Monetary policy and employment in developing Asia

Nikhilesh Bhattacharyya
February 2012

Regional Office for Asia and the Pacific
Bhattacharyya, Nikhilesh

Monetary policy and employment in developing Asia / Nikhilesh Bhattacharyya ; ILO Regional Office for Asia and the Pacific. - Bangkok: ILO, 2012
viii, 18 p. (ILO Asia-Pacific working paper series)

ISBN: 9789221257431 (web pdf)

ILO Regional Office for Asia and the Pacific

promotion of employment / banking / bank / economic development / Asia

13.01.3

ILO Cataloguing in Publication Data

The designations employed in ILO publications, which are in conformity with United Nations practice, and the presentation of material therein do not imply the expression of any opinion whatsoever on the part of the International Labour Office concerning the legal status of any country, area or territory or of its authorities, or concerning the delimitation of its frontiers.

The responsibility for opinions expressed in signed articles, studies, and other contributions rests solely with their authors, and publication does not constitute an endorsement by the International Labour Office of the opinions expressed in them.

Reference to names of firms and commercial products and processes does not imply their endorsement by the International Labour Office, and any failure to mention a particular firm, commercial product, or process is not a sign of disapproval.

ILO publications can be obtained through major booksellers or ILO local offices in many countries, or direct from ILO Publications, International Labour Office, CH-1211 Geneva 22, Switzerland, or ILO Regional Office for Asia and the Pacific, 11th Floor, United Nations Building, Rajdamnern Nok Avenue, Bangkok 10200, Thailand, email: BANGKOK@ilo.org. Catalogues or lists of new publications are available free of charge from the above address, or by email from pubvente@ilo.org.

Visit our website at www.ilo.org/publns or www.ilo.org/asia

Printed in Thailand
Preface

The Report of the Director-General at the 100th Session of the International Labour Conference stated that sound macroeconomic policies were essential if nations were to move to a new and “efficient” growth path that addressed decent work deficits. The ILO has a long history of researching the role macroeconomic policies can play to promote employment that is both productive and decent. Early studies by ILO economists highlighted the importance of monetary policy for economic and employment stability and the ILO was among the first international organizations to advocate that all nations establish central banks.

This paper by Nikhilesh Bhattacharyya provides an overview of the approaches central banks in developing Asia have taken towards promoting economic stability and employment. It looks at ways central banks are concerned with labour market outcomes, and what central bank policies have done to promote employment. Finally, the paper examines why central banks in developing nations do not include employment among their legislated objectives, unlike central banks in Australia, Europe, and the United States.

This paper is part of the ILO Asia-Pacific Working Paper Series, which aims to enhance our understanding of the relevant issues and stimulate discussion, knowledge sharing, and further research for the promotion of decent work in Asia and the Pacific.

Sachiko Yamamoto
Regional Director for Asia and the Pacific
Table of contents

Preface ............................................................................................................................................................................... iii
Acknowledgements .............................................................................................................................................................. vi
Abstract ............................................................................................................................................................................ vii
1. Introduction ................................................................................................................................................................. 1
2. What role does monetary policy play in promoting employment? ............................................................ 2
   2.1 Stability-focused central banks and job creation ........................................................................................... 3
   2.2 Central banks with a dual mandate for growth or employment in addition to stability .................. 5
3. How concerned are central banks with labour market outcomes? ............................................................ 7
   3.1 Some central banks actively promote employment ...................................................................................... 8
   3.2 More research needed on linkages between monetary policy and employment ...................................... 9
4. Employment a feasible objective for central banks in developing Asia? ........................................................ 10
   4.1 Employment objectives should be measurable and quantifiable .......................................................... 11
   4.2 Better data needed ............................................................................................................................................ 12
   4.3 Central banks can help governments achieve employment objectives ..................................................... 14
5. Conclusions ............................................................................................................................................................... 14
References ....................................................................................................................................................................... 16

List of boxes

Box 1. The noble ideal but harsh reality of directed credit ...................................................................................... 6

List of figures

Figure 1. A simplified social contract of a stability-focused central bank ............................................................ 3
Figure 2. A simplified social contract of a central bank with a dual mandate ..................................................... 5
Figure 3. Share of own-account workers and contributing family workers in total employment (%) .......... 11
Figure 4. Central bank policy rates and unemployment rates in Australia and the United Stats (%) .......... 12

List of tables

Table 1. Labour market analysis in the latest available annual reports of central banks .................................. 10
Acknowledgements

This paper benefited from helpful comments from Somsajee Siksamat from the Bank of Thailand and ILO colleagues who attended a presentation of an earlier version of the paper. The author is very grateful to Sukti Dasgupta, Gyorgy Sziraczki, and Ruttinya Bhula-or for their comments and help in organizing an opportunity to present my research. This author is also grateful to comments from Iyanatul Islam and Duncan Campbell. Thanks are also due to Monrudee Sucharitakul for her help with administrative support.
Abstract

Despite the high prevalence of vulnerable employment and working poverty in developing Asia, full employment is not a legislated objective of any central bank in the region. As this paper shows, however, many central banks are actively using monetary policy to promote productive employment, and they do appear concerned with labour market outcomes. By working closely with governments, central banks in developing Asia help to promote macroeconomic stability and strive for the goal of full employment. But given the gaps in employment data and the structural roots of vulnerable employment and poverty, tasking central banks in developing Asia with an employment objective, as has been done in Australia and the United States, appears inappropriate.

About the author

Nîkhîlesh Bhattacharyya previously worked as an Economist in the ILO Regional Office for Asia and the Pacific in Bangkok, Thailand.

The responsibility for opinions expressed in articles, studies and other contributions rests solely with their authors, and publication does not constitute an endorsement by the International Labour Office of the opinions expressed in them, or of any products, processes or geographical designations mentioned.
### Abbreviations and acronyms

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Full Form</th>
</tr>
</thead>
<tbody>
<tr>
<td>ADB</td>
<td>Asian Development Bank</td>
</tr>
<tr>
<td>ICBC</td>
<td>Industrial and Commercial Bank of China</td>
</tr>
<tr>
<td>ILO</td>
<td>International Labour Organization</td>
</tr>
<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
</tr>
<tr>
<td>Lao PDR</td>
<td>Lao People’s Democratic Republic</td>
</tr>
<tr>
<td>MDG</td>
<td>Millennium Development Goals</td>
</tr>
<tr>
<td>NAIRU</td>
<td>non-accelerating inflationary rate of unemployment</td>
</tr>
<tr>
<td>NGO</td>
<td>non-government organization</td>
</tr>
<tr>
<td>SME</td>
<td>small and medium-sized enterprises</td>
</tr>
</tbody>
</table>
1. Introduction

The recent global financial crisis has inspired much debate regarding the role of central banks. In developing economies, one important issue concerns the appropriate outcomes and instruments of monetary policy. Proponents of inflation targeting have argued that central banks should embrace just one clear objective, that of maintaining price stability. Others have argued that, rather than focus only on price stability, central banks should also actively use monetary policy to foster economic development and job creation. This paper evaluates the arguments behind both propositions, and examines central bank approaches to monetary policy in developing Asia and the contribution these make to job creation.

This paper builds on a long history of ILO research on monetary policy. ILO economists in the 1920s, who were leading advocates of creating central banks in all nations, were visionary in their research on the influence of monetary policies on economic and employment stability. ILO case studies across a range of nations during the interwar years helped to quantify and raise awareness of the linkages between monetary stability, prices and unemployment. Indeed, ILO economists during this period were among the first to advocate a scientific approach to setting monetary policy based on the price level and employment, an idea that Taylor (1993) quantified in a seminal paper to describe the actual behaviour of the Federal Reserve in setting U.S. monetary policy in the 1970s and 1980s.

In recent years, the ILO has increased its engagement with central banks, providing insights into employment issues and discussing the role monetary policy can play in creating productive employment. The current ILO view of the appropriate role for monetary policy was outlined in the Report of the Director-General to the 100th International Labour Conference (June 2011), which stated that central banks should regard full employment as a goal along with low inflation and financial stability. Although most central banks do not specify full or high employment among their goals or objectives, in developing Asia many do engage in actions that promote job creation and economic development.

This paper provides guidance for ILO officials as they step up their interactions with central banks. It also adds to a thin literature assessing how the developmental role of central banks varies across nations in Asia. The rest of the paper is structured as follows. Section 2 provides an overview of the two dominant mandates of central banks in developing nations, looking at how, under each of these, central banks contribute to creating productive employment. Section 3 discusses ways some central banks in developing Asia use monetary policy to promote employment, and the extent to which they appear to monitor labour market developments.

---

1 Before the global financial crisis, the IMF supported the adoption of inflation targeting by non-industrial countries. In a 2006 paper the IMF argued that, subject to certain caveats, inflation targeting led to better macroeconomic outcomes than alternative monetary policy regimes (see IMF: Inflation targeting and the IMF [IMF, 2006]). Following the crisis, however, the IMF position appears to have changed (see O. Blanchard: Monetary policy in the wake of the crisis [IMF, 2011]). At the Asian level, R. Rajan and E. Prasad have argued in “Why an inflation objective?” (in Business Standard, 2008) that the Reserve Bank of India should relinquish all objectives other than price stability, while the Asian Development Bank argued that the People’s Bank of China should change its monetary policy framework and adopt elements of inflation targeting (see Asian Development outlook 2011: South-South economic links [ADB, 2011, box 3.9.1, p. 123]).

2 J. Felipe, in “Does Pakistan need to adopt inflation Targeting? Some questions” (2009), asks whether price stability is the most important objective for the State Bank of Pakistan, and concludes that an exclusive focus on price stability (in the form of inflation targeting) is inappropriate at this time. G. Epstein outlines arguments in Beyond inflation targeting (2009) that central banks should have a broader mandate than price stability, and provides case studies for India, the Philippines, and Viet Nam.


Section 4 explores the appropriateness of a full employment objective for a developing-nation central bank. Section 5 presents conclusions.

2. What role does monetary policy play in promoting employment?

Monetary policy is a broad term, one with different meanings in different contexts. The *New Palgrave Dictionary of Economics* defines monetary policy as “actions taken by central banks to affect monetary and other financial conditions in pursuit of the broader objectives of sustainable growth of real output, high employment, and price stability”. In industrialized economies, monetary policy is usually confined to movements in one policy instrument (typically a short-term interest rate), and usually central banks have a narrow mandate (typically a primary or exclusive objective of price stability). In developing economies, central banks tend to use more than one policy instrument, and usually pursue multiple objectives.

There are four main channels — credit, interest rates, exchange rates, and wealth — through which central banks use monetary policy to influence the supply and demand for goods, services, and labour. By altering monetary policy or changing public expectations about future monetary policy, a central bank influences the volume of bank lending, the exchange rate, asset prices, and the supply of money in the economy. By altering the amount that banks can lend to the public and the supply of money, a central bank influences the amount of credit used by households, businesses, and the government. Changes in the supply of money also affect the price of money, i.e. the interest rate, which influences savings and borrowing decisions. Monetary policy also affects the exchange rate and asset prices, which also exert a large influence on borrowing, spending, and saving decisions. The way in which monetary policy affects employment varies significantly from country to country. Unfortunately in many developing nations there have been few studies conducted by central banks exploring the relationship between monetary policy and employment. Despite uncertainty about the nature of the relationship between monetary policy and employment, it is generally accepted that monetary policy has a significant impact on domestic economic activity and employment.

Generally speaking, central banks in developing economies fall into two broad categories. They either focus only on maintaining price and financial stability, or they pursue a range of objectives, which may include, in addition to stability, high economic growth or development. Stability-focused central banks aim to maintain price and financial stability. This makes an indirect contribution to employment, in that it is more conducive to job creation than an environment of unstable prices and financial conditions. Central banks with a growth or employment objective also pay close attention to price and financial stability, but they tend to actively use monetary policy when they believe that economic growth or employment are below desired levels. This can differ from the approach of a stability-focused central bank under which monetary policy may remain passive or unresponsive to weak economic growth or employment in cases where stability may be put at risk.

There is no definitive answer as to whether an exclusive central-bank focus on stability or a broader mandate is better for job creation and development. Each approach has both benefits and drawbacks (this is discussed in greater detail below). In Latin America, there are examples of rapid gains in productive employment and development after central banks scrapped broader

---


6 A search of the English versions of central bank web sites researched for this study reveal that working papers investigating the linkage between monetary policy and employment were only available for two central banks (in Bangladesh and Pakistan). It should be noted, however, that major differences are often apparent between the local-language versions of central bank websites and their English counterparts.
mandates and focused exclusively or primarily on stability (e.g. the performance of Brazil and Chile after central banks adopted inflation targets). In Asia, there are examples of rapid development over the past two decades assisted by central banks pursuing a range of objectives (e.g. China and India).

2.1 Stability-focused central banks and job creation

A stability-focused central bank has a clear social contract with the rest of society: its role is to maintain prices and financial stability. In a developing nation context where volatility in international commodity prices and bad harvests can lead to price shocks, a stability-focused central bank has a commitment to prevent isolated bursts of inflation confined to a few goods from becoming widespread and persisting over time. A commitment to financial stability means ensuring that neither domestic nor external forces result in a disruption in the supply of credit for productive purposes. With the central bank focusing exclusively on stability, the objectives of creating an inclusive financial system and supporting economic development are left to the government.

Figure 1. A simplified social contract of a stability-focused central bank

Over the past decade-and-a-half, global sentiment has shifted towards scrapping other objectives and making price stability the sole or primary objective of monetary policy. Between 2003 and 2008, according to the International Monetary Fund (IMF), the number of countries classified as having an inflation-targeting monetary policy regime - where price stability is the sole or primary objective of monetary policy, and there is a publicly announced numerical target for inflation - rose from 23 to 44. These numbers understate the central bank shift towards scrapping objectives other than price and financial stability - many more central banks have become focused on stability in practice, but do not meet the strict criteria for inflation targeting, since they choose not to specify explicit numerical targets for inflation.

Stability-focused central banks contribute to job creation in an indirect but important manner. A commitment to price stability allows wage claims between workers and employers to take place with some certainty regarding future cost-of-living pressures and financial conditions.

7 Figure 1 presents a simplified schema of main central bank and government objectives that influence labour market outcomes. In this case, the central bank objectives are modelled upon those of the Central Bank of Sri Lanka as outlined on its website. See “Objectives of the Bank”, available at: http://www.cbsl.gov.lk/htm/english/03_about/a_4.html (accessed 31 August 2011).

Uncertainties related to financial instability or high and unstable inflation can lead to social problems and industrial disputes. Price and financial stability are also very important in attracting and maintaining domestic and foreign investment. The perceived capacity of a central bank to provide stable inflation and prudent financial standards is an important determinant of vulnerability to sudden stops in international capital inflows, which can lead to sharp contractions in investment, output, and employment.9

To achieve price and financial stability, a central bank can adjust monetary policy. In the absence of restrictions on international financial flows, a central bank can choose to use only one of the following as its policy instrument: short-term interest rates, monetary aggregates, or the exchange rate. In practice, most developing economies maintain some restrictions on international financial flows (“capital controls”). This allows the central bank limited control over the exchange rate as well as either interest rates or monetary aggregates. However, capital controls restrict foreign investment and thus can hinder economic growth and job creation. Over the last decade the trend in developing nations has been to open up financial markets and reduce restrictions on international financial flows.10

Where central banks have total control over only one instrument, the intuitive impulse is to pursue only one objective as well. As some observers have put it, “trying to do too much with one instrument is a recipe for ineffectiveness, especially in difficult times. Moreover, the notion that monetary policy can itself raise long-term growth through activist policies is problematic - in fact, faith in that belief led to stagflationary episodes in the U.S. in the 1970s and 1980s.”11

Although having a central bank focus exclusively on stability is intuitively appealing, this entails a number of drawbacks. One of the most common objections is that, with widespread poverty and inadequate employment opportunities in many developing economies, monetary policy can and should play an active role in addressing these problems. In almost all cases where economies have managed to attain high per capita incomes, during their development stage monetary policy had a broader focus than just price stability. In Europe and North America from the end of World War II until the 1970s, monetary policy was used to maintain low interest rates to support rapid investment and lessen the cost of servicing national debt.12 One researcher notes that, during the rapid development stage in the newly industrialized East Asian economies, inflation was contained through appropriate incomes and employment policies to ensure wages did not increase faster than merited by productivity, while monetary policy helped to drive rapid investment growth by keeping real interest rates low.13

From a practical standpoint, the rapid structural change taking place in many developing economies complicates attempts to maintain price stability by focusing on only one particular price index, which is the common practice in most advanced economies as well as in those developing economies that have adopted inflation targeting. Determining whether an emerging market central bank should target wage or price inflation requires detailed information on the structure of an economy.14 In industrialized economies, prices tend to be flexible and wages rigid.

---

10 For a quantitative analysis of how capital controls have been reduced over time in Asia see J. Aizenman, M.D. Chinn and H. Ito: Surfing the waves of globalization: Asia and financial globalization in the context of the trilemma. National Bureau of Economic Research Working Paper Series, No. 15876 (NY, Columbia University, 2010).
- implying a central bank should target price inflation, as it is flexible and responds quickly to monetary policy adjustments, unlike wages, which are rigid and respond slowly to monetary policy changes. In emerging economies, on the other hand, rigidities tend to exist in both prices and wages, and which type of inflation should be targeted is not immediately clear. If prices are rigid and unresponsive to monetary policy (as can be the case due to administrative controls or import dependence), then monetary policy should not aim to keep a measure of consumer price inflation fixed at a low rate. Likewise, if consumption or a certain geographic area is unresponsive to monetary policy (as is often observed in some areas of developing nations due to weak linkages with financial sectors), then monetary policy should focus only on stabilizing variables and geographic areas over which it can exert a major influence.

### 2.2 Central banks with a dual mandate for growth or employment in addition to stability

Central banks with growth or employment objectives target these variables in addition to maintaining price and financial stability. This implies a complex social contract, since the central bank is responsible for delivering a range of outcomes. In some instances where a central bank has multiple objectives, price stability is explicitly legislated as monetary policy’s primary objective. In most developing economies where multiple objectives are delegated to central banks, however, there is commonly no legislated prioritization of objectives, though in practice price and financial stability tend to be the main central bank objectives in almost all developing economies.

#### Figure 2. A simplified social contract of a central bank with a dual mandate

Achieving multiple objectives with only one main monetary policy instrument requires a central bank to work in close coordination with government. In the many developing economies where central banks are often tasked with supporting state development plans, the relationship with government is very different from that in most industrialized economies, where central banks are often independent from government and have complete autonomy in deciding monetary policy.

---

15 Idem.

16 Figure 2 is a simplified representation of some main objectives directly affecting employment. It is based on the objectives of the Nepal Rastra Bank, as outlined in N.M. Maskay and R. Pandit: *Macro-financial link and monetary policy management: The case of Nepal*, NRB Working Paper, Serial No. NRB/WP/7 (2010). In Nepal’s case, the Government plays a major role in ensuring price stability, since, under the commitment to an exchange rate peg with the Indian rupee, the fiscal deficit must be contained so as not to put pressure on Nepal’s balance of payments.
A close and coordinated relationship is necessary for a central bank with employment or developmental objectives as monetary policy is a blunt instrument that affects the economy at the aggregate level, while achieving employment or developmental objectives requires policies that target specific industries and geographic areas. Conventional monetary policy affects interest rates, the total amount of available bank credit, and the exchange rate. To direct credit to specific industries or geographic areas, a central bank can impose lending quotas on commercial banks, mandate interest rate controls, or set up schemes to encourage lending for specific purposes. However, central bank programmes to direct credit have become less popular and are only used by a few central banks in Asia.

Over time it has been increasingly recognized that central banks should only play a role in directing credit at very early stages of financial development; and market forces should be relied upon to direct credit thereafter (see box 1). To encourage the flow of credit to certain geographic areas or industries, governments can set up their own development and commercial banks. Where successful in channelling funds to industries and regions with high returns, these banks will be able to compete with private banks, possibly even out-perform them. Indeed, the largest bank in the world, based on market capitalization, is a majority public sector-owned bank that prioritizes lending for industrialization and regional development.17

---

**Box 1: The noble ideal but harsh reality of directed credit**

Development economists have increasingly accepted that misallocation or misuse of available resources is a major factor in underdevelopment and sluggish growth rates in poor countries. Such misallocations and misuses include financial resources in the form of credit. Many firms and households with high potential returns are unable to access credit on fair terms. But central banks have the ability to correct this imbalance. Chandavarkar (1987, p.4) argues that “more than statutes and formal powers it is the central bank’s status, expertise and influence in relation to the government, developmental agencies and the financial community which defines its opportunity set as a regulator, innovator, participant, guarantor and catalyst of financial development.” Indeed, in many industrialized economies central banks that currently do not direct credit for specific purposes were, as they underwent rapid industrialization, in fact doing so. Chandavarkar notes that, during their development phase, central banks in Italy, Japan, the Netherlands, Sweden, the United States, and West Germany all directed credit to underdeveloped industries and regions as well as to small businesses.

Unfortunately, many developing economies have been unsuccessful in attempts to replicate the promotional policies used by central banks in East Asia and the Western Hemisphere during their own periods of transition from middle-income to high-income status. Rather than acting as a catalyst and innovator for financial development, as initially envisaged, promotional activities by developing nation central banks in many cases became tools of financial repression, which restrict competition in the financial sector and impede the flow of savings away from where they would have yielded the highest return. An ADB study evaluating the role of central banks in microfinance stated that “… it is now widely accepted that controlling interest rates and directing credit for developmental purposes have not been effective in achieving their objectives.” Beck (2008) identifies one major factor behind the poor performance of measures to direct credit as poor governance leading to regulatory capture by special interest groups. Even with programmes that have not fallen prey to regulatory capture, and which direct funds

---

17 As of 31 December 2010, the Industrial and Commercial Bank of China (ICBC) had a market capitalization of US$233.69 billion. Under controllable risks, ICBC prioritizes lending to support national investment projects, key industries, and key enterprises that fall within the Chinese Government’s industrial policy.
to worthy firms that are financially constrained, it has often been impossible to design measures that stop firms who aren’t financially constrained from also participating and exploiting the use of subsidized credit not meant for them. Zia (2008) reports that, in Pakistan, 44 per cent of a central bank-funded credit subsidy programme designed to channel funds to credit-constrained exporters was absorbed by financially unconstrained publicly listed firms with no major impact on their export production, but rather subsidized credit was used to boost profits.

Sources:

In order for monetary policy to be used as a tool for promoting employment and growth as well as stability, other policies must also be used to promote economic and financial stability. It has been argued that stabilization and full employment should be at heart of all macroeconomic policies, rather than merely in the confines of individual policy areas. This requires that fiscal policy, monetary policy, capital account management (international investment) policies, and prudential regulation all act countercyclically. And such has been the approach of many governments and central banks over the past decade in developing Asia.

3. How concerned are central banks with labour market outcomes?

Many central banks in developing Asia are engaged in programmes to promote employment and development. This is despite employment rarely featuring as an objective or goal of monetary policy. Some central banks do include employment-related outcomes among their goals (e.g. Bangladesh Bank espouses the goal of supporting high employment), though none have employment outcomes among their legislated objectives. More common is a commitment to support economic development or growth, though even this is only observed in about half of the economies in developing Asia.

---

19 The movement of public debt in developing Asia suggests that fiscal policy has been countercyclical over the business cycle in recent times. Based on data from the IMF World economic outlook database (April 2011), during the period between 2002 and 2007, when global economic growth was strong, in developing Asia gross government debt as a percentage of GDP declined by 10 percentage points and fell by an even larger margin in the ASEAN-5 economies. In 2009, government debt increased slightly as governments implemented stimulus packages in response to the global financial crisis, but government debt was projected to fall in 2010 and 2011 as stimulus was withdrawn and global economic growth recovered. By comparison, in advanced economies government debt rose slightly between 2002 and 2007, rose sharply in each of the subsequent three years, and was not projected to decline in the foreseeable future (the forecasts extend till 2016), reflecting at best an acyclical movement or even, arguably, a procyclical movement.
20 The following central banks in low- and middle-income Asia list among their objectives, alongside price stability, outcomes related to either economic growth or supporting government policies: Bangladesh, China, India, the Lao People’s Democratic Republic (Lao PDR), Malaysia, Nepal, Pakistan, and Viet Nam. The following central banks list price stability as their primary objective: Afghanistan, Bhutan, Cambodia, Indonesia, Mongolia, the Philippines, Sri Lanka, and Thailand.
The choice of central bank mandate does not appear related to a nation’s level of income or financial development. It seems instead to be a product of historical and country-specific factors. Stability-focused central banks can be found in both the second-highest and lowest-income economies in developing Asia (Thailand and Afghanistan, respectively). Generally speaking, however, nations that required IMF support during the Asian financial crisis of the late 1990s or during the first half of the last decade have subsequently chosen to task their central banks with a sole or primary objective of price stability (e.g. Afghanistan, Indonesia, Mongolia, the Philippines, the Republic of Korea, Sri Lanka, and Thailand).

3.1 Some central banks actively promote employment

Although employment does not feature as an objective of monetary policy in any developing Asian economy, some central banks do engage in policies to direct credit to promote productive employment. The Reserve Bank of India has a non-binding mandate requiring commercial banks to direct a certain percentage of their loan portfolios to priority areas, with the stated goal of the policy being to “enhance credit flow to employment intensive sectors such as agriculture, micro and small enterprises, as well as for affordable housing and education loans”. Central banks in Cambodia and Viet Nam also assign lending targets to commercial banks for specific sectors. In China, the central bank does not announce public targets for lending to priority sectors, but does regularly guide commercial banks regarding which sectors they should direct credit to. However, as pointed out by India’s Planning Commission, the policy of lending targets as a means of ensuring an inclusive financial system has several inherent flaws. Although priority sector lending targets in India have encouraged the flow of credit to underdeveloped sectors, it has often failed to improve the flow of credit to financially under-served segments within sectors. Moreover, directing the flow of credit away from sectors where it would be most profitable hinders bank profitability, and shifts the task of financial inclusion away from government to banks — a responsibility, arguably, that is better served by the state. Concerns with such problems have led many central banks in developing Asia to abandon priority sector lending targets over the past two decades.

In other nations where central banks engage in policies to direct credit, the main tool used is a refinance programme, whereby the central bank finances a portion of a commercial banks’ loan that meets certain criteria (e.g. lending to priority areas). Bangladesh Bank, arguably the Asian central bank most actively promoting development and inclusive growth, operates two main refinance programmes targeting small and medium enterprises and sharecroppers. Both schemes aim to extend development goals beyond financial inclusion. For example, the SME refinance programme mandates that at least 15 per cent of loans be made to women entrepreneurs, while loans made under the agricultural credit programme are disbursed by NGOs. In Nepal and Pakistan, central banks also use refinance programmes for industries and areas that have been adversely affected by conflict and for small firms, among other purposes. The People’s Bank of China has used refinance programmes to encourage lending to areas hit by natural disasters (e.g. the 2008 Sichuan earthquake).

Aside from the cases outlined above, central banks in developing Asia do not have standing programmes that direct credit, though some temporary programmes were established in response to the global financial crisis. In 2009, Bank Negara Malaysia established a SME assistance facility in response to tight financial conditions that were impairing SME ability to access bank credit.

---

22 People’s Bank of China: Annual report 2008 (2009), p. 32. The People’s Bank of China had guided financial institutions to “appropriately control loans to medium- and long-term projects including basic construction projects, restrict loans to enterprises with high-energy consumption, high emissions and excess capacity, and strengthen credit support to priority areas and vulnerable enterprises such as the agricultural sector, small- and medium- sized enterprises”.
This facility focused not just on reducing the cost of and improving SME access to credit, but also established a SME modernization facility, a refinance scheme designed to help firms purchase or upgrade equipment and improve energy efficiency.

Building an inclusive financial system that caters to all households and firms is an important way central banks in developing Asia contribute to employment creation. Several central banks have instituted policies to improve financial education and broaden access to financial services. In every developing Asian economy except China’s, the central bank is responsible for regulating the banking system, and is therefore also responsible for ensuring that the banking system is inclusive. Financial exclusion is a major problem in developing Asia, where lack of financial education and inability to access financial services hinders economic activity and job creation. It is estimated that most of the population is excluded from the financial system in Bangladesh, Cambodia, China, India, Indonesia, Lao PDR, Pakistan, the Philippines, and Viet Nam.24

In most of these economies, financial exclusion has declined over the past decade, in part because of reforms by central banks promoting financial inclusion. Some of the policies implemented by central banks include the promotion of agent banking and microfinance providers, mandating that commercial banks promote basic savings accounts for small-scale savers and the acceptance of mobile phone payments.25

3.2 More research needed on linkages between monetary policy and employment

Thorough analysis of labour market trends is essential, if central banks in developing Asia are to monitor progress in achieving their objectives. Employment quantity and quality are key determinants of poverty, and can be used as measures of economic development. Incomes also make a good measure of living standards and, for a central bank, income trends are important for gauging inflationary pressures. Labour productivity, industrial relations, and income inequality are other indicators a central bank can use to assess economic performance and to get early warning of potential future problems.

A lack of detailed central bank labour market analysis is apparent in several nations in developing Asia. For example, there are few central bank investigations of the relationship between monetary policy and employment within these countries.26 Meanwhile, most central bank periodicals publish only brief analyses, if any, of employment and income trends. Table 1, below, presents labour market analysis included in the latest available English-language annual reports available on central bank websites. Several reports make only brief reference to domestic labour market trends or no reference at all. Some of the least developed nations in Asia feature among those lacking labour market analysis (e.g. Afghanistan ranks last in Asia in the 2010 United Nations Human Development Index).

---

25 See Hannig and Jensen (op. cit., 2010) for further discussion of the challenge of financial inclusion and analysis of policies to address it.
26 A search of the English version of the websites for the central banks listed in table 1 found that the only working paper, policy paper, or independent study investigating the relationship between monetary policy and employment was from Bangladesh Bank (Employment promoting growth in Bangladesh: Monetary and financial sector issues, Policy Analysis Unit Policy Paper 0904 [2008]), which looked at some of the monetary and financial sector issues affecting employment promotion.
Table 1. Labour market analysis in the latest available annual reports of central banks

<table>
<thead>
<tr>
<th>Analysis of employment trends</th>
<th>Analysis of wage or income trends</th>
</tr>
</thead>
<tbody>
<tr>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td>Afghanistan, Cambodia, Lao PDR</td>
<td>Afghanistan, Bhutan, Lao PDR, Maldives, Nepal, Viet Nam</td>
</tr>
<tr>
<td>Brief analysis</td>
<td>Brief analysis</td>
</tr>
<tr>
<td>Bangladesh, Bhutan, Maldives, Nepal, Philippines, Viet Nam</td>
<td>Bangladesh, Philippines</td>
</tr>
<tr>
<td>Detailed analysis</td>
<td>Detailed analysis</td>
</tr>
<tr>
<td>China, India, Indonesia, Malaysia, Pakistan, Sri Lanka, Thailand</td>
<td>China, India, Indonesia, Malaysia, Pakistan, Sri Lanka, Thailand</td>
</tr>
</tbody>
</table>

Source: Author’s assessment, based on an analysis of the websites dedicated to the central banks in this table.

In other developing Asian nations, central banks do perform detailed analyses of labour market trends. Annual reports in some nations have analysed linkages between employment and consumption, the employment intensity of output growth in specific sectors, labour productivity in relation to incomes, and the factors affecting household incomes.

The extent of analysis varies widely, however, reflecting the data constraints that often face central banks. Of the central banks listed in table 1 that provided brief or no labour market analysis in their latest annual reports, only one (the Philippines) had access to a regular labour force survey. The rest either relied upon irregular labour market information or had no data at all to rely on. With the exception of the Philippines, in the nations where annual reports in 2010 were lacking in labour market analysis, either the central bank or the government plays a major role in directing credit in the banking system, in many cases with employment outcomes in mind. Given improved labour market information, these central banks could not only better gauge their respective national employment situation, they could also evaluate the effectiveness of any government- or central bank-directed credit programmes, and, based on these assessments, adjust policies accordingly.

4. Employment a feasible objective for central banks in developing Asia?

In developing economies, both the nature of the employment challenge and data constraints complicate the adoption of full employment as a monetary policy objective. This does not mean that central banks in developing Asia cannot engage in policies to promote job creation and development. Many do so. But full employment should be a goal of monetary policy, rather than a short- or medium-term objective against which the performance of a central bank can be assessed.

---

27 Bank Indonesia: *Economic report on Indonesia* (2010), section 1.2. This report also analyses incomes and labour productivity.
28 See Reserve Bank of India (op. cit., 2011), p. 22, for a discussion of the need to raise employment intensity in the manufacturing sector. Other parts of the report analyse incomes, poverty, and income inequality.
4.1 Employment objectives should be measurable and quantifiable.

In most developing nations, the unemployment rate is usually very low. This merely reflects the fact that, for large segments of society, unemployment is not an affordable option, and it does not provide a clear picture of the labour market situation. The textbook concept of full employment commonly applied to industrialized economies - the lowest possible rate of unemployment consistent with stable prices - cannot be applied in a developing nation setting, where large portions of the workforce are employed in a non-wage sector that absorbs those unable to find wage employment. To gauge the labour market situation in developing nations, the ILO looks at vulnerable employment, which refers to workers involved in own-account employment and contributing family work. Figure 3, below, shows how vulnerable employment represents a large share of jobs in many developing Asian economies.

![Figure 3. Share of own-account workers and contributing family workers in total employment (%)](image)

Note: Data is for 2010. For India, data refers to urban households only; for Sri Lanka, data excludes northern and eastern provinces.

Sources: For Indonesia, Pakistan, the Philippines, Sri Lanka, and Thailand, data is from the respective national statistical office labour-force surveys. For India, data was obtained from the Report on employment and unemployment survey (2009–2010), Ministry of Labour and Employment.

In industrialized economies, where non-wage employment usually represents a small portion of total employment, a central bank with a full-employment objective will actively adjust monetary policy to achieve the lowest rate of unemployment consistent with price stability, which is also referred to as the non-accelerating inflationary rate of unemployment (NAIRU). To accomplish this, central bankers implement a monetary policy that seeks to minimize the portion of unemployment due to cyclical factors. Although the NAIRU is not a known quantity and changes over time, central bankers in industrialized economies use reliable methods to estimate it. Figure 4 shows how, in the United States, where the central bank pursues a full employment objective, there has historically been an inverse relationship between cycles in the Federal Reserve funds rate (the instrument of monetary policy in the US) and the unemployment rate. This is to say that, over time, the data indicate that interest rates rise (a contractionary monetary policy) when unemployment falls, while interest rates fall (a more expansionary monetary policy) when unemployment is rising. In Australia, where the central bank also has an employment objective, a

31 D. Mazumdar: Constraints to achieving full employment in Asia (Geneva, ILO, 1999).
similar relationship between monetary policy and unemployment cycles can be observed when taking into account the large drop in structural unemployment since the late 1990s.

**Figure 4. Central bank policy rates and unemployment rates in Australia and the United States (%)**


A central bank with an employment objective must be able to differentiate between structural and cyclical unemployment. Structural unemployment reflects unemployment resulting from a mismatch between the structure of employment vacancies and the skills of the available workforce. Cyclical unemployment, on the other hand, reflects unemployment due to fluctuations in the business cycle, and is symptomatic of deficient aggregate demand. Monetary policy can play an active role in dealing with cyclical unemployment by lifting demand in the short and medium term through a monetary expansion, but it cannot be used as a tool to deal with structural unemployment, which requires targeted policies.

In developing nations, where full employment is a harder concept to define and measure, making this a monetary policy objective is not straightforward. A large portion of vulnerable employment in developing nations is due to structural factors rather than cyclical, and policies other than monetary policy can often play a larger role in reducing vulnerable employment and creating decent work. Rather than representing an objective that monetary policy can be assessed against in the short- and medium-term, full and productive employment should be a long-term goal that a central bank can support in close coordination with the government. Central banks in developing nations can support the promotion of productive employment opportunities by developing an inclusive financial system that serves all individuals and firms, channelling savings to where they will gain their highest return. This will help to address the misallocation of financial resources that hinders growth in many developing nations, and which has been identified as a major reason large gaps persist between rich and poor nations.³²

### 4.2 Better data needed

Even if full employment were easier to define as a concept applicable to developing economies, the lack of timely and detailed employment data in most low- and middle-income Asian economies would prove an obstacle to adopting an employment objective for monetary policy.

As with any policy objective, timely data is needed to assess whether policy is set appropriately to meet the objective. For price stability, central banks look at price indices; for financial stability, central banks can regularly assess bank lending standards and practices, monitor non-performing loans, and undertake studies to predict exposures to interest rate and exchange rate risks. Unfortunately, in developing Asia the problem of inadequate labour market information is particularly bad. China and India, the two most populous nations, only conduct comprehensive national employment surveys every few years. Among the low- and middle-income nations in Asia, only Malaysia, the Philippines, Thailand, and Sri Lanka publish the results of labour force surveys on a quarterly basis. Unfortunately, some of the nations with the largest decent work deficits are also those where labour force data is sparsest, though national statistical agencies and the ILO are helping to ameliorate this situation.33

Aside from the measurement issue, it is not immediately clear, in a developing nation context, which employment variable a central bank should target.34 Ideally, monetary policy should be used to moderate fluctuations in the unemployment cycle (i.e. deviations from the NAIRU), rather than to try reducing the structural components of unemployment (vulnerable employment or poverty). In industrialized nations where central banks have employment objectives, usually the unemployment rate is used to assess whether there is full employment by comparing the current unemployment rate with the estimated NAIRU. In developing nations, however, the unemployment rate is clearly inappropriate for gauging full employment. Theoretically, the vulnerable employment rate or poverty rate could be used, but this would require detailed knowledge of what portion of vulnerable employment or poverty is due to structural or causal factors — and this something that can change significantly over time in response to a wide range of factors (e.g. technology adoption influencing productivity, changing relative prices or methods of production).

In nations where central banks do adopt a full employment objective, timely employment data is of crucial importance. In Australia and the United States, detailed results of labour force surveys are released on a monthly basis with only a one-month lag. This allows central bankers to respond rapidly to changes in labour market conditions.35 In many developing Asian economies, central banks with an employment objective would find the infrequency of employment surveys and gap between observations problematic, especially where high economic growth, progressive policies, financial inclusion, and the adaption of technology has led to large declines in the component of vulnerable employment and poverty due to structural factors.

Timely and comprehensive employment data remains crucial for a central bank even if it does not have an employment objective. Though most developing nation central banks do not have an employment objective for monetary policy, in many nations supporting government policies or sustaining high economic growth are objectives, and these goals entail promoting more jobs and

33 Various ILO projects support the improvement of labour market information and analysis in a number of Asian nations, including Afghanistan, Bangladesh, Cambodia, Indonesia, Malaysia, Mongolia, Pakistan, Timor-Leste, and Viet Nam. For further details, see the work of the Economic and Labour Market Analysis department on the ILO web site (www.ilo.org), in particular the Monitoring and Assessing Progress on Decent Work (MAP) project.

34 Similar arguments can be made against inflation targeting on the grounds that the consumer price index is not the best tool for assessing price stability in developing nations, and often the inflation targets adopted are inappropriate. The rapid adoption of new technologies, it is argued, can significantly skew consumer price indices in developing nations (see M. Yörükoğlu: “Difficulties in inflation measurement and monetary policy in emerging market economies”, in Bank for International Settlements (eds.): Measurement of inflation and the Philippine monetary framework (2010), pp. 369–389.) Others argue that, in some nations, low single-digit inflation targets are not always appropriate (see S. Anwar and I. Islam: Should developing countries target low, single digit inflation to promote growth and employment? Employment Working Paper No. 87 [2011]).

35 In Australia, the latest monetary policy tightening cycle began in October 2009, as the cash rate rose from 3 per cent to 3.25 per cent. Only a few months earlier, unemployment had fallen for the first time in the business cycle, dropping from its cyclical peak of 5.8 per cent in August 2009 to 5.7 per cent in September 2009.
higher incomes. Without timely employment data, it is hard to assess progress made on these fronts and high-frequency indicators usually available in developing economies (e.g. GDP and industrial production) are of limited use in assessing whether or not government policies are having an impact on broader society or on just a minority of the population. Moreover, timely labour force data with respect to such factors as wage pressures, productivity trends, and the distributional effects of monetary policy is necessary for a central bank to assess the outlook for inflation.

4.3 Central banks can help governments achieve employment objectives

Several national development plans in Asia have adopted employment targets. For example, Indonesia’s medium-term development plan, announced in 2009, aimed to reduce the unemployment rate to 5 per cent by 2014. Malaysia’s Tenth Development Plan, announced in 2010, planned to add 1.4 million jobs and reduce the unemployment rate to 3.1 per cent by 2015. Meanwhile, all United Nations Member States have committed to the Millennium Development Goals (MDGs), which include full and productive employment and decent work for all, as well as halving, between 1990 and 2015, the proportion of people in extreme poverty.

Achieving employment and poverty targets means ensuring that the quality and pattern of economic growth is inclusive. Policies should be tailored to specific sectors while promoting greater productivity and higher employment. Central banks can help by advising on whether sectoral flows of credit are adequate to achieve employment objectives. As documented in Sections 2 and 3 (above), however, it is generally accepted that central banks should engage in directing credit only in the very early stages of financial development, and only a few central banks in developing Asia use monetary policy to direct credit. Rather than central banks using quantitative lending targets or schemes, it is far more common to find state-owned banks with mandates for supporting investment in specific sectors.

Even without resorting to directing credit, central banks can play an important role in helping to achieve national employment and poverty targets. At the least, they can play the role of advisor, using their understanding of macroeconomic conditions to provide policy guidance and measure progress. Given that financial exclusion and financial underdevelopment are important determinants of poverty, central banks can help achieve national poverty targets by promoting financial education and a financial system that caters to individuals and firms at all income levels. This involves increasing household access to banking services, improving credit information, making it easier for businesses to register their collateral with banks, and improving information on available financial services.

5. Conclusions

Central banks in developing Asia have been contributing to the promotion of productive employment, but tasking them with an employment objective remains problematical.

Assessing monetary policy performance against an employment objective presents a challenge because of the following difficulties, common in developing nation contexts:

- defining full employment; and
- disaggregating the cyclical and structural causes of vulnerable employment, underemployment, and poverty.

---

36 i.e. those whose income is less than US$1 per day on a purchasing power parity basis.
Rather than designating an employment target or objective, central banks can work closely with governments to ensure that monetary policy is supportive of inclusive and job-rich economic growth. Indeed, as this study has tried to show - in contrast to the common practice, in industrialized economies, of having independent central banks with narrow mandates that focus primarily on maintaining low inflation - the relationship between central bank and government in developing Asia is often one of coordination and overlapping objectives.

With employment and incomes exerting a major influence on prices and economic growth, central banks should pay close attention to labour market information. In developing nations, assessing the state of labour markets is complicated by the relatively high share of non-wage employment, and looking solely at unemployment or underemployment rates yields only a limited view of the true state of the labour market. Timely and detailed labour market information is therefore of crucial importance for central banks.

In developing Asia, many central banks would benefit from better labour market information and, perhaps, improved capacity to make sense of it. The ILO can help by supporting efforts to improve labour market information and analysis, as well as by providing assistance to central banks interested in increasing their knowledge of labour markets.

More research is needed to clarify linkages between monetary policy, economic growth, and employment, including how - due to the high prevalence in developing Asia of non-wage and informal employment - related developing-economy issues differ from their developed-economy counterparts. This will help governments and central banks design coherent policies to promote employment during periods of expansion, and to sustain employment during downturns. Evaluating the effectiveness of directed credit programmes is another area where the ILO may be of assistance. These schemes are often justified on the basis of employment promotion, but in most cases there is no publicly available, detailed analysis of whether the programmes have actually achieved their objectives.
References


Monetary policy and employment in developing Asia

Despite the high prevalence of vulnerable employment and working poverty in developing Asia, full employment is not amongst the legislated objectives of any central bank in the region. However, as this paper shows, many central banks are actively using monetary policy to promote productive employment and do appear concerned with labour market outcomes. By working closely with governments, central banks in developing Asia help to promote macroeconomic stability and strive for the goal of full employment. But tasking central banks in developing Asia with an employment objective, as is done in Australia and the United States, appears inappropriate given the gaps in employment data and the structural roots of vulnerable employment and poverty.