so far have not led to a re-emergence of credit flows to the real economy on a large enough scale. This partly reflects reduced demand for credit as the private sector goes through a process of debt consolidation to repair its balance sheet, but past experience has shown that recapitalising and reforming the financial system after a crisis takes a long time. Hence, in

the short run, there is little alternative to using expansionary fiscal policy to boost global demand in order to reverse the inexorable decline in global output and employment.

There is by now, a number of cross-country evaluations undertaken by various agencies, the most prominent among them being the International Institute of Labour Studies (IILS) of the ILO, the IMF, Brookings Institute and the OECD. The paper noted that there are concerns about both the size and composition of fiscal stimulus packages: they seem to be inadequate relative to the magnitude of the output gap. Their composition is such that they do not maximise the employment impact of fiscal interventions.

The paper noted that insufficient attention has, so far, being given to the particular concerns of the large number of developing countries that fall outside the purview of the G20. One justification for this approach is that such countries will gain from the positive externalities engendered by a successfully executed global approach to the current world-wide recession. For example, if a globally coordinated fiscal expansion succeeds in boosting global demand, then the typical developing economy gains even if, at the national level, it is unable to mount counter-cyclical policies. The paper argued that such a rationale rests on indirect compensation for the victims of the crisis (that is, the typical developing economy) and limits the discussion to the macroeconomic realm. Many developing economies probably lack the ability to mount appropriate labour market and social protection policies and may not be able to adequately protect the poor and the vulnerable from external shocks. They also lack adequate resources to reverse the secular decline in public investment in infrastructure. The issue of direct assistance to developing countries through an external financing facility cannot be ignored. The G20 communiqué issued at the conclusion of the London Summit appears to have endorsed this idea (discussed in section 6 of the paper), but it is crucial to make a distinction between enabling developing countries to tide over short-term financing needs from efforts that enable them to finance a fiscal stimulus package that can contribute to their long-term growth trajectory. One study on sub-Saharan Africa suggests that, if a USD 50 billion aid-financed program on infrastructure investment could be designed and implemented, it would remove the output gap for the region, yield long-term growth benefits and engender spill over benefits to the donor countries.

Section 5 of the paper revisited the theme that many developing countries find themselves in an invidious position because they lack the fiscal and policy space to cope with global downturns. This paved the way for a discussion of alternative interpretations of fiscal and policy space. One interpretation of policy space deals with the extent to which multilateral rules on international trade and investment can constrain the options available to developing countries to pursue industry and trade policies that reflect their national aspirations. A second strand that predates the first stems from open economy macroeconomics and is highly pertinent to the issues discussed in this paper. The literature pertaining to this genre illustrates the case of middle-income developing countries with access to global capital markets. Capital account liberalisation in many cases seems to have led to ‘liability dollarisation’, that is the build-up of liabilities in foreign currency by the private sector. This has attenuated the ability of policy makers to cope with recessions induced by ‘sudden stops’ in capital flows that reflect shortcomings in global capital markets. Such restrictions on policy makers have been compounded by IMF agreements that typically entail a combination of restrictive monetary policies, fiscal adjustments and structural reforms in a bid to restore investor confidence.

The paper proceeded to argue that developing countries can, in principle, develop the resilience to cope with capital account crises and external shocks. One can harness fiscal resources not only to fortify the capacity of policy makers to cope with business cycles, but also to pursue long-term growth and employment-oriented policies. The notion of mobilising fiscal resources for growth, employment promotion and counter-cyclical interventions leads one to a discussion of fiscal space in developing countries. One can make a distinction between the IMF approach to fiscal space and an alternative view

proffered by analysts associated with the UNDP. In the case of the former, the emphasis is on engendering fiscal resources to attain policy goals and targets in a manner that can preserve fiscal sustainability and macroeconomic stability. This prescription rules out large-scale deficit financing. The alternative view is that an emphasis on fiscal sustainability, while sound in principle, has led in practice to the use of short-run fiscal targets. The practice of fiscal prudence in many developing countries has led to cutbacks in capital expenditure and hence to secular declines in public investment, especially in infrastructure. This has led to the notion that enhancing fiscal space means mobilising domestic resources to finance a public investment-led development strategy to promote growth, attain the Millennium Development Goals (MDGs) and the ILO's Decent Work Agenda.

The paper proceeded to argue that, despite the critique of the IMF approach, one has to contend with finding sustainable ways of increasing fiscal resources to promote growth, employment creation and poverty reduction. Aid inflows have turned out to be an unpredictable source of financing for many developing countries, despite impressive gains in overall volume in recent years. There is little alternative to increasing the share of tax revenue in GDP, especially for low-income countries with low tax burdens. Of course, one has to acknowledge that domestic resource mobilisation is a long-term agenda. The current challenge is to cope with the consequences of the global economic downturn. Not surprisingly, proposals to develop external financing facilities that can enable developing countries to tide over temporary economic setbacks have come to the fore.

Section 6 of the paper warned against the risk of reverting to 'business as usual'. This means reverting to a policy model that held sway since 1980 and that extolled the benefits of free markets, free trade and macroeconomic conservatism but paid insufficient attention to their costs. This policy model needs to be substantially modified by drawing on values and principles of the ILOs Decent Work Agenda (DWA) that are an integral part of the MDGs. This would entail:

- A fundamental orientation of macroeconomic goals and targets involving the incorporation of 'full and decent employment for all' (as enshrined in the first goal of the MDGs)
- Use of monetary policy to support the above goal
- Public investment in infrastructure as an important fiscal policy tool that can lead to sustainable employment creation
- Greater attention to the financing needs of SMEs in attempts to fix the financial system
- Active capital account management and a prudent approach to liberalisation of foreign direct investment
- A comprehensive social protection system that provides economic security for all, regardless of where they work and live and regardless of the state of the business cycle
- Complementing the social protection system by active labour market policies that focus on training programs and employment services for displaced workers, with the long-term aim of developing an education and training system that enhances the productive potential and employability of the work-force
- Greater reliance on social dialogue as it allows greater opportunities for employers and workers to provide inputs to policy design and to share adjustment costs at the enterprise-level in the event of global recession.

Section 7 of the paper offered an evaluation of the G20 declaration at the recently concluded London Summit. It reflects on the views of critics who maintain that the G20 declaration, while promising to harness new resources on a significant scale to assist developing countries, have fallen short in a number of areas. These deficiencies include lack of a clear template to tackle the reform of global economic governance, the lack of fresh and practical ideas to fix the financial system, failure to agree to a new round of fiscal expansion to cope with the steep decline in global demand, and the insufficient appreciation of the scope for regional solutions to strengthen fiscal and policy space in developing countries. The paper suggested that developing countries can also learn from each other, most notably, from successful cases of crisis management as well as successful operations of national stabilisation funds.

Appendix

Table A.1: Looking beyond the crisis: Current policy approach vs. an alternative framework (National Employment Strategy or NES based on DWA and MDGs)

Policy approaches	Current policy approach	Alternative approach (NES based on DWA and MDGs)
Goal(s)	Growth, macroeconomic stability and poverty reduction as reflected in MDGs	MDG1b (2008 version): Full and decent employment for all, including young men and women within a framework of macroeconomic stability
Targets and indicators	Low, single digit inflation (less than 5%) Low budget deficits (less than 3% of GDP) Low current account deficit (less than 3% of GDP) Unemployment rate Growth of employment Growth of real wages	Decent work deficits as measured by: Labour productivity Unemployment rate Employment-to-population ratio Share of vulnerable employment Working poverty (proportion of workers earning less than a 'living wage') Plus: trends in informalisation; wage-productivity relationship; wage share in national output; income inequality Moderate and stable rate of inflation Sustainable current account deficit Long-term fiscal sustainability
Diagnostic framework: binding constraints on growth and employment creation	Labour market regulations, in conjunction with other regulations, that impair the investment climate and adversely affect investor confidence	Survey data reveal lack of good quality infrastructure, access to finance by SMEs and business regulations as binding constraints
Monetary and financial policy	Monetary policy to target low, single digit inflation Competitive financial system Prudential regulation Financial integration	Monetary policy to support implementation of MDG1b within a framework of price stability Incentives to provide access to finance to SMEs Incentives to provide access to finance for sectors/industries with dynamic comparative advantage Competitive financial system Prudential regulation
Exchange rate, capital account management and FDI liberalisation	Competitive and stable real exchange rate, Open capital account combined with FDI liberalisation	Competitive and stable real exchange rate, FDI liberalisation on a case-by-case basis with focus on employment creating potential Active capital account management to discourage short-

		term capital flows
Fiscal Policy	Fiscal policy to support inflation targeting by aiming low budget deficits Public expenditure oriented towards expenditure on health, education and infrastructure, inc. agricultural development Domestic resource mobilisation through broadening the tax base	Fiscal policy to support implementation of MDG1b within a framework of long-run fiscal sustainability Public expenditure oriented towards expenditure on health, education and infrastructure, inc. agricultural development Public investment to act as employment creation tool and provision of 'green' jobs using ILO's EIIP approach Domestic resource mobilisation through broadening the tax base
Labour market and social policy	Labour market flexibility combined with targeted social safety nets drawing on 'best practice' menu	Ratification and implementation of core labour standards Enterprise-level discretion on hiring and firing decisions combined with comprehensive social protection entailing tailor-made instruments geared towards the particular needs of workers in the formal economy, informal economy and rural areas
Global and regional cooperation	Macroeconomic policy coordination when required, global rules to encourage continued integration through trade and financial flows	Promoting 'fair globalisation' through: *Reform of international financial architecture to temper volatility associated with financial globalisation *Deepening voice and representation of developing economies in global economic governance *Global and regional cooperation to support capacity of developing economies to implement counter-cyclical policy
Mechanisms for consultations on policy design and delivery	Initially technocratic, primarily involving finance ministry and central bank, now participatory within the framework of the PRSPs	Social dialogue entailing government, workers and employers at both enterprise and national level
Monitoring and evaluation	Cross-country and intra-country empirical analyses vetted through peer review	Cross-country and intra-country empirical analyses vetted through peer review supplemented by country-specific 'field experiments' Periodic 'stress tests' to assess vulnerability and capacity to deal with global business cycles

Box A.1: From boom to bust: the case of Dubai

In 2002, Dubai, the semi-autonomous city that forms part of the United Arab Emirates, opened its property market to overseas investors and embarked on a debt-driven strategy to drive a monumental building boom in private dwellings and infrastructure. It aspired to become a world-class regional hub for business, transportation and tourism. It became a magnet for a massive inflow of workers and skills from various parts of the world - entailing both the toiling masses on construction sites and domestic services to high-end professionals in finance and real estate. Well over 90% of Dubai's population consist of expatriates.

The 2002 strategy set off an asset price bubble. Prices of real estate skyrocketed, while the stock prices of major property developers shot up to stratospheric levels. Both investors and government officials did not seem unduly perturbed with the onset of the global economic crisis. Even in October, 2008, a record 70,000 visitors participated in Dubai's annual Cityscape property show.

Unfortunately, Dubai could not insulate itself from the global economic maelstrom. Its debt-driven strategy led to a government and public sector debt amounting to 103% of GDP, raising concerns among rating agencies that Dubai will not be able to meet its external debt obligations. The asset price bubble seems to have burst, with property prices tumbling well over 20% from their peak. Stock prices of key property developers have also plunged and decimated their net worth. Major construction projects have been put on hold. Recent reports indicate that 1400 to 1500 work-visas were being cancelled everyday, while news about thousands of cars abandoned at the airport by debt-ridden expatriates who fled the city is a grim reminder of the dramatic reversals of the fortunes of many.

Even during its golden years as a poster child of globalisation, some analysts worried about the high-risk growth strategy that Dubai embarked on. These concerns were manifold: the activities of international criminal fraternities, the economy of the global black market, terrorist networks and lack of decent of wages and poor working conditions of semi-skilled and unskilled expatriate workers. Dubai at least has the advantage of access to financial assistance from Abu Dhabi, its sister emirate that sits atop the world's largest sovereign wealth fund. Nevertheless, the rulers and administrators of Dubai will need to reflect on what has happened and how to navigate the future. What happens to Dubai will also affect the lives of millions of migrant workers.

Sources: Scott Macleod (2008) 'How Wall Street's Bust Threatens Dubai's Boom', *Time*, October 19; Simeon Kerr (2009), 'Emirate on the Ebb', Financial Times, January 29; Christopher Davidson (2008) Dubai – the Vulnerability of Success, New York: Columbia University Press

Box A.2: From Boom to Bust: the Case of Latvia

The case of emerging economies in Eastern Europe is particularly instructive. Consider, for example, the experience of Latvia. The economy contracted at an annual rate of 10.5% in the final quarter of 2008 and is expected to decline by a similar magnitude in 2009. This is an unenviable record. Latvia 'faces the steepest plunge into recession of any (EU) member country and the sharpest economic contraction on the continent since the aftermath of the collapse of the Soviet Union in the early 1990s'. It is hard to believe that only very recently Latvia was the fastest growing economy in the EU. The Latvian bubble burst last year 'when foreign banks stopped funding a consumer and property boom'. The private sector is now saddled with huge liabilities denominated in foreign currency. Foreign liabilities as a proportion of GDP are now more than 80%. A stabilisation package has recently (December, 2009) been negotiated with the IMF, entailing a package of spending cuts and tax increases worth 7% of GDP. Latvia is one of the few countries in the region that finds itself in the unenviable position of pursuing pro-cyclical policies.

Sources: Robert Anderson and Stefan Wagstyl (2009), 'Latvia sees its economy enter fierce contraction', February 10, *Financial Times,*; ILO (2009b) 'Policy Responses to the Economic Crisis: A Decent Work Approach in Europe and Central Asia', paper prepared for the 8th European Regional Meeting, February; World Bank (2009) *EU10: Regular Economic Report*, February;

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