POLICY BRIEF

A global policy package to address the global crisis

International Labour Organization

INTERNATIONAL INSTITUTE FOR LABOUR STUDIES

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Preface

This Policy Brief draws on data and analysis developed in the World of World Report 2008, the new Institute's flagship publication. It is based on inputs from the staff of the Institute of International Labour Studies, namely Uma Rani Amara, Lucio Baccaro, Matthieu Charpe, Verónica Escudero, Megan Gerecke, Sameer Khatiwada, Emily McGirr, Naren Prasad and Steven Tobin. Assistance was provided by Maryse Grelard, Thanh Thuy Nguyen Couture, and Judy Rafferty, with coordination by Ekkehard Ernst.

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A global policy package to address the global crisis

A global policy package is needed to overcome the crisis

A global policy package is needed to overcome the current financial crisis, in the spirit of the historic Bretton Woods agreements. Bail-out plans of the financial sector, crucial as they are, will not be enough. Indeed the world economy is being affected by a vicious cycle of rapidly declining confidence, leading to lower demand, output and employment, which is further depressing confidence. What is needed is a global, coordinated stimulus package which breaks this vicious cycle.

In addition, as the *World of Work Report 2008* demonstrates, one of the main factors of the current global financial turmoil has been rising economic and social imbalances that built up over the past two decades.[1] By putting in place conditions for a more balanced distribution of the gains from economic growth, avoiding "deregulation-solves-it-all" solutions, the risk of major systemic crises like the present one would be attenuated. Acting quickly on this front and supporting disposable income through a global stimulus package is instrumental to overcome the current crisis and put the world economy on a sustainable path. The ILO has a major role to play in this global policy package.

What went wrong?

Inappropriate financial regulation has been the enabling factor behind the crisis...

In their analysis, most commentators of the current financial crisis focus on excess liquidity and risky lending as key sources of the crisis. This reflects three mutually-reinforcing factors:

- *First, inappropriate financial regulations*. By setting the wrong incentives, financial deregulation has allowed for the introduction of excessively risky financial products with incompletely understood characteristics. As a consequence, the risk assessment of both the individual products and the systemic consequences of increasing default rates on credit markets could not be carried out properly.

- *Second, inadequate remuneration practices of bank managers*. The generalization of generous remuneration packages for bank managers has bolstered incentives to adopt ever more risky lending strategies. In particular, the common practice of linking bonus pay to share options has narrowed managerial focus on short-term (financial) profit instead of the long-term viability of the firm and performance of the real economy.

- *Third, excess liquidity creation*. It is widely argued that some elements of macroeconomic policy have further contributed to the presence of excess liquidity. In trying to mitigate the negative consequences of the burst of the technology bubble in 2001, the liquidity created by expansive monetary and fiscal policies was channelled into the housing market, leading to the largest housing bubble in United States history.

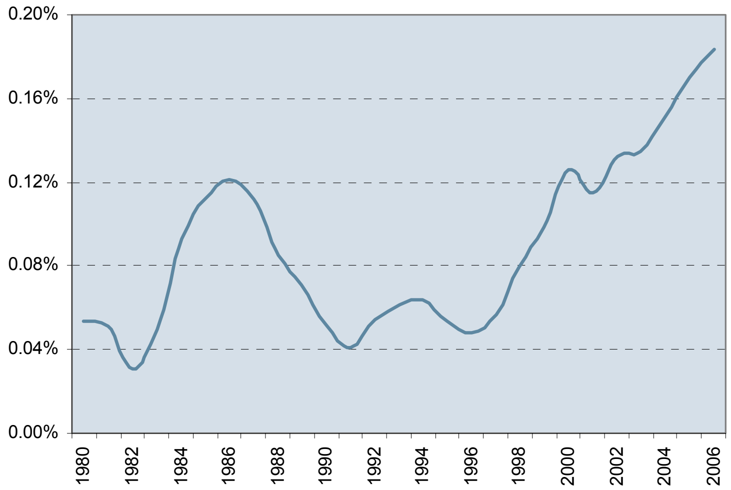
...but the crisis is also the product of an unbalanced globalization process...

This analysis, however, misses a crucial point. Indeed, the crisis is also a reflection of two inter-related structural factors, namely global savings-investment imbalances and growing income inequalities across the globe. Both imbalances and inequality grew from the outset of the early 1990s, well before the deleterious effects of financial deregulation were set in motion. And they both paved the way for the current crisis.

...as some countries adopted export-led models and others saved too little...

First, certain countries in Central and Eastern Europe, but also Spain and Turkey and the United States recorded large and growing current account deficits. The opposite happened in East Asian countries and resource-rich economies in the Middle East, which accumulated large foreign exchange reserves. The result was a steep intensification of current account imbalances (Figure 1). It is this global "savings glut"[2] that allowed market interest rates to reach historical lows in the early 2000s, providing cheap financing conditions to increasingly risky borrowers and fuelling housing bubbles.[3]

Figure 1. Significant global savings-investment imbalances built up since the early 1990s



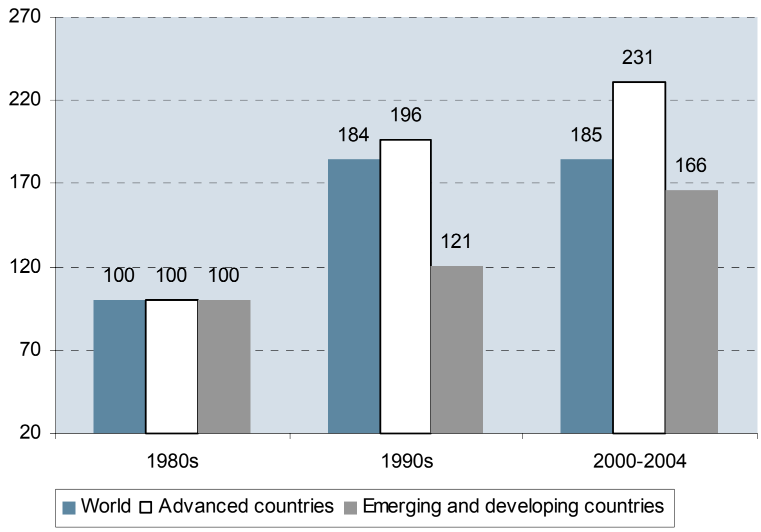
Note: The figure displays the standard deviation of the current account balance of 130 countries as a percentage of World GDP.

Source: IILS estimates.

...and, within countries, income inequalities grew excessively…

Second, the build-up of large savings-investment imbalances has gone hand-in-hand with growing income inequalities within countries (Figure 2). The incomes of high-income groups have grown much faster than is the case of their middle- or low-income counterparts. In emerging countries, in the face of inadequate social security coverage, households increased precautionary savings substantially. As income disparities rose, richer households – which typically save more – fuelled aggregate savings disproportionately. In contrast, in countries where current account deficits deteriorated the most, the relative stagnation of median wages and incomes triggered a rising demand for credit to sustain consumption possibilities and housing investment decisions. This was made possible with the advent of new, lightly regulated financial products that allowed excessive debt accumulation.[4]

Figure 2. Income inequalities have been on the rise worldwide



Note: The figure displays the evolution of the (GDP-weighted) Gini coefficients using averages for 1980-1989, 1990-1999 and 2000-2004. The Gini coefficient for the period 1980-1989 is equal to 100.

Source: IILS estimates.

…fuelled by the "mantra" of wage moderation…

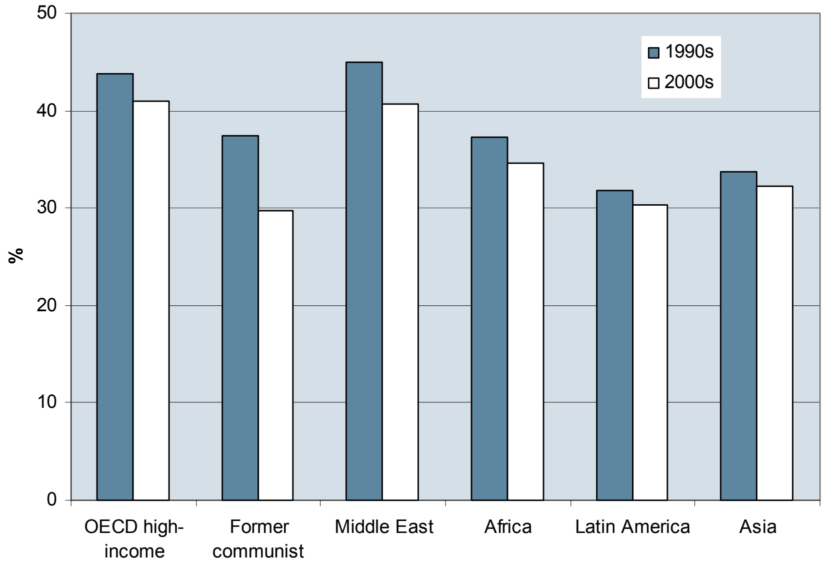
To shed light on the possible policy responses to the crisis, it is therefore useful to examine the factors behind growing inequalities.

First, a major driver of these income disparities has been wage moderation among low- and middle-income households. As a consequence, the wage share – the part of gross domestic income that goes to employees – has been declining since the early 1980s and increasingly so with more integrated financial markets. In the United States, for example, median real wages grew by a mere 0.3% per year between 2000 and 2006. During the same period, labour productivity increased by 2.5% per year.[5] Simultaneously, the revenue share that goes to the richest 10% of households has been on the rise, suggesting that the moderation in wage growth of low- and middle-income households is even more pronounced than indicated by the fall in the wage share.[6] In particular, top executives enjoyed exceptionally fast income gains relative to the average worker. For instance, the ratio of CEO compensation of the 15 largest American companies to average US wages increased from 370 to 521 between 2003 and 2007.

…cuts in taxation on high incomes…

Second, in addition to wage moderation, tax polices have become less progressive and therefore less able to redistribute the gains from economic growth. Top income tax rates have been cut in the majority of countries (Figure 3), a trend which may partly reflect international tax competition to attract or retain high-income people. The resulting shortfall in tax revenues has been offset by rising indirect taxation, with typically regressive effects.

Figure 3. Falling tax rates on high incomes



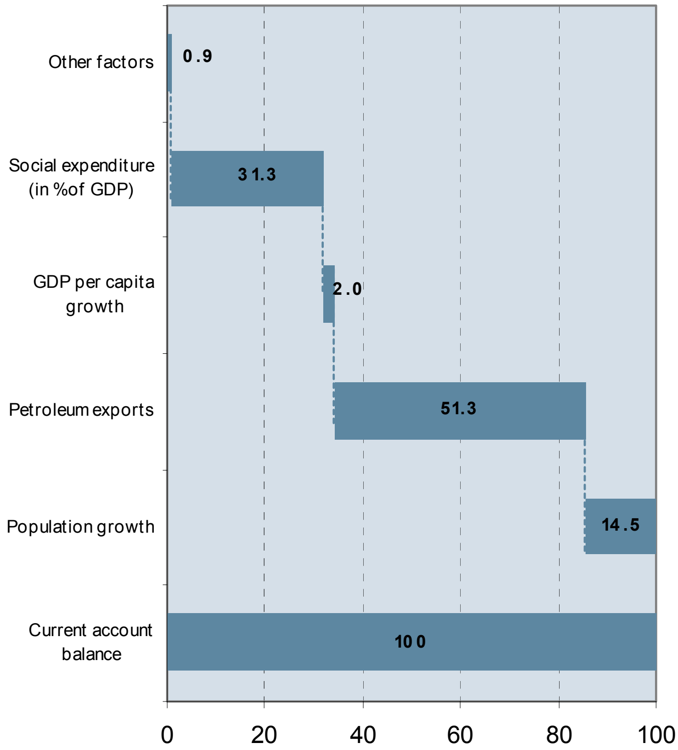
Note: The figure displays the evolution of top marginal tax rates on individual income in various world regions (unweighted averages).

Source: IILS estimates.

… and limited welfare policies in some large countries

Third, the weaker progressivity of tax systems has in general not been offset by increased recourse to social transfers for redistribution, a trend that further deepened global savings-investment imbalances**.** In China, for instance, budget surpluses built up over the years and were not used to pre-fund social policies and to step up social protection for the large informal sector. As a consequence, households save over 40% of their income. This represents a more general trend. Evidence based on a large sample of ILO countries suggests that, other things equal, the lower social spending, the higher current account surpluses. Indeed, IILS estimates show that more than 30% of the variance of global current account balances can be explained by social spending patterns (Figure 4).[7]

Figure 4. Social security spending contributes substantially to variations in the current account balance



Note: The figure displays the contributions of social expenditure (in % of GDP) to variations in the current account balance.

Source: IILS estimates.

In short, wage moderation combined with a weaker ability of taxes and welfare benefits to redistribute the gains from economic growth resulted in a marked, probably unprecedented increase in income inequalities. Rising income inequalities, in turn, fuelled global savings-investment imbalances. This means that households in emerging economies have indirectly financed the spending of low- and middle-income households in (some) developed economies. The resulting financial market bubble required ever more fresh capital to keep expectations high, a situation that was doomed to end in a global crisis.

Only a small spark was necessary to light the fire

Given the rising imbalances, the tightening of monetary policy that started in 2006 in the US constituted the tipping point for a disorderly financial market adjustment. And it was finally the combined shock of energy and commodity prices that put an end to the period of cheap money and easy access to credit across the globe. When central banks started to raise interest rates, the cracks in the financial architecture became visible, first in the US housing market, then spreading to auto loans, credit card debts and eventually across the Atlantic to spark a fire in the banking landscape among European countries and some emerging eonomies.[8]

Lax financial regulation, combined with the fact that loans with opaque and improperly assessed risk characteristics had been sold to international lenders, facilitated the global spread of the shockwave. Banks effectively stopped lending to each other, drying up liquidity on the inter-bank market. Central Banks needed to jump in to provide liquidity but the shock was deep enough to uproot the entire US investment banking system and causing the first bank-run in the UK in more than a century.[9]

What are the social consequences of the crisis?

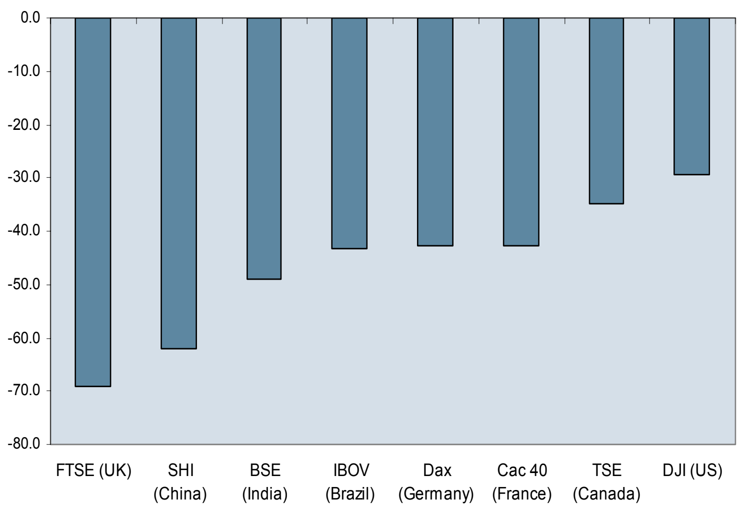
The global financial crisis has eroded people's wealth...

The housing bubble burst, in some developed countries, with rates of return on residential property approaching zero, or becoming negative, in early 2008. In most cases, this represents the lowest returns in more than two decades.[10] Emerging economies have followed a similar trend, though with some delay. For instance, real estate prices in China's capital fell in September 2008 – the first such drop on record. These trends have a disproportionate effect on middle-class households, for whom home equity represents a larger share of wealth and savings.

In addition to declining home equity values, major stock indices have also fallen sharply, losing nearly half their value since the beginning of the year (Figure 5). This has had an immediate and dramatic negative impact on pensions, prompting concerns about the adequacy of retirement savings for many individuals.

The combination of declining equity markets and falling home values has significantly eroded households' wealth. For instance, households' net worth in the United States has been reportedly cut by over $USD 2 trillion since early 2008.

Figure 5. Major stock market indices have substantially declined in 2008

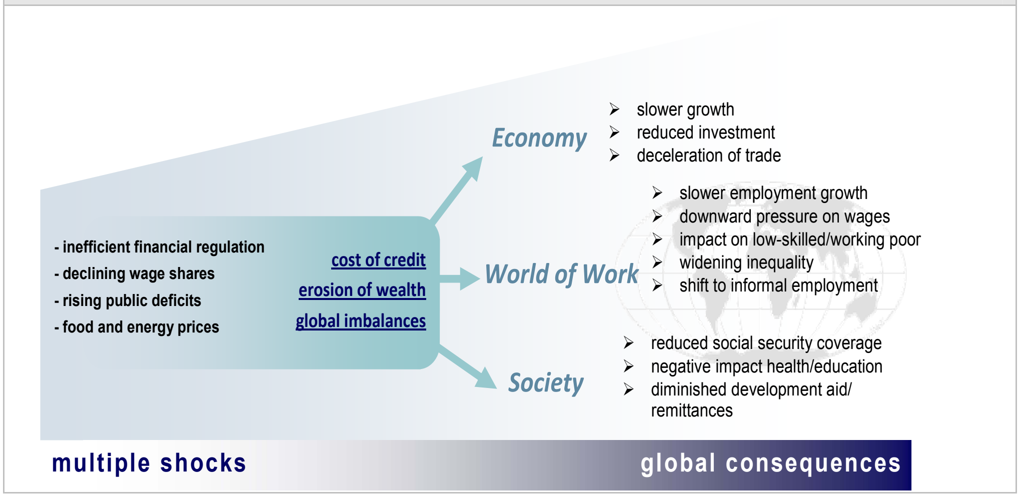


Source: IILS estimates based on http://www.cnbc.com/id/15839121/

… and, more importantly, has put a depressive cycle in motion

The financial crisis is taking its toll on the real economy through three channels: i) by rising interest rates and drying up liquidity in the credit market, it causes investment to stall; ii) by depressing confidence of households and firms, it affects consumption and job creation; and iii) by slowing trade and migrants' remittances, it spreads the shock globally. Since job losses affect disproportionately the low-skilled and vulnerable groups, income inequalities can be expected to rise further as a result of the crisis. Moreover, should the downturn be long and protracted, long-term unemployment is likely to increase substantially, jeopardizing any rapid economic turn-around, reducing the effectiveness of policy stimuli and increasing the bill for the taxpayer to get out of the crisis. Finally, the global spread of the shock will depress development prospects in emerging economies and developing countries (Figure 6).

Figure 6. Financial crisis – Origins and potential consequences



The slowdown of global activity is underway...

The crisis brought to a halt the long period of economic expansion exhibited by the world economy almost uninterruptedly since the mid-1990s. Several advanced countries such as France, Germany, Italy, Spain the United Kingdom and the United States have already experienced negative growth in 2008. The IMF has again revised growth forecasts, with advanced economies expected to experience a decline of GDP in 2009. Similar dramatic slowdowns are expected for most emerging and developing countries. For example, growth in emerging economies would reach 5% in 2009, down from 8% in 2007.[11]

Trade is being strongly affected as well. Exports to the United States and the European Union from countries like Japan and China have already begun to decline. According to the IMF, world trade is expected to grow by a mere 2% in 2009, down 4 percentage points compared with the earlier forecast. This provides an indication of the size of the shock expected to hit developing and emerging economies, which rely heavily on trade and foreign direct investment.

...causing unemployment to rise…

Employment losses have already been mounting in many countries and unemployment rates have risen throughout 2008 in all G7 countries except Germany. For example in Japan, the United States and the United Kingdom alone, employment losses reached over 1.1 million in the three months to September 2008.

Employment in the construction sector is especially vulnerable in the early stages of a crisis. This is often followed by job losses in the sector closely associated with the source of the initial shock – in this case, financial services. As the crisis spreads to other areas, low-skilled workers are often the most affected by job loss. Even when economic activity recovers, these workers face difficulties obtaining new employment and, even if they do find a job, this entails considerably lower wages than prior to the recession.

…and social conditions to worsen substantially

The immediate impact of job loss is felt in terms of income reduction, but also through loss of non-cash benefits such as employer-sponsored health and social security coverage. The loss of these benefits, in the context of tighter government budgets, can be a particularly severe blow to middle- and low-income households.

There is also a risk that international development aid shrinks, and that deteriorating labour market conditions could lead to a reduction in the volume of international remittances. The reverberations of the crisis could also affect internal migration, as when higher urban unemployment prompts jobless workers to return to rural communities. This has started to happen in China.

Participation in education and training may be affected as well. School attendance may initially drop, particularly in developing countries, as some youth, especially in low-income households, withdraw from school to contribute to household income. On the other hand, in the context of falling real wages, the opportunity cost of school is reduced and in combination with rising unemployment, some individuals may choose to pursue education and training rather than participate in the workforce. However, with credit increasingly difficult to access, students and their families may find it harder to borrow to finance the costs of education. The combination of these factors could comprise the achievement of development targets. The ILO estimates that, as a result of the crisis, the number of working poor living on less than 2 dollars a day could increase by over 100 million.[12]

Incomes of workers in the informal economy will also be affected…

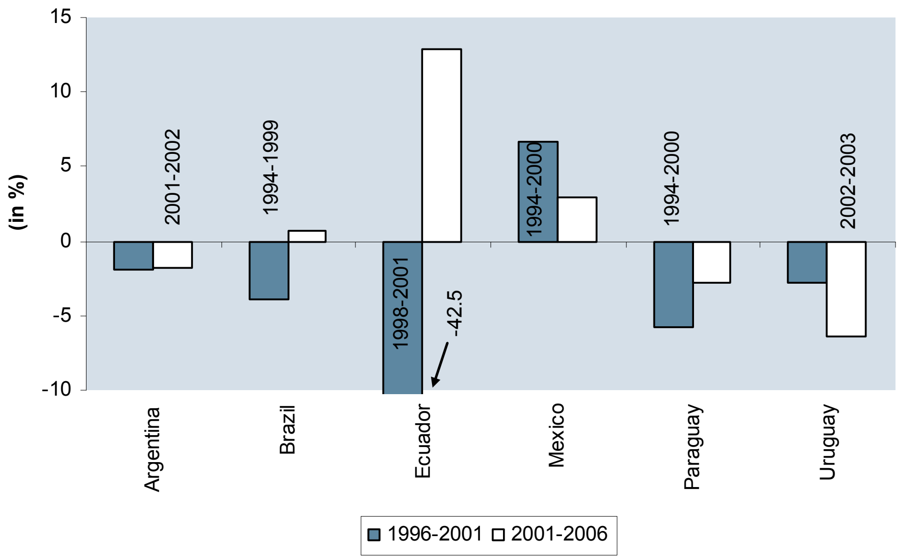
Rising real interest rates and slower growth are expected to worsen conditions in the informal economy – a particular concern for emerging countries – and will constrain remaining possibilities for informal workers to move to the formal economy. Moreover, slower growth associated with reduced profit margins is likely to generate substantial downward pressure on informal-economy wages. As indicated by the *World of Work Report 2008*, already before the crisis, wages in the informal economy were stagnating or even falling in some countries (Table 1).

	1983-94	1994-2000	2000-2005
Table 1. Real wage growth in India			
Urban Males	1.5	3.1	-0.4
Urban Females	2.9	3.9	-1.1
Rural Males	2.5	3.6	1.8
Rural Females	4.1	5.0	1.4

Note: The table displays average annual real wage growth rates for working-age population (15-64 years).
Source: IILS estimates.

This trend is likely to accelerate with the financial crisis, as layoffs of formal workers will increase the ranks of informality and put further downward pressure on wages. Past experience in Latin America, for instance, shows that financial and banking crises have been associated with substantial decelerations or even declines in real wages (Figure 7).

Figure 7. Crises put downward pressure on wages
(impact of earlier crises on real hourly wages in selected Latin American countries)



Note: The figure displays the average annual growth rates of hourly real wages for the periods 1996-2001 and 2001-2006. The dates close to the columns indicate the years of a systemic banking crisis.
Source: IILS estimates.

...and migrants' remittances will fall

In contrast to earlier crises, the global nature of the current one and the likely severe labour market impact across the world makes it unlikely that remittances will help stabilise receiving countries. Remittances from migrant workers have started to decline, lowering disposable incomes and government revenues in receiving countries. An estimate by the Inter-American Development Bank shows that remittances to Latin America will decrease by around 2% in 2008 (the first decline since 2000).[13] In particular, the reversal in the construction sector in the

United States, where 20% of, mainly Hispanic, migrants work, is contributing to these shifting fortunes. Similarly, remittances going to Asia, especially to the Philippines, are likely to decline as workers in resource-rich Middle East countries are the first to lose their job and to return to their home countries. According to the Asian Development Bank, smaller countries in the Pacific will also see their remittance income decrease due to slowdowns in Australia, New Zealand and the United States.[14] A similar story emerges from the 30 million Africans who work and send remittance back to Africa. As the crisis lingers on, this phenomenon will become more widespread leading to a serious shortfall in revenue generation in some of the poorest countries in the world. To the extent that job losses become more severe, migrant workers are also likely to be sent back to their home countries on a large scale, further worsening the social conditions and the labour market situation there.

Pension wealth is being worn away...

Participants in funded pension programs have already suffered a significant deterioration of their pension wealth as a result of the financial crisis. Given that the majority of pension assets are held in various financial instruments linked to stock-market performance, recent drops in stock prices have had a significant adverse impact on these pension funds. For example, the United States Congressional Budget Office estimated that the value of assets held by defined-benefit pension plans has declined by roughly 15% over the past year.[15] Such an erosion of pension wealth has obvious implications for the security and the financial stability of individuals approaching or in retirement. Already, an increasing number of individuals are turning to their pension accounts to help meet immediate costs in the context of the economic slowdown and rising unemployment. Hardship withdrawals from 401(k) pension accounts in the United States have grown by an estimated 14% in the first eight months of 2008. In this context, there may be mounting pressure for additional public support for pensions. Argentina, for example, recently announced a nationalization of pension funds.

…and budget deficits may lead to cuts in spending on social security

As result of the economic slowdown and the deceleration in trade, businesses are likely to close, leading to a decline in income and corporate tax revenues across the world. In addition, rising real interest rates will put substantially new burden on countries which have taken on high public debt. While especially high-income countries are likely, at a minimum, to let their automatic stabilizers play out, the expected substantial decline in tax revenues will create pressure on governments in emerging countries to proceed with pro-cyclical budget cuts, eliminating social assistance to low-income households, and further depressing domestic demand. Partly, countries that have accumulated large current-account surpluses may be able to refrain from cutting spending much by selling part of their reserves. However, to the extent that short-term macroeconomic stability and balanced-budget issues are being given more prominence, social programmes on unemployment, education and health are typically the first that will be reduced or phased out in times of adverse economic circumstances. This financial crisis is no exception; however, the long-term adverse consequences of such regressive cuts in social spending can be substantial.

What can be done now?

A global policy package is crucial to overcome the crisis and tackle underlying imbalances

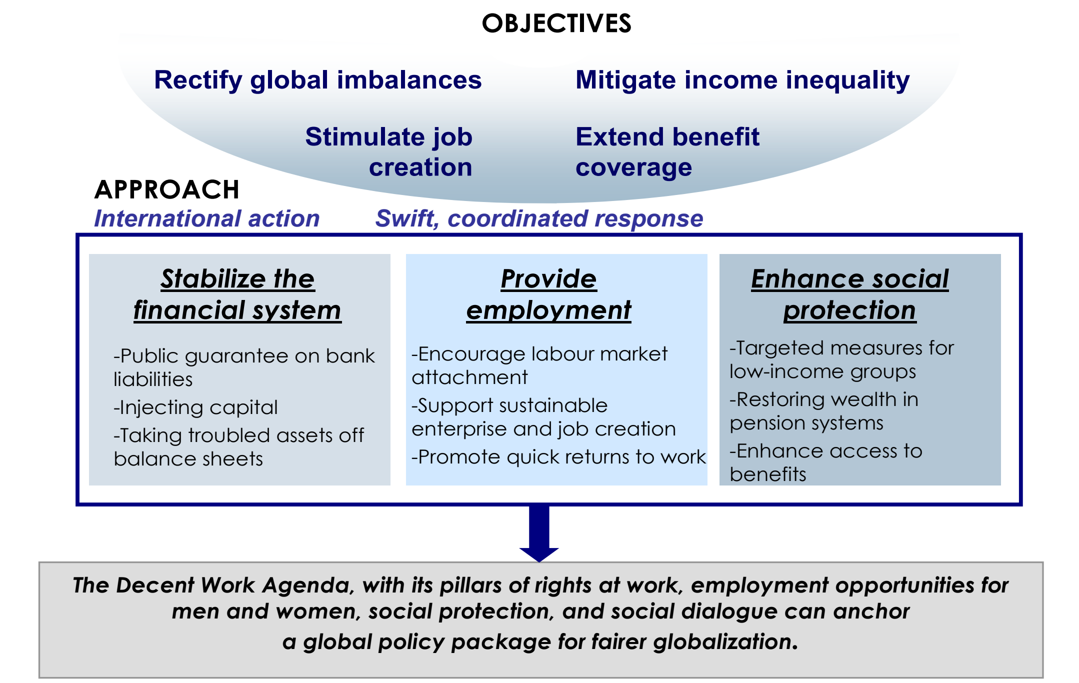
There is a remedy to avoid the bleak scenario depicted above. Indeed, by launching a global policy package, the international community would respond to the current juncture of failing capital markets, drying-up of credit, massive job losses and growing poverty.

Such a policy package needs to follow a three-pillar approach (Figure 8). An immediate policy objective is to stabilize the financial sector and restore confidence on capital markets. In addition, a macroeconomic stimulus is needed to boost domestic demand, thus support the economy and job creation. Finally, to mitigate the adverse effects of the crisis on disposable incomes and income inequality, social welfare systems need to be strengthened and workers' rights protected. Experience shows that social dialogue can be instrumental in designing an effective package of measures.

The important novelty of this proposed policy package is that it would not only help mitigate the crisis, but would also rectify the global imbalances that have been underlying the financial crisis.

Remedies based on the so-called Washington consensus – encompassing further labour market deregulation, cuts on social protection and little focus on core labour standards — need to be avoided. Indeed, such an approach would not only damage the social fabric, but would also compromise the recovery. Likewise, solutions that involve trade protectionism need to be avoided.

Figure 8. A global policy package



The proposal global package includes, first, stabilizing the financial system…

Given the environment of mutual distrust among financial actors, doubts about the value of troubled assets, and shortage of capital, the most urgent task is to stabilize the financial system and stop the downward spiral. It is now widely acknowledged that a three pronged approach – restoring confidence by providing explicit public guarantee on bank liabilities, taking troubled assets off banks' balance sheets, and injecting capital – is the right first-order response.

With this in mind, authorities in Europe and the United States have launched coordinated international steps to provide a blanket guarantee on bank liabilities, quick recapitalization, and taking troubled assets off banks' balance sheets. Furthermore, the IMF has announced a special low-cost lending facility to make funds available for bank recapitalization, especially for countries where banks carry large amounts of assets. How to inject capital in the failing bank sector is still a matter of considerable debate but strong action that reorients banks' lending behaviour back again to the private sector and away from buying government bonds is an essential pre-condition for the credit market to fulfil its main role as growth engine again. In this regard, bold intervention rather than chirurgical cuts are likely to be the more successful approach to stabilizing the financial system.

… in a coordinated way…

Internationally coordinated efforts are vital because there are large positive externalities to coordinated financial rescues – capital injections by authorities in the United States would help alleviate the European financial crisis, and vice versa.

After a series of governmental and regional responses, world leaders have called for an international summit. It is essential, however, that such coordinated action includes not only a selected group of industrial countries but brings together as large a country group as is necessary to restore confidence and stability in the financial system. There have been calls for G20 summits and Asian and European leaders recently met in Beijing to forge a multilateral solution. Such an international approach is essential as the financial crisis has its original in global imbalances that can only be reduced when both industrial and emerging countries coordinate their action and implement policies jointly.

… which also strengthens macro-prudential regulation…

Despite the coordinated international responses in the short-run, the global financial system is likely to remain volatile until there are structural adjustments and the new financial system emerges. This requires regulatory action to take systemic risks into account in banking supervision. In particular, regulators should be empowered to acquire all the information needed to assess the system's vulnerabilities from all financial entities whose actions may have systemic effects. As a result of such reforms, encouraging or imposing simpler financial products that can be priced more easily could go a long way in addressing the systemic nature of the current crisis. Moreover, the reforms to prudential regulation should ensure to make the financial system less pro-cyclical. Evidence overwhelmingly shows that crises always follow a period of boom, but the international regulatory regime has not yet developed structures to prevent the emergence of bubbles. Systemic resilience could therefore greatly be enhanced with "speed limits".

…limits incentives for excessive risk taking…

The current reward structure for executives and bank managers needs to be adapted to prevent excessive risk taking. The existing remuneration model leads to misallocation of risk and places burden on those least capable of taking on large gambles. Some have argued that a realignment of individual incentives with long-term firm survival would require abolishing shareholder value as an indicator of success for the compensation schemes of managers. Some countries like the UK have moved in this direction by requiring that capital injections come with restrictions on executive pay and dividend policies, and this should be used as a best practice by all governments.

Whatever regulatory reform is made in the next coming months, it needs to be assessed against its implications for job creation. Simply choking off the financial sector to avoid any risk taking is certainly not in the interest of wage earners. Furthermore, small businesses that create the bulk of employment in many countries are heavily relying on external financing but also constitute risky investments for banks. The ability to borrow is important for these businesses, and policies must ensure that their credit capacity is being upheld with any new regulatory reform.

… and prevents protectionist reactions

Economic and financial pains such as the current financial turmoil tend to lead countries to pull back from trade openness. As history, especially the experience in the aftermath of the stock market crash in October 1929 shows, protectionist strategies are likely to make matters worse. Today's economies are highly interconnected – even more so than in 1929 – and any attempt to restore economic stability by closing borders to trade and capital flows is bound to fail and would generate even more substantial income and employment losses in the long-run. Nevertheless, this financial meltdown is a reminder that international economic integration requires appropriate regulation to sustain prosperity. This is key to ensuring continued social and political stability that supports policies for freer trade.

Second, the global package would include support to innocent victims of the crisis…

Income inequalities and social conditions are likely to worsen further following the hit from the financial crisis. Even though the initial effect of the crisis and the massive destruction in financial wealth may have led to a (slight) decline in measured income inequality, the social consequences emanating from job destruction and falling wage are expected to be more severe. In this regard, it is important that policy makers take immediate action to mitigate these effects. In particular, three consequences for vulnerable groups need to be addressed: (i) the loss in income following the rise in global unemployment, (ii) a quick return to employment for those who lose their job and – if possible – employment guarantees for those whose jobs are affected only temporarily and (iii) restore wealth in pension systems, especially if they are publicly funded.

In addition, the massive hit that global aggregate demand takes from the substantial liquidity losses can be mitigated to some extent by (coordinated) macroeconomic and social policies. Attention should also be paid to the effect of the crisis on certain groups like women, children, elderly and migrants. Social capital and the use of family solidarity should be enhanced in order to cushion the shocks of the crisis. Earlier experiences during the Asian crisis (see box) demonstrate that at times of crisis, implementing even basic social security programmes can help limit the economic and social consequences of the crisis, restoring confidence, and thereby shortening its length.

Social policies in the aftermath of the Asian crisis

A comparison with the current crisis

The current financial crisis bears striking resemblances with the 1997-1998 Asian crisis, both in terms of their origins – excessive leveraging led by overly optimistic growth expectations – and their social and economic consequences. Even though the current crisis may turn out to be less severe than the one in Asia due to the absence of a currency crisis, the social policy innovations to which the turmoil in Asia have given rise to make a comparison with the current situation worthwhile.

Social impacts of the Asian crisis

The Asian financial crisis caused widespread social distress in affected countries, reversing the impressive trends in poverty reduction that had been achieved in these countries (see Table B1). Massive lay-offs meant a sharp rise in unemployment and underemployment. Labour force participation declined as workers became discouraged. At the same time, inflation caused real wages and income to suffer, as prices on essential goods climbed. Informal sector earnings also declined due to the influx of workers from the formal sector and lowered demand for informal products. Also, the burden of adjustment fell disproportionally on migrant workers and women.

The crisis revealed the weakness of social safety nets and failed to cope with the rapid increase in poverty and open unemployment. In the region, social assistance was typically limited to people who were unable to work (rather than the poor in general). Of the affected countries, only the Republic of Korea had unemployment insurance and even this system was newly implemented and had only limited coverage. In general, the social safety nets were unable to address the extent of the crisis and appear to have slowed the pace of recovery.

Policy innovations and old traditions

In reaction to the financial crisis, the ILO recommended strengthening social protection schemes – such as introducing or expanding self-financing unemployment insurance and expanding social assistance schemes to relieve extreme poverty.* For those out of a job, passive income assistance was recommended as a cost-effective means to moderate the social impact of economic crises. A concern was that social assistance programmes would take time to be set up as they involve extensive targeting. The ILO recommended, therefore, that in the interim, for countries without a functioning social assistance programme, public works programmes should be introduced; these programmes are typically capable to self-target by paying subsistence wages.

This ambitious social agenda to mitigate the consequences of the crisis had not been followed by all countries in the region. Korea, Taiwan and, to a lesser extent, Thailand, significantly expanded their social safety nets. Thailand focused on employment creation and continued coverage of social security schemes for contributors who had lost their jobs. Thailand also attempted to address the effect of the crisis on education enrolment and on access to health care. In Korea, the pre-existing unemployment benefit scheme was extended to cover all workers except daily ones; in addition, qualifying conditions were relaxed and benefit levels were increased. Furthermore, Korea offered extensive wage subsidies, and in 2000, introduced the Minimum Living Standards Guarantee, which coupled training programmes with income supplements.

In contrast, Singapore, Malaysia, Indonesia and the Philippines reacted with a renewed focus on traditional values of self-reliance, family networks and economic growth. These countries introduced some temporary means of social assistance, and in the case of Indonesia, subsidies to counter high inflation on essential goods. The countries also reacted by exporting and repatriating migrant workers – a process more difficult to execute than expected.

Countries that implemented – at least part of – the social agenda and increased their social spending (such as Korea or Thailand) fared significantly better, both in terms of mitigating of rising poverty and unemployment and in terms of the speed with which they recovered from the crisis. In particular, the public works programmes proved to be successful, even though poor design and lack of proper monitoring meant that even better results could have been achieved. In contrast, countries that relied more on traditional and informal networks, such as Indonesia or the Philippines, were less effective and continued to suffer from high unemployment and poverty rates even five years after the crisis.

Table B1: Economic and social developments in South-East Asia (1990-2004)

	Indonesia	Korea, Rep. of	Malaysia	Philippines	Thailand	Taiwan
Annual per capita GDP growth						
1990-1996	5.7	6.3	7.0	0.4	7.0	6.1
1998	-14.4	-6.6	-9.3	-2.6	-10.8	3.7
Poverty incidence						
1996	11.3	9.6	8.2	37.5	11.4	:
1998	20.3	19.2	:	:	13.0	:
Change	79.6	100.0	:	:	14.0	:
Unemployment %						
1995	7.2	2.1	3.1	9.5	1.7	1.8
1996	4.9	2.0	2.5	8.6	1.5	2.6
1997	4.7	2.6	2.4	8.8	1.5	2.7
1998	5.5	7.0	3.2	10.3	4.4	2.7
1999	6.4	6.3	3.4	9.8	4.2	2.9
2000	6.1	4.1	3.0	11.2	3.6	3.0
2001	8.1	4.0	3.5	11.1	3.3	4.6
2002	9.1	3.3	3.5	11.4	2.4	5.2
2003	9.6	3.6	3.6	11.4	2.2	5.0
2004	9.9	3.7	3.5	11.8	2.1	4.4
Government spending on social security (% of GDP)						
1995	:	1.2	0.8	0.3	0.6	3.4
1996	:	1.4	0.8	0.5	0.7	3.1
1997	:	1.5	0.9	0.8	0.7	3.5
1998	:	1.8	0.8	0.8	0.9	3.3
1999	:	2.1	0.8	0.8	0.9	3.3
2000	:	2.2	0.9	0.7	1.1	3.9
2001	:	2.7	1.2	1.0	1.2	4.1
2002	:	2.3	1.2	1.0	1.5	3.4
2003	:	3.0	1.4	0.9	2.0	3.8
2004	:	3.1	1.0	0.9	1.6	3.6
Estimated decline in migrant workers						
to 1998	:	117 000	4 000 000	:	460 000	:

Compiled from: World Bank 2000; IMF World Economic Outlook Database, 2008; Asian Development Bank Statistical Database System, 2008); Asian Development Outlook 2007 (based on CEIC Data Company Ltd.; Bank of Thailand, available: www.bot.or.th); ILO 1999

*: Lee, E. 1998. "The Asian Financial Crisis The Challenge for Social Policy", International Labour Office, Geneva.

… including proper access to well-designed unemployment benefits…

Policies need to be put in place to make sure that those being laid off in the course of the crisis are properly protected against substantial losses of disposable income.[16] Currently, over two thirds of the unemployed worldwide do not have access to any sort of unemployment insurance. Even for those that do, benefit replacement rates are often very low, barely providing replacement income to cover the most basic consumption needs. Only Nordic and some Continental European countries offer replacement rates of 60% or above of previous earnings. The absence of proper unemployment insurance pushes many of those loosing their jobs into informal employment, leaving them without proper protection and making their future re-integration into the formal labour market more difficult.

During this crisis, government should therefore make sure that workers get adequate protection. This could be achieved through encouraging social dialogue and ensuring that labour rules are respected and that the crisis does not become an excuse for firing people. Moreover, in order to prevent a further increase in poverty and income inequality and to maintain a decent living standard for all, governments should make sure that those who loose their jobs are protected through the use of unemployment benefits. Such policies have been successfully enacted in past economic crises in the Nordic countries (Finland, Sweden) in the early 1990s where social transfers increased considerably, especially for unemployment benefits.

It is also important that access to benefits is extended to those workers who for some reason are unable to access the unemployment benefit. In these cases, of course, extended coverage of benefits should be granted on the condition that workers provide in return a tangible service or undertaking (e.g. training or job-search assistance). In addition, this also provides an opportunity for the unemployed to acquire specific skills which may help them in the future. For example, during the financial crisis of 1997, Korea extended its unemployment benefit to cover all firms that laid off jobs and created a public works programme for those who were unable to get the benefits since they have not contributed to the unemployment insurance, excluded from the benefits or were in the informal employment.

Unemployment benefits, social protection and employment protection are also part of the core ILO conventions that many member states have ratified. It is important that these conventions are upheld, despite the adverse economic developments as a result of the crisis. And the crisis can provide a unique opportunity for those countries that are still lacking proper social insurance systems to enact innovative policies and strengthen labour legislation. Not only will this help these countries to mitigate the consequences of the crisis, it will also allow them to return more quickly back on track and improve their economic resilience to shocks.

… encouragement to those without a job to stay in the labour market and find a new job quickly…

Unemployment benefit systems should be supplemented by public works programmes and effective active labour market policies to help vulnerable groups maintain the link with the labour market. Currently, a number of emerging countries have introduced employment guarantee programmes, and active labour market policies have become a common denominator in those industrial countries that have a long tradition of unemployment benefit systems. Main elements of these programmes include employment services (such as job matching, career guidance and job-search support; adequate management of unemployment benefits; and the referral of jobseekers to reintegration programmes after a period of unsuccessful job search), training, public works, wage and hiring subsidies, and promotion of self employment. So far, these programmes, if well designed, have proved to be very beneficial, helping cushion economic shocks without jeopardizing growth. For example, universal social policies such as those used by Nordic countries (e.g. Denmark, Sweden) have managed to support economic development by maintaining high employment and strong labour force participation while at the same time leading to favourable social outcomes (see World of Work Report 2008, Chapter 6). Moreover, these programmes should also ensure to be open to informal workers to maximise their beneficial economic and social impact.[17]

Third, macroeconomic policy needs to support the recovery beyond "automatic stabilisers"…

With the onset of the global recession and the rise in job losses, governments are called upon for a coordinated action to limit the adverse consequences for domestic demand, over and beyond what automatic stabilizers may already be able to achieve. Moreover, to the extent that low-income households are likely to disproportionately bear the cost of the economic slowdown, targeted measures to support their disposable income – for instance through temporary increases in earned income tax credits or hardship benefits in depressed areas – should be considered. Finally, it should be noted that were the economic and social crisis to worsen substantially with a prolonged financial meltdown, macroeconomic policies need to remain pro-active for a longer period. The main lesson from the Japanese debt crisis has been that early reversal of stimulating policies can push the economy into deflation, substantially rising real interest rates and dampening economic activity. Such a scenario is, however, not on the horizon.

…and allow exchange rate adjustments to rectify global imbalances

Moreover, the current crisis must be used to rectify international currency misalignments due to exchange rate manipulation of some countries. Many emerging markets have used undervalued exchange rates to foster perspectives for their exposed sector. Some of the emerging economies benefiting from strong export growth have experienced real exchange rate depreciations, further opening up their current account surpluses. Appropriate exchange rate adjustments are needed, however, to allow economies to rebalance their internal and external demand components accordingly. Available evidence suggests that rebalancing growth between emerging and developed economies or even within developed economies would only partly resolve the problem of global current account imbalances. Relying solely on adjustments in the real exchange rate, however, are likely to take a long time to restore equilibrium and are typically very painful.[18] International fora and organizations therefore need to place more emphasis on helping countries adjust their nominal exchange rates in an attempt to stabilize global imbalances. Such coordinated approaches to managing exchange rates would also improve the stability of the international financial system better protecting countries against uncoordinated unravelling of the exchange rate and currency crises.

A global policy package needs to restore growth and support sustainable enterprises and job creation

First and foremost, however, a global policy package needs to support global economic activity. All countries involved are called upon to share in their effort to limit to the extent possible the adverse macroeconomic consequences of the coming world recession. Most importantly, policy actions need to be taken fast and the stimulus has to be substantial in order to close the global shortfall in aggregate demand. Current discussions in the euro area in this respect seem to be too timid to make any difference and run the risks of ending the economy into a similar debt-deflation spiral that Japan experienced during the 1990s. In comparison, a stimulus similar to the one that eventually helped Japan to overcome its crisis would involve a deepening of the deficit by an additional 3 percentage points for the next four to six quarters to come.

As regards the instruments of such a policy approach, monetary policy alone cannot mount these problems as the standard transmission mechanisms through lower interest rates and credit growth are shut down as a consequence of the crisis and are only slowly opening up again. Also, automatic stabilizers of the tax-benefit system need to play a substantial role but will not be sufficient to restore consumer and investor confidence, a necessary precondition for activity to resume. Rather, additional and substantial coordinated fiscal stimulus packages are necessary to support growth and job creation. To avoid possible dilution effects, policy makers across the globe need to coordinate their efforts and provide such a stimulus in a synchronous manner. Rapidly decelerating energy and commodity prices will help in this respect, softening the pressure on inflation rates and restoring some of the lost purchasing power of households. Moreover, simulation studies show that benefits for job creation are maximum when fiscal packages are set up around increases in public investment, possibly linking the package to other policy objectives such as infrastructure development or expanding capacity in green energy.[19]

Temporary measures in deficit countries may be necessary…

Deficit countries such as the United States have started to provide the necessary stimulus which will help to resume global activity. Their range of action, however, is more limited, especially in the light of reducing global imbalances. In particular, the excess liquidity at the heart of the financial crisis calls for a prudent macroeconomic policy stance in these countries over the medium-term. Nevertheless, and in the short-run, temporary measures such as one-off tax rebates or time-bound public investment projects would be an appropriate measure to support activity and help restore confidence in the private sector. Such measures will prevent unemployment from unravelling and helping to put a floor under aggregate demand. This is a pre-condition to stabilize global economic activity as these countries continue to constitute the main driver for world demand until the global imbalances have been fully resolved.

…but the burden falls especially on economies with excess savings

The main burden of fiscal stimulus, however, will fall on countries and regions that have provided excess savings to international markets in the past. These countries have sufficient room to strengthen domestic demand and to bring absorption in line with their production capacities. In this regard, surplus countries in the developing world may want to strengthen their social programmes such as introducing unemployment benefits or providing appropriate health care services and old-age pension systems. Such an approach could bring a double dividend in these countries. On the one hand, it would absorb the enormous surpluses that have been built up over the past. On the other hand, it would support and improve social conditions, in particular of low-income households. This would bring down income disparities and could contribute to reverse the current trend of raising inequality.

Push for a pro-poor growth agenda would strengthen growth…

A further push for a pro-poor growth agenda in emerging economies is likely to generate another double dividend in relation to the current crisis. Strengthening disposable income growth of especially low-income households helps to compensate for the adverse effects of higher food prices and fewer employment opportunities in the export sector. Currently, the proportion of 'working poor' is rising rapidly, and as such, policy reforms need to focus on improvements in the quality of employment, with better incomes, which would help restore disposable incomes even among the lower income groups. The reform strategy should also involve government spending to strengthen human capital capabilities, in terms of basic education and skill training in growing sectors, which would help in gaining employment with better remuneration. By the same token, such a pro-poor growth reform policy would help rebalance growth from export orientation towards domestic demand, thereby contributing to a reduction in persisting global current account imbalances. To be effective, however, such a growth strategy needs to lift particularly low-income households out of poverty, i.e. growth needs to benefit disproportionately low-income households.

…and more broadly alleviate income disparities

A pro-poor growth agenda will also reduce income inequalities, which contributes to stabilizing the economy. To be effective, such a policy needs to strengthen the role of social partners and restore some of the progressivity of the tax system that has been lost over recent years. As the recent *World of Work Report 2008* has shown, the rise in income inequality across countries is driven by variations in the institutional configuration of labour markets and welfare states. To reverse these trends, tackling income disparities at the source by limiting the variation of market incomes would be the most effective measure and involves a strengthening of the role of social partners in negotiating a more equal distribution of the benefits of growth.

Moreover, tax and social policies should be redesigned to support employment, a key redistribution mechanism. This should include universal access to basic social services, such as education, health and water, which both supports economic growth and limit the risk of excessive income inequality. It should also involve a rise in effective top marginal income tax rates – often achieved simply by removing exemptions from tax codes – and expanding the importance of social expenditure in public finances.

In emerging economies, policies should also be directed towards increasing agricultural productivity and non-farm activities, brought about by a more conducive investment climate for small and medium scale firms. Public safety nets, public works, and state support for micro credit and insurance can help low-income households to manage risk. Such a growth strategy would further contribute to alleviate income disparities and strengthen potential growth of the economy. In this regard, the use of conditional cash benefits – such as cash grants for the unemployed to meet their basic necessities – may prove to be an interesting innovation during crisis times.

The ILO's Decent Work Agenda would help put the world economy on a sustainable path

Rising income disparities lie at the heart of the current financial turmoil. Current policy proposals, however, disproportionately focus on the symptoms of the crisis such as regulatory failures in financial markets. While these may be sensible proposals, they do not address the source of the imbalances and will only retard new crisis-prone structures building up in the coming years – as was the case following the IT bubble.

The current crisis should, therefore, be taken as an opportunity to undertake a broad overhaul of social policies, refocusing on equal opportunities and a fair distribution of the benefits of growth and globalization. This also means that wages should be better connected with productivity developments – traditional wage moderation strategies are not the answer. The policies from the past will no longer work in today's multi-polar environment. But the goal of a Fair globalization encompassing equal employment and income opportunities combined with social protection and security remains at the fore of policy makers' minds. The *World of Work Report 2008* has shown that these goals can be achieved by welfare states strengthening redistribution and social partners concentrating on their core business. And, as this policy brief has demonstrated, a double dividend can be expected from this social agenda in the form of more stabile employment and wage growth and less volatility in international financial markets. This is the core of the ILO's Decent Work Agenda.

Notes and References

[1]International Institute for Labour Studies. 2008. *World of Work Report 2008: Income Inequalities in the Age of Financial Globalization.* ILO, Geneva.

[2] Bernanke, B., 2005, "The Global Saving Glut and the U.S. Current Account Deficit", Sandridge Lecture, Virginia Association of Economics, Richmond, Virginia, available at http://www.federalreserve.gov/boarddocs/speeches/2005/200503102/default.htm.

[3] Guichard, S., Turner, D., 2008, "Quantifying the effect of financial conditions on US activity", OECD Economics Department, Working Paper, No. 635.

[4] Growing demand for credit would not have been met by adequate funds without some fundamental changes in the banking landscape. First, rising competition between financial institutions both domestically and globally contributed to lower lending standards. In the US, for instance, banks have been eager to take on new mortgage in regions with particularly intense competition and where new entrants had been large in comparison to the market size (see Dell'Ariccia, G.; Igan, D., Laeven, L., 2008, "Credit booms and lending standards: Evidence from the subprime mortgage market"; IMF Working Paper, no. WP/08/106). In addition, securitization – i.e. the possibilities for banks to bundle their loans and sell them in parts on the market – opened new possibilities to remove these mortgages from their balance sheets. This further induced banks to become more lenient with new credit applicants, extending loans even to those households that were typically excluded from access to credit. In addition, securitization reduced the need of banks to increase its own funds following credit expansion. As risks were transferred to the market, banks were not forced to provision appropriately for risks. Even though securitization was supposed to reduce banks exposure to risk, it indeed induced banks to take on more risks. As a result, even borrowers with a higher risk profile (such as borrowers with low incomes, bad credit histories or limited disposable income) were able to access credits, so-called sub-prime mortgages. In 2000 these sub-prime borrowers accounted for 9% of all borrowers but within 6 years their share had increased to 20%.

[5] At the state level, fourteen US states had even falling wages over that same period.

[6]There is also a widening gap between managers and workers wages. For instance, wage dispersion has increased between managers and low skilled workers in "food preparation and sales" from 4.2 to 4.9 between 2000 and 2006. Two main factors can be put forward to explain wage moderation in the US: the international division of labor and the weak bargaining position of employees. Emerging economies have been competing over the past decades with developed economies for low skilled intensive goods. Given the lower labor costs in these countries, production has been increasingly outsourced away from developed economies, leading to lower demand for unskilled labor. In addition, despite low unemployment figures, workers could not push for higher wages because of a weak bargaining position. Non-standard employment has reduced the bargaining position of employees. In addition, migration has contributed to increase the labor force over the past decades, limiting wage increases.

[7] Detailed estimates are available on request at the International Institute for Labour Studies.

[8] Early signs of cracks in the system appeared when contraction in the U.S. housing sector started in 2005. Lower population growth, over-supply of new buildings, and bubble-high prices increasingly weighed on housing demand. Inventories of unsold new homes increased rapidly, and house prices decelerated. But it was the combined shock of energy and commodity prices that finally put an end to the period of low-interest rates, cheap money and easy access to credit. With rising interest rates, the negative trends in the US housing market quickly accelerated and by the end of 2007 new housing permits had fallen dramatically. The fact that most of the sub-prime mortgages were given out on a variable interest-rate basis – with the risk of potentially large adjustments to monthly payments if interest rates rose – rapidly accelerated the unravelling of the crisis. The original belief that the risk of higher default rates of sub-prime borrowers could be compensated by an ever expanding housing market that would continue to improve the lender's overall position proved untenable. As money market rates increased, foreclosures increased, as expected, but occurred at the same time the housing market and valuations cooled.

This left the lending institutions with assets of significantly reduced or, in some cases, worthless value.

[9] Besides reducing lending standards, the securitization of mortgages had another negative side effect that caused the shock to spread globally. Many of these sub-prime mortgages actually never made it on the balance sheets of the lending institutions that originated them. Increasingly, these products had been bundled together with prime mortgages and a variety of assets to be sold on the market (so-called mortgage-backed securities, MBS). The problem was that that assets with different risk profiles were bundled together and nevertheless received a high investment grading, making them attractive to international investors, including European banks with free cash to go asset-shopping. However, when sub-prime borrowers failed to repay their mortgages, the originating institution needed to finance the foreclosure with their own money, bringing the asset back on its balance sheet. This left many banks in a financially unviable situation, in a rather short, unmanageable timeframe. And, the fact that nobody knew how much more of those MBS would return on their balance sheets, banks effectively stopped lending to each other, drying up liquidity on the inter-bank market substantially, both in the US and in Europe.

[10] International Monetary Fund (IMF), World Economic Outlook 2008, October.

[11] International Monetary Fund (IMF). 6 November 2008. "World Economic Outlook Update".

[12] International Labour Office. 20 October 2008. Press Release. "ILO says global financial crisis to increase unemployment by 20 million".

[13] Inter-American Development Bank. 2008. "IDB estimates of 2008 remittance flows to Latin America and the Caribbean".

[14] Asian Development Bank. 2008. "Navigating the Global Storm: A Policy Brief on the Global Financial Crisis".

[15]The volatility in asset prices has even steeper consequences for defined contribution pension plans, as they are more heavily weighted towards stocks. In defined contribution plans, which have increasingly replaced defined benefit plans in recent decades, individuals bear the investment risk associated with broad market fluctuations. Data from the Federal Reserve indicates that the decline in the value of financial assets has eroded the value held in pension funds by roughly $1 trillion from the second quarter of 2007 to the second quarter of 2008, constituting almost 10% of the assets held (private sector and public sector combined). Asset prices have continued to fall further since the end of the second quarter, with pensions experiencing corresponding declines.

[16] The Director General of the ILO has noted the importance of medium-term action to establish a socio-economic floor of opportunity and protection, combining a minimum package of social rights and guarantees. International Labour Office. 2008. "Social Consequences and Responses to the Financial and Economic Crisis". Discussion paper by Juan Somavia, Director-General of the International Labour Office to the United Nations system Chief Executives Board, New York.

[17] ALMP are generally believed to have emerged from Sweden in the 1950s which is part of the Swedish economic and social policy making. This model was soon followed by Germany and France in the 1970s and later by the European Union as a policy for structural transformation. The transition economies used ALMP during the shift from planned to market economy in the 1990s, while many developing and emerging countries are making use of this to cushion the effects of unemployment increases during economic downturns or for increasing social protection to workers. ALMP were widely used in Korea, Thailand, and Indonesia during the East Asian financial crisis of 1997. A study by ILO (Auer et al. 2005) shows the various components of the ALMP are given different priorities in different regions of the world. Expenditure on ALMP for example various from around 1% of GDP in European countries (where the Nordic countries spend the most and the UK, Greece and Italy spend the least), to 0.3% in the transition economies (0.4% in Poland and Hungary and 0.14% in Czech Republic). In the developing worlds of Latin American and Caribbean 0.4% of GDP on average is used for training and employment programmes, while in East Asia, mainly Korea it is 0.3%. However, due to large

informal sector workers in the emerging and developing countries, it is extremely difficult to cover everyone in the labour force. Sweden and Finland used ALMP during their economic crisis in the early 1990 while East Asian countries used different components of the ALMP during the Asian financial crisis of 1997. Some of the elements of the East Asian experience of ALMP have remained a legacy of the crisis such as unemployment benefits, government services and to some extent social protection. Similar policies could be used in this current financial crisis in order to absorb the shocks of increasing unemployment, underemployment and precarious employment.

[18]Euro area exchange rate misalignments have caused in the past substantial social costs. In particular, Germany that entered with an overvalued real exchange rate in 1996 in the euro area need to proceed to a real exchange rate devaluation through low inflation, which ultimately meant low wage growth. As a consequence, disposable income growth have been stagnant for more than 10 years (1995 to 2006) contributing substantially to the recent rise in income inequalities.

[19] Heilemann, U.; Wappler, S.; Quaas, G.; Findeis, H. 2008. “Qual der Wahl? Finanzpolitik zwischen Konsolidierung und Konjunkturstabilisierung. Wirtschaftsdienst”, *Zeitschrift für Wirtschaftspolitik*, Vol. 88, No. 9, pp. 585-593.

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