UNCTAD/TDR/2012

UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT
GENEVA

TRADE AND DEVELOPMENT REPORT, 2012

Chapter VI

THE ECONOMICS AND POLITICS OF INEQUALITY RECONSIDERED

UNITED NATIONS
New York and Geneva, 2012

Chapter VI

THE ECONOMICS AND POLITICS OF INEQUALITY RECONSIDERED

A. Introduction

It is often believed that an efficient outcome of market processes in an increasingly globalized economy requires greater inequality between capital and labour incomes and a greater dispersion of personal income distribution. This chapter argues that such a belief is misguided.

Chapter IV of this *Report* has examined how globalization and technological change, and their interplay, have exerted pressure on income distribution. In this chapter it is argued that the apparent impact of these forces on inequality in many countries must be understood in the context of macroeconomic and labour market policies which have caused unemployment to rise and remain high. It suggests that neither globalization nor technological improvements inevitably require a shift in the distribution of income that favours the rich and deprives the poor of the means to improve their living standards. The rise of inequality observed in many countries could have been mitigated, if not prevented, by more appropriate macroeconomic and labour market policies without adversely affecting their international trade and technological progress.

A particular school of thought – which does not reflect economic reality – has dominated perceptions over the past few decades. It considers rising inequality as being a "normal" result of globalization and the use of more capital and advanced technologies in the production process. This chapter challenges that view and suggests that economic policies and institution-building based on a different understanding of the way a market economy evolves over time could lead to a more equitable as well as a more efficient form of economic development and structural change.

> The measures being proposed and implemented in several countries in response to the crisis are tending to increase inequality even further.

The tremendous influence of mainstream economic theory on the thinking of a majority of economists and policymakers about growth and development is reflected in the current public debate on economic policy in many countries. Public opinion and many policymakers are increasingly concerned about the trend of rising inequality in a large number of developed and developing countries. But at the same time the measures that are being proposed and implemented in several countries to overcome the current economic crisis are tending to increase inequality even further. Growing income gaps, high unemployment in many countries and increasingly

frequent shocks and crises over the past 35 years raise serious doubts about the appropriateness of the theoretical foundations of the macroeconomic and labour market policies traditionally pursued in many countries. Indeed, the observation that it has not been possible to reduce unemployment by means of greater income inequality necessitates a fundamental policy reorientation.

Rising unemployment due to slow growth of an economy has a dual impact on inequality. First, it has a direct impact on inequality through lower – or no – incomes for the unemployed compared with their potential income from employment. Second, high and persistent unemployment tends to weaken the negotiating power of labour, thereby exerting downward pressure on real wages.

This chapter addresses inequality in terms of both functional and personal income distribution. Section B discusses the link between rising unemployment and the fall in the wage share. It shows that it is erroneous to apply the simple neoclassical supply-and-demand model that underlies widespread calls for greater wage flexibility in the labour market. Such a model neglects to consider the negative effects on domestic demand that result from a downward adjustment in the level of wages in response to initial demand shocks. Policies based on this model lead to greater inequality as a result of a falling share of wages, and they fail to generate additional employment or prevent a rise in unemployment. Rather, they tend to worsen the employment situation further by depressing consumer demand and reducing the incentives for fixed investment. On the other hand, regular adjustments of average nominal wages in line with average productivity growth would prevent a fall in the share of wages while generating additional domestic demand, which would induce increased output and the creation of new employment.

Section C of this chapter goes on to challenge the proposition that greater flexibility of wages at the firm or sectoral level (i.e. the greater differentiation of wages for similar occupations across firms or sectors) contributes to reducing so-called structural unemployment. It argues that in a dynamic and efficient economy, it is not flexibility of wages, but flexibility of profits – both overall and across firms – that helps to absorb shocks and leads to faster growth and employment creation.

Drawing on the analysis of the macroeconomic interaction between wages, productivity and employment in the earlier sections, section D of this chapter develops policy proposals for labour market and macroeconomic policies aimed at achieving better outcomes, not only in terms of income distribution but also in terms of growth and employment creation. Essential elements in this regard are the strengthening of institutions in support of collective wage bargaining and the addition of an incomes policy to the macroeconomic policy toolkit. This would allow the linking of real wage growth and the resulting rise in household demand – a key determinant of output growth in most economies – to the trend in productivity. At the same time, it would broaden the choice of combinations of instruments for macroeconomic management, and allow monetary policy to be geared, more than in the past, to stimulating investment and growth.

> Developing countries have considerable scope to reduce inequality by distributing the productivity gains more equally and in a way that boosts domestic demand.

This is a particularly important concern for developing and emerging economies. Developing countries may need to achieve a more drastic reduction of income inequalities than developed countries. Traditional social inequality, inherited power and commodity bonanzas in these countries often obstruct the creation of what is sometimes called “equality of opportunity”, which is a precondition for a successful and dynamic division of labour. On the other hand, there is considerable potential for productivity growth in these countries as a result of increased specialization and division of labour. They also have the possibility to draw on the advanced technologies developed in other countries and combine them with relatively cheap domestic labour. This means that they also have considerable scope to reduce inequality by distributing the productivity gains more equally, and in a way that boosts domestic demand.

Clearly, preventing a further increase in inequality or achieving its reduction in developing countries requires additional policy measures, especially in favour of the lowest income groups and the rural

areas. By absorbing a greater share of the gains from productivity growth and commodity rents, governments can also widen their "fiscal space", and increase infrastructure investment and spending on equality-enhancing public services, especially in education and professional skills formation. But for deepening the division of labour, many developing countries will need to increase their fixed investment in the formal manufacturing sector and attract a large number of the self-employed poor and those employed in the informal sector into formal employment with the promise of reasonable, rising and reliable wage incomes.

In addition to these issues related to national policies, section D addresses the international dimension of the employment-wage-growth nexus. It draws particular attention to the necessity of an appropriate currency regime for preventing misalignments of the real exchange rate. It also calls for greater cooperation among developing countries in determining the conditions for FDI. This cooperation should aim at a more equitable sharing of the huge productivity gains that can result from the combination of advanced technologies with relatively low real wages in developing countries.

B. The interaction between unemployment and the wage share

1. *The traditional approach: employment creation through wage restraint*

Mass unemployment has accompanied growth and development over the past few decades. Since the mid-1970s the unemployment rate in developed countries has never fallen much below 6 per cent (chart 6.1). The hope that the market mechanism would generate full employment and reward labour with at least a constant share of rising income has hardly materialized anywhere. In a number of developing countries, even though official unemployment has declined in recent years, it has remained relatively high overall. Indeed, absorbing a rapidly growing workforce into productive employment continues to be a major development challenge (*TDR 2010*, chap. IV).

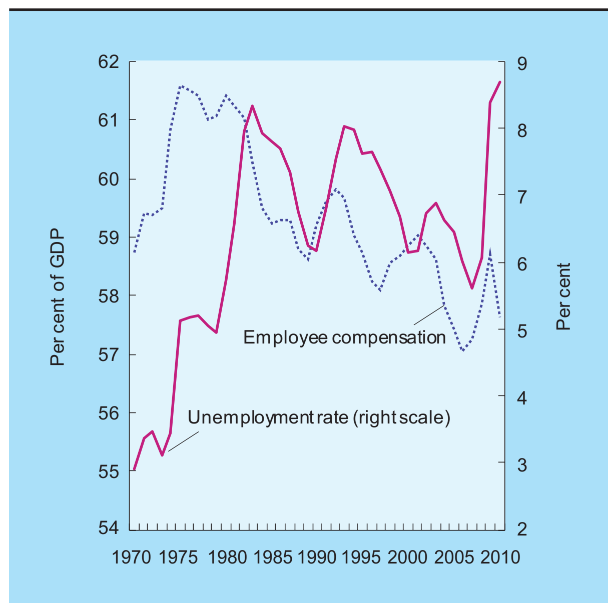
The apparent inability of economic policy to deal with rising and persistent unemployment after the mid-1970s motivated the return of economic thinking to what had been a mainstream economic model in the 1920s. The unwillingness of workers to accept lower wages was considered to be the main reason for unemployment inertia (see, for example, Hayek, 1960). Consequently, many economists and policymakers believed that too little inequality and the resistance of unions to accept lower wages were the main culprits of the new unemployment problem (see, for example, Nickell, 1997; Siebert, 1997; Elmeskov, Martin and Scarpetta, 1998).

Since the end of the 1980s, the OECD has championed the revival of this old approach based on the simple neoclassical model of the labour market. Indeed, the policies designed in many countries in line with its recommendations explain, to a large extent, the rise in inequality observed in developed countries during the past three decades. In 1994, the *OECD Jobs Study* described the mechanism that, according to traditional neoclassical theory, should lead to superior results on the labour market as follows:

> The adjustment process itself depends on the interplay of employers' demand for labour, which will be negatively related to the level of real wages, and the desire to be employed, which will be positively related to the level of real wages. In principle, there will be a real

Chart 6.1

EMPLOYEE COMPENSATION AND UNEMPLOYMENT RATE IN DEVELOPED COUNTRIES, 1970–2010



Source: UNCTAD secretariat calculations, based on *OECD.Stat Extracts* database; European Commission, *Annual Macro-economic* (*EC-AMECO*) database; United States Bureau of Labor Statistics; and ILO, *Key Indicators of the Labour Market* (*KILM*) database.

Note: Developed countries exclude Eastern European countries. Employee compensation is calculated as a percentage of GDP at factor costs. There is a break in 1991 due to German reunification.

> wage level – or, more correctly, a level of real labour costs – that ensures that all who want to work at that wage will find employment (OECD, 1994, Part I: 69).

It further noted: “Self-equilibration in the labour market requires, in addition to a negative relationship between labour-demand and labour costs, that wages respond to market conditions: labour-market slack putting downward pressure on real wages and vice versa” (OECD, 1994: Part II, 3).

This position is exactly what Keynes had attacked in his *General Theory* some 60 years earlier as follows:

> Thus writers in the classical tradition, overlooking the special assumption underlying their theory, have been driven inevitably to the conclusion, perfectly logical on their assumption, that apparent unemployment … must be due at bottom to a refusal by the unemployed factors to accept a reward which corresponds to their marginal productivity. A classical economist may sympathise with labour in refusing to accept a cut in its money-wage, and he will admit that it may not be wise to make it to meet conditions which are temporary; but scientific integrity forces him to declare that this refusal is, nevertheless, at the bottom of the trouble (Keynes, 1936/1973: 16).

Clearly, whatever the reasons for the rise in unemployment, the existence of a large number of unemployed workers exerted a downward pressure on wages as the balance of power in wage negotiations shifted towards employers. In this environment unions and social movements were weakened, or could not be strengthened. Mainstream economists were united in their attempt to do away with what they considered to be the downward stickiness of wages, overly tight social safety nets and many other ingredients of the so-called “welfare state”. The policies generally adopted over the past 25 years have sought to keep wage increases low in comparison with overall productivity gains and accepted a concomitant increase in the share of capital income.

Workers facing the permanent threat of prolonged unemployment are often willing to accept lower wages in the hope of keeping their jobs. Such an outcome gives the appearance of being the result of a normal market process where an excess supply of a good is expected to induce a fall in its price, which would then lead to increased demand. However, from a macroeconomic point of view of the labour market in the context of the entire economy, application of this simple supply-demand mechanism is not as straightforward as it appears at first sight; indeed it is fallacious (*TDR 2010*, chap. III).

The explanation that high and rising unemployment was the result of real wages exceeding their equilibrium level could not be easily rejected in the 1970s, when the wage share reached historical highs in developed countries. However, in the subsequent decades, unemployment rose while real wages lagged far behind productivity growth. This suggests that the idea that reliance on the simple market mechanism can prevent unemployment is erroneous. Just ahead of the new big jump in unemployment in developed countries – from less than 6 per cent in 2007 to close

to 9 per cent in 2010-2011− the share of wages in overall GDP had fallen to the lowest level on record since the end of the Second World War (i.e. to 57 per cent, down from more than 61 per cent in 1980). This should be a wake-up call. If unemployment rises more than during any other recession that occurred during the last three decades, even though the share of wages in GDP has fallen, there must be something fundamentally wrong with an economic theory that justifies the rise of inequality mainly in terms of the need to tackle persistent unemployment.

The neoclassical approach to employment theory assumes that falling nominal wages signal a lasting fall of real wages and a change in the relative prices of labour and capital. This would give firms an incentive to alter the production process by employing more labour and less capital in the future. However, this process would have to be extremely rapid, and all firms would have to engage in it simultaneously: only an instantaneous transition from one production structure to the other would prevent overall demand from falling. In a scenario of falling demand, however, the conditions under which firms adjust to the change in relative prices of labour and capital are fundamentally different. If wages per head or per hour fall and the growth in the number of workers or the number of hours worked does not compensate for the fall in wages, the wage sum will fall and induce a further drop in demand. It is highly improbable that in such a situation companies will take strategic decisions and engage in a restructuring process using more labour and less capital based on the expectation of lastingly lower real wages and unchanged demand.

The crucial point in this reasoning is the sequence of events and not the a priori logic of a market with normal supply and demand curves. The widespread idea that wage reduction in a recession increases employment and output is based on the assumption that supply and demand are a given and are independent of each other. However, this view, based on partial equilibrium analysis, is not tenable for the labour market at the macroeconomic level (*TDR 2010*, chap. III.B).

Indeed, the recent experiences of some developed countries, such as the United States, suggest that the macroeconomic process works in the opposite direction of what is suggested by the neoclassical model of employment and the labour market. In the United States, wages have been lagging behind productivity for many years, but unemployment rose at least as sharply as in former recessions when the financial crisis occurred in 2008, and it seems to be more persistent than ever before. There is growing agreement that cutting wages in a situation of fragile recovery, as has been done in the United States since 2010, would be counterproductive.

Cutting wages when the recovery is fragile would be counterproductive.

For employers, a fall in wages would seem to bring relief from the recession-induced pressure on their profits. However, if further falling demand by private households depresses their business even more and exerts an additional downward pressure on prices, this relief will be short-lived. With reduced household demand, companies will have to cut their production correspondingly. As a secondary effect, lower capacity utilization will cause a downward adjustment in investment plans and additional lay-offs. On the other hand, the expectation of higher profits as a result of falling nominal wages is based on the assumption of unchanged overall demand. However, this assumption does not reflect reality. Again, the sequence of events is crucial. If demand falls immediately after the drop in wages,[1] the expected substitution of falling wages by higher profits will not take place, because a reduction of overall output in the first round will have a negative impact on profits.

While this analysis holds for closed economies, it seems to be less clear-cut for open economies that have a large share of exports in total demand. Under certain circumstances exports may indeed react positively to wage cuts: if wages are cut only in one country, if the productivity trend of that country remains intact and if its exchange rate does not appreciate, the fall in wages may stimulate export demand (through increased price competitiveness) or lead to higher profits in the export sector. The overall effect on demand may still be negative if domestic demand is greater than exports, as in most economies, but the potential impact of improved competitiveness should not be underestimated. Even a one-off improvement in competitiveness of a country can have a lasting effect on export demand, as the producers in that

country gain market shares and thus benefit disproportionally from global demand growth. A continued depreciation of the real exchange rate by means of wage cuts without an exchange rate mechanism to compensate through appreciation of the currency could massively distort international trade and create large imbalances, as the effects on competitiveness accumulate and create a huge absolute advantage for the country over time, as happened in Germany (see section D.5 below).[2]

Moreover, seeking greater competitiveness by translating part of the productivity gains into lower export prices creates a fallacy of composition: employment creation in one country at the expense of growth and employment generation in other countries is not sustainable. A similar strategy followed in countries whose producers compete with domestic exporters will tend to trigger a downward spiral in wages but without any positive employment effects.

2. The alternative approach: wage growth as the key determinant of demand growth

The foregoing analysis has important implications for the treatment of inequality. The labour market should not be analysed in isolation, but in relation to overall growth. This is because the creation of new employment is a positive function of output growth rather than a function of falling wages and a deteriorating share of wages in GDP. In developed countries, employment cycles and growth cycles are observed to be closely linked. Employment growth is typically closely associated with the growth of aggregate demand and output (chart 6.2). Differences in macroeconomic and employment performance among these countries over time result from their varying macroeconomic policy stances rather than from different degrees of flexibility of their aggregate wage levels. In the post-war period until the mid-1970s, when employment grew much faster, there was much less wage restraint than during the last two decades that witnessed meagre employment creation. A downswing like the Great Recession of 2008 and 2009 reduces employment despite wage flexibility and very low wage shares in GDP. In order to reduce unemployment, all the developed countries need sustained recoveries based on rising mass incomes, which, through their effects on imports, will also create additional export and income opportunities for developing countries.

The proposition that greater flexibility of the aggregate wage level and lower average wages are necessary to boost employment, as they lead to a substitution of labour for capital in the economy as a whole, can be directly refuted, given the strong positive correlation between investment in gross fixed capital formation (GFCF) and employment creation that exists in developed countries (chart 6.3). This correlation contradicts the neoclassical model: in the real world, companies invest and disinvest in capital and labour at the same time, and the level of their investment depends on the overall state of the economy, which determines their demand expectations. This implies that, in the macroeconomic context, capital and labour can be considered substitutes only to a very limited extent. Rather, they are used as complementary inputs in the production process which are combined – depending on the available technology at any point in time – to achieve a planned quantity of output, with little or no regard to their relative prices or functional income distribution.

Thus investment in real productive capacity and the rise in demand that motivates such investment are the main drivers of both income growth and employment creation. While the elasticity of employment in relation to growth is likely to differ from country to country, and from period to period, the evidence of the close link between growth, employment and investment belies the popular belief that unemployment can be remedied by shifting the distribution of income from labour to capital and from lower income groups – with a low propensity to save – to groups at the top of the income ladder, which have a relatively high propensity to save.

For developing countries and transition economies, statistical evidence suggests that the link between GDP growth or gross fixed capital formation and formal employment is weaker than in developed countries. This partly results from the fact that changes in informal employment and self-employment dampen the cyclical effects, as these two categories serve as buffers between formal employment and what can be defined and measured as unemployment. Indeed, in developing countries more than in developed countries, workers who are laid off in the formal sector of the economy in bad times often tend to move into

Chart 6.2

GROWTH OF EMPLOYMENT AND REAL GDP IN SELECTED COUNTRIES, 1981–2011

(Per cent)

Source: UNCTAD secretariat calculations, based on table 1.1; UN/DESA, *National Accounts Main Aggregates* database; ILO, *LABORSTAT* and *KILM* databases; *OECD.StatExtracts*, *Annual Labour Force Statistics* and *Main Economic Indicators* databases; ECLAC, *CEPALSTAT* database; and national sources.

Note: Corr. = correlation.

Chart 6.3

GROWTH OF EMPLOYMENT AND GROSS FIXED CAPITAL FORMATION IN SELECTED COUNTRIES, 1981–2011

(Per cent)

Source: UNCTAD secretariat calculations, based on UN/DESA, *National Accounts Main Aggregates* database; ILO, *LABORSTAT* and *KILM* databases; *OECD.StatExtracts*, *Annual Labour Force Statistics* and *Main Economic Indicators* databases; ECLAC, *CEPALSTAT* database; and national sources.

Note: Corr. = correlation.

the informal economy because of the lack of social safety nets (*TDR 2010*, chap. III.B.3). In developing and transition economies that are highly dependent on the production and export of primary commodities, there is usually a weaker link between growth and employment creation. This is because short-term growth can react strongly to internationally determined prices for their export commodities. In fact, the strong increases in commodity prices that occurred during the period 2002–2008 led to income growth without higher employment in the commodities or the formal sectors (UNECA, 2010). Nevertheless, in most other large developing countries and transition economies analysed in charts 6.2 and 6.3, with the exception of China, employment growth also remains positively correlated with growth of both GDP and investment in fixed capital. In the case of China, apart from the significant buffering effects of the informal sector and self-employment category, the demographic trend has played a significant role in the evolution of employment. In addition, the large stimulus package in response to the financial crisis helped boost employment when external demand for Chinese exports was weakening.

Higher wages and lower inequality can stimulate demand and output growth …

Whether a fall in unemployment can be achieved without an increase in inequality in a dynamic economy depends critically on how income gains generated by greater productivity are distributed. The crucial link is between nominal wages and employment at the macroeconomic level. From this perspective, it is not the factor-cost aspect that matters, but primarily the role of wages as the major determinant of aggregate demand (i.e. the consumption of wage earners). Higher wages and lower inequality can stimulate demand and output growth, which in turn can provide incentives for increased investment in productive capacity, with attendant effects on employment creation and productivity gains.

… which in turn can provide incentives for increased investment in productive capacity, with attendant effects on employment creation and productivity gains.

As continuous productivity gains increase the supply capacity of the economy, a rise in unemployment can only be avoided when companies can expect aggregate demand to expand at a similar rate. Since domestic incomes from wages are the main driver of domestic demand, regular adjustments of the level of real wages in line with the overall increase in productivity serve to stabilize demand expectations and generate sufficient effective domestic demand to avoid a rise in unemployment. This will feed a virtuous cycle of demand growth, investment, productivity increases and employment creation. The policy implications of this reasoning are discussed in section D of this chapter.

Regarding developing countries, there are a number of additional considerations. The main differences between developed and developing countries are not to be found in macroeconomic processes, but in corporate decision-making about production and investment, and in the structural and institutional factors governing the labour market. In many developing countries, the agricultural and services sectors are usually quite large and informal, and small-scale self-employment is common, though there are considerable differences across countries. In addition, formal employment in the manufacturing sector represents a relatively small share of total remunerative occupations, and unionization of labour and collective bargaining typically play a much smaller role than they do in most developed countries.

Following the almost universal adoption of export-led growth strategies during the 1980s and 1990s, the corporate sector in developing countries began to make decisions on production and investment primarily with reference to external demand and competition on global markets. Moreover, these countries import most of the higher end technologies from the more advanced economies. This appears to exacerbate the problem of combining technological progress, investment and productivity growth with employment creation. For this reason, it is even more important for developing countries to pursue policies and establish institutions that aim to prevent a further increase in income inequality and ensure that all kinds of productivity gains translate into higher incomes for all groups of their populations.

No doubt, in developing countries that are still highly dependent on the production and export of primary commodities, the link between growth and employment creation is less direct than in developed countries. Their growth performance is often strongly influenced by movements in internationally determined prices of primary commodities. Strong increases in commodity prices, as witnessed during the period 2002–2008, can lead to income growth without an increase in real output and employment in the commodities sector. This is all the more reason why governments should take measures to appropriate a substantial share of the higher commodity rents and channel them to other sectors where additional investment is urgently needed to advance diversification and the creation of formal employment (as discussed further in subsection D.3 below).

The situation is different in emerging market economies that have already reached the stage of having a more diversified production structure. In some of these economies, technological catching up has led to rapid growth in their tradable goods industries through an expansion of net exports. However, even countries with significant and growing exports of manufactured goods have sometimes found that this success has only a modest effect on aggregate employment in manufacturing. This may be explained by the high capital intensity of much of their export-oriented production, combined with the loss of employment in production activities oriented to the domestic market that are outcompeted by imports. The challenge of ensuring that the growth process delivers more and better quality employment is therefore even more pressing in such countries.

In these countries, productivity growth is often passed on through lower prices, while keeping wages depressed in an attempt to maintain or improve external competitiveness. This explains why the export prices for certain manufactures produced in developing countries with relatively high productivity gains due to FDI have been falling relative to the prices of manufactures produced in developed countries (*TDR 2005*, chap. IV). It is understandable that countries pursuing a strategy of export-led growth and producers of manufactures in these countries seek to gain the competitive advantages just described. However, policymakers who support such a strategy should be aware that such practices may deprive a large proportion of their populations of a share in the productivity gains. Moreover, it leads to an overreliance on exports for income growth, which may have adverse effects in the long run and in particular during periods of crisis or slow global growth.

C. Wage flexibility at the firm level and the dynamics of a market economy

Although attributing rising unemployment to excessively high wages has proved to be seriously flawed and the attempt to reduce unemployment through wage restraint and greater income inequality has failed, few have questioned the theoretical foundations of this approach. Instead, the same theoretical reasoning has led to an increasing emphasis on greater "relative flexibility" of the labour market. This refers not so much to the aggregate wage level, as to the structure of wages for similar occupations across sectors and firms, and over time. It implies the decentralization of wage setting and varying wages among and within firms according to their individual performance. The greater "relative" flexibility of wages increases inequality among workers employed in different sectors or firms. This is supposed to remove so-called "structural unemployment". Again, it was the OECD that spearheaded this approach, stating:

> In particular, greater wage flexibility, reductions in barriers to labour mobility and greater competition would make it easier for

> the unemployed to find jobs at the going wage, although it is noticeable that profit shares are now at historically high levels. It may be that there has been insufficient relative wage flexibility or that excessive job protection has discouraged hiring even though there has been wage moderation" (OECD, 1994: Part I, 73).

It also noted:

> Some of the key links between wage and price rigidities and employment and output performance have been explored in the context of various modeling exercises. These tend to show that differences in wage and price rigidities indeed have significant implications for the size and duration of trend and cyclical movements in unemployment. In particular, in the longer run, it is those economies with less flexible labour markets and greater wage rigidities which appear likely to experience greater persistence in both unemployment and inflation. Hence, policies to reduce labour market rigidities and improve flexibility are likely to reduce the size and duration of adverse movements in unemployment associated with exogenous disturbances and make it easier to close output gaps (OECD, 1994: Part I, 69).

In this view, in many developed countries there was not sufficient wage differentiation between the lowest and highest paid occupations to overcome structural unemployment. As noted by the OECD (1994: Part II, 2): "A fully flexible wage structure would ensure that abilities did not matter for employment: all ability groups could price themselves into work".

The belief that greater wage flexibility and a further weakening of institutions for collective wage setting at both the country and the firm level is the only way to adjust to changes in demand has persisted, despite growing concerns about inequality (Barkbu, Rahman,Valdés et al., 2012). For example, the President of the European Central Bank (ECB) hinted at the "fact" that the insistence of many countries to defend their welfare State was the main stumbling block to recovery of the European economies from the crisis when he called "for labour market reform that increases flexibility and mobility".[3] Similarly, with reference to the crisis in the euro zone, the IMF suggested that the ability of economies to adjust to shocks could be improved by "a wage-setting mechanism that is more responsive to firm-level economic conditions" (IMF and G-20, 2012:1). This was based on the belief that even cyclical movements of unemployment and inflation are driven by relative wage inflexibility. It means that even after a fall in the aggregate wage level, high "structural" unemployment may persist due to insufficient flexibility of the labour market.

Section B of this chapter has shown that labour as a whole cannot simply "price itself into work". A pertinent question is whether the adjustment of wages in specific sectors or individual firms at the microeconomic level is an effective way of dealing with shocks. And should shocks, whether of external or internal origin, be absorbed by flexible wages and rising inequality? What kind of adjustment enabled the superior performance of market economies in terms of growth, investment and development in the past? What kind of adjustment is consistent with the empirical evidence of a high correlation between changes in the employment of labour and of capital? In finding answers to these questions some preliminary considerations may be helpful.

In the traditional view, a fall in the demand for the goods or services produced by firms prompts them to lay off workers to avoid a cut in profits due to lower capacity utilization. The laid off workers, in an attempt to individually "price themselves back to work" are ready to accept lower wages to maintain their jobs or be hired by another employer as soon as possible. Thus, full employment can be restored even if a decline in production by the individual company is permanent. According to this reasoning, the fall in wages will allow the workers that were laid off in the first round to be reemployed, even if the level of production is lower than before. However, in a market economy, an abrupt fall in demand is *not* a typical shock experienced by an individual company. At any given level of aggregate demand, demand shocks to one company are typically triggered by strategic moves of competing companies and in response to changes in consumer preferences.[4]

It is in the logic of competition that if a certain firm is outcompeted in the market for the goods or services it produces, demand will shift to its competitors that have followed a more successful business strategy. The loss of jobs in the former firm will therefore be compensated by the creation of additional jobs in the firms that have been more successful in the competitive process and need more workers to boost production in order to meet the increased demand for their products. What is required in this process is not

a downward adjustment of wages, but a temporary safety net for the laid-off workers to avoid pressure on wages, as well as the provision of possibilities for retraining and new skill acquisition.

If a winning company has achieved its success by applying a new production technology or introducing a new product, the eventual effects on employment are similar. A new technology that improves productivity in one plant and creates a temporary advantage for comparable products for the innovating company will tend to trigger a general fall in prices as the innovation is imitated by other firms. It will also lead to a general increase in real wages and domestic demand throughout the economy. This would allow those workers who are no longer needed in the innovating company to find jobs elsewhere in firms that are benefiting from the increased demand, without having to accept pay cuts. If real wages rise in line with productivity at the level of the overall economy, the rise in demand to absorb the abundant workers would be generated by the real growth of the economy.

The idea that more flexible labour markets and greater flexibility of wages at the firm or sectoral level can reduce unemployment is even less convincing if applied to situations where the business model of a company or sector becomes obsolete as a result of changing consumer preferences. In this case, downward flexibility of wages at the firm level would imply preserving the obsolete structure by what would amount to a subsidy provided by the workers. If, at the same time, other firms benefit from growing demand for their products, the reasonable response would not be falling wages but falling profits in the obsolete firm and a closing down of idle capacities. Meanwhile, firms benefiting from the change in consumer preferences would add new capacities and absorb the temporarily unemployed. Again, it is falling or rising profits rather than falling or rising wages that would be the main force moving companies or their branches in or out of business.[5]

Generally, wage adjustments at the level of the firm cannot be efficient because it is usually impossible to identify the concrete reasons for the shock to which the firm is exposed. In the vast majority of cases, subsidies, be they provided by the government or by workers, are not an appropriate answer to the challenge posed by a fall in demand on a specific market. Considering that the wage reduction leads to lower demand at the macro level, there is no realistic scenario where the efficient reaction of a dynamic market system to supply or demand shocks would be falling wages and rising inequality.

Another important argument against greater wage flexibility at the micro level is that the labour force employed by firms has many different skills and qualifications. The ways in which the different segments of the labour market function for each of these skills depends on the interregional and intersectoral mobility of labour, and the degree of unionization and centralization of wage negotiations. Under conditions of a well-integrated economy and high mobility of workers or centralized wage bargaining, it can be expected that similar wages will be paid in each of these segments. This means that the individual firm has to accept the market-established wage for a given qualification. Thus the idea that firm-level flexibility of wages can increase overall efficiency by determining a level of remuneration for workers in line with their marginal productivity is an illusion. Marginal productivity is a theoretical concept based on the idea that the contribution from, for example, one hour of work of a certain type of worker is measurable and clearly identifiable. However, in most modern production settings, it is impossible to measure the contribution of each individual employee to the value added produced by its firm (box 6.1).

The individual firm is a price taker, as the prices are set in the different labour markets. Therefore, it cannot cut wages in case of a shock that affects it individually, as workers would simply leave and find work elsewhere. Admittedly, there may be a number of obstacles to the geographical mobility of workers, which may limit the equalization of money wages to a certain region or agglomeration, especially in developing countries. The argument against promoting greater wage flexibility at the level of the firm is even stronger when the case of a positive shock for an individual firm is considered. For example, if entrepreneurs implement innovative ideas that increase

Falling or rising profits, rather than falling or rising wages, are the main force that moves companies in or out of business.

Box 6.1

WAGE DETERMINATION AND MARGINAL PRODUCTIVITY

Marginal productivity is a theoretical concept based on the notion that the contribution from, for example, one hour of work of a particular worker is measurable and clearly identifiable. If the same wage is paid to all workers in a given segment of the labour market, all of them would have to accept a wage cut if one additional hour were added to a work process and if in that additional hour a lower output were produced than during the previous hours (a production process with diminishing returns to scale). This concept would be valid only if the inputs of many different employees into the production process were highly standardized and could be clearly identified and measured. However, this is not the case in most modern production settings.

The large majority of employees work in an environment where neither the marginal contributions of individual members of a production team nor their relative contributions can be measured. What is the marginal productivity of, say, a nurse in a hospital and what is his or her relative contribution to the overall outcome compared with that of the chief surgeon or the chief of administration? Because this is unknown, most of the employees in modern societies are remunerated in a way that reflects roughly the scarcity or availability of people with a similar qualification but not their individual marginal productivity. Rising productivity in particular production processes adding up to the increase in the overall productivity of the economy is typically reflected in falling prices of the goods that are produced more efficiently. The lower price level implies that the real wages of all employees are correspondingly higher even though there has been no improvement in the productivity of every employee. It is the team – and, in this extreme version, the team of the whole economy – that is rewarded by the greater output of the team as a whole, and not that of the individual employee, in the production process.[a]

[a] Take the example of a teacher at an elementary school who teaches exactly the same things for 40 years without any innovation or increase in productivity and without any change in salary. The teacher will nevertheless enjoy rising purchasing power if economy-wide productivity growth leads to falling prices in the economy as a whole. If the economy has an explicit inflation target, all nominal wages have to rise by this target plus the productivity growth rate, but that is only a technical matter and does not change the substance of the adjustment process.

productivity so that they can offer their goods much cheaper than before, it would be counterproductive for them to renegotiate wages at the level of the firm. The expectation that workers in their company will immediately try to appropriate a part of the pioneer rent would reduce the incentive for a potential pioneer in the first place, and thus reduce the innovative dynamism of the economy. Although other workers may be willing to accept a lower wage than those already employed in such a firm, a more efficient arrangement would be one that keeps individual wages unchanged and rewards pioneer firms with a temporarily higher profit arising from the greater-than-average increase of the productivity of their firm. It will also enable them to use part of the pioneer rent to reduce the price of their product, which will lead to a fall in the prices of competing products throughout the economy as the more efficient mode of production is imitated by followers and thus benefits all workers.

To the extent that the wage tends to be similar in each segment of the labour market, temporary differences in profits could be significant. As observed already by Keynes (1930/1971), these differences serve to redirect the resources of the economy from uses where they are no longer needed to those where the maximum benefit for the society can be expected. Wage flexibility at the sectoral or firm level does not contribute to such an outcome. On the contrary, flexible wages tend to preserve obsolete structures and dramatically reduce the ability of the economy to adjust to new circumstances and to exploit its innovative potential.

Intertemporal structural change, as discussed in the preceding paragraphs, is characterized by pioneering enterprises which are able to improve their productivity faster than their competitors or to attract additional demand by introducing new products. Hence their success is explained by a combination of firm-specific higher productivity and given wages for the economy as a whole.

The same principles apply to international structural change, especially as it involves developing countries – that is, when the initial change results from a developing country's catching up process or the relocation of production from a developed to a developing country. International structural change often results when the technology from a more developed country is used in another country where wages and the average productivity level are much lower. Consequently, investment behaviour that is focused on the international or interregional transfer and implementation of technologies that are already known leads to lower prices or higher profits. However, the shocks resulting from this kind of structural change are similar to the ones resulting from intertemporal change. Again, single firms or their branches face competition from other firms offering comparable goods at lower prices due to lower production costs. And again, the reaction of trying to defend market shares by reducing real wages is not supportive of growth, additional employment creation and the reduction of inequality.

For developing countries, the strategy of acquiring, one way or another, technologies developed and already used elsewhere is indispensible for catching up. A downward adjustment of wages by individual firms or sectors in developed countries which are competing with producers from developing countries using such technologies has a similar effect as a protectionist measure. This practice is frequently taking place with the benign neglect of governments and trade unions on the erroneous assumption that it preserves jobs. But this is as counterproductive as subsidies to declining firms that suffer from an internal shock. A more rational approach would be to consider that the developing countries will use the increased proceeds of their exports to buy more imports from the developed countries, thereby creating new opportunities for other firms and new jobs in the latter countries.

To sum up, from a macroeconomic perspective, downward adjustments of average real wages leading to greater inequality between profit and wage incomes is an entirely ineffective remedy for unemployment when an economy is facing the most frequent kind of shock, namely a demand shock. Flexibility of wages at the firm or sectoral level and the resulting increase in inequality of labour incomes are equally ineffective, because they reduce the potential dynamics of competition among firms and the incentives for innovative investment. It is flexible profits, rather than flexible wages, that fit the dynamics of modern market systems. In the real world, shocks are mainly absorbed by profits and not by wages. This applies also to shocks created by competition through international trade and FDI. The change in profits leads firms to adjust to the new situation instead of trying to restore the unrestorable. The static neoclassical model of segregated labour markets with flexible wages, which regularly produce inequality in case of adjustment to shocks – be they international or intertemporal – should not guide adjustment policies at any stage of development.

D. Economic policy and institution-building to reduce inequality

1. The participatory society and dynamic adjustment

As discussed in sections B and C of this chapter, successful strategies for economic growth, catch-up and sustained improvements in welfare for all groups of the population cannot be achieved through deregulation of labour markets. Indeed, in many countries, such deregulation has contributed to slower growth and higher unemployment.

As the division of labour advances and the dependence of every participant on its success increases, it is important that the benefits be shared in a manner that increases the demand for the goods and services produced in line with the resulting growth in productivity. This is the only way an economy can avoid the danger of rising and persistent unemployment or the need to repeatedly adopt a "beggar-thy-neighbour" policy stance in order to create demand for its supply surplus. In developing and developed countries alike, the participation of the majority of the population in these gains is not only desirable for reasons of social justice and cohesion; it is also crucial for growth, because, as the main consumers of domestically produced goods and services, a rise in their income will result in higher demand, which will boost production.

Successful strategies for income growth and employment for all depend on investment in fixed capital. In economies with a dominant private sector, such investment is strongly influenced not only by the conditions for financing such investment, but also by expectations concerning the growth of demand for the goods and services that are produced with that capital. Therefore, investment can be expected to rise in a broad range of activities and greater diversification achieved in the long run only if the proceeds from all productive activities are channelled through private households of all income groups. This requires appropriate economic policies and regulatory institutional arrangements to systematically balance the negotiating power between profit earners, who make decisions on investments, and wage earners who are the main drivers of consumer demand. Furthermore, resorting to additional, unorthodox, policy instruments would increase policy options and the number of possible combinations of policy instruments that can be employed to achieve the desired rate of output growth and higher rates of employment, while at the same time avoiding rising inflation and inequality.

2. Macroeconomic policies and institutional arrangements

Once it is recognized that the market mechanism cannot restore equilibrium between the supply of and demand for labour through rising inequality, the role of the government in stabilizing the overall economy becomes crucial for employment creation and income distribution. With appropriate policies, governments can prevent the huge additional costs that arise if the pressure on wages stemming from high unemployment is allowed to permeate the whole economy.

The euro area currently provides the most striking examples of the failure of wage restraint coupled with macroeconomic policies that are inimical to growth. In the Southern European members of the area, unemployment has soared despite large wage cuts. In order to absorb this surplus labour, additional employment opportunities need to be created by means of appropriate monetary, financial and fiscal

policies aimed at achieving a strong growth dynamic based on fixed capital formation (see also *TDR 2010*, chap. V and *TDR 2008*, chap. IV). Governments that quickly and aggressively tackle rising unemployment with expansionary monetary and fiscal policies could also minimize the period of uncertainty and threat of job losses. Strong countercyclical policies in times of recession or below-potential growth are particularly important in countries where social safety nets are inadequate or absent. This is why it is justified to view the more aggressive economic policy stance of the United States as a substitute for the more advanced social safety nets in Europe. On the other hand, if Europe were to cut spending on welfare programmes during the crisis, it would have to change its attitude towards the role of macroeconomic policies. Cutting the safety net and withdrawing macroeconomic stimuli at the same time is bound to fail and will produce more unemployment and greater inequality.

In addition to employment- and growth-supporting monetary and fiscal policies, an appropriate incomes policy can play a significant role in achieving a socially acceptable degree of income inequality. Developing certain rules for determining the evolution of mass incomes in a growing economy would greatly facilitate the task of monetary, financial and fiscal policies. A well-designed incomes policy based on such rules could help prevent a rise of inequality in the growth process, while also contributing to employment growth by enabling a steady expansion of domestic demand. A central feature of an incomes policy should be to ensure that average nominal wages rise at the same rate as average productivity (plus the inflation target, see below). The implementation of such a policy requires an institutional framework adapted to the economic structure and the specific historical context of each country. Such a framework is all the more important, given that an incomes policy can serve not only as an instrument for employment generation, but also as a means of controlling inflation.

In order to preserve the wage share and ensure that real wage growth does not exceed the increase in an economy's supply capacity, the nominal wage adjustment should also take account of an inflation target. In this context, it should be borne in mind that in the absence of a major import price shock, the change in unit labour costs (i.e. the relation between wages and productivity growth) is the main determinant of the rate of inflation. There is empirical evidence for this in developed countries, in particular during periods when there was sufficient job creation and unemployment was on the decline (chart 6.4).

When wages in an economy rise, as a rule in line with average productivity growth plus the inflation target, the share of wages in GDP will remain constant and the economy as a whole will create a sufficient amount of demand to fully employ its productive capacities. In applying this rule, wage adjustment should be forward-looking. This means that it should be undertaken in accordance with the productivity *trend* and with the inflation *target* set by the government or the central bank for the next period, rather than according to the actual rates of productivity growth and inflation in the preceding period (i.e. backward-looking).

Greater attention should be given to institution-building, including collective bargaining between unions and employers' associations, and related governance reforms.

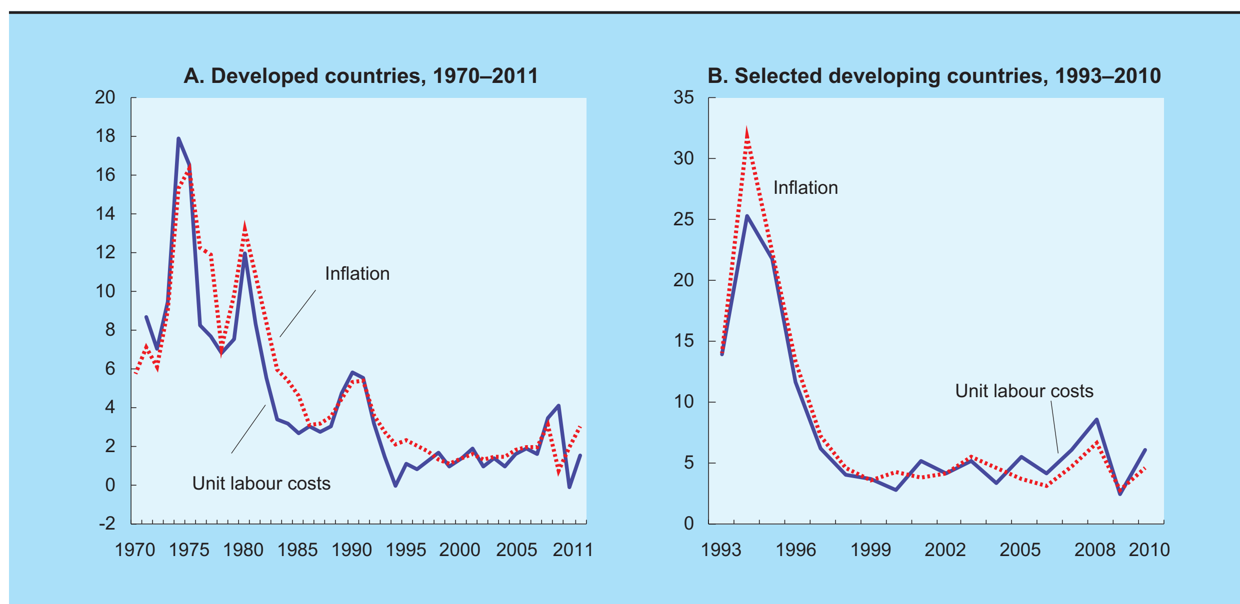
The medium-term productivity trend (for example, the average annual increase over five years) is preferable to the actual annual productivity growth, because the latter tends to be volatile and is influenced by cyclical movements of capacity utilization, and thus does not provide the basis for sustainable income growth. Moreover, wages should not be indexed according to past inflation, as has frequently been the practice. Such a scheme tends to perpetuate inflation without securing the desired level of real wages. This is because producers, faced with increasing labour costs, would be able to pass this cost increase on to prices as demand rises faster than output. By contrast, the application of the proposed scheme would ensure that the increase in unit labour costs – the major determinant of future inflation – does not exceed the inflation target.

The experience with backward-looking wage adjustments in response to the impact of the oil shocks in the mid-1970s and at the beginning of the 1980s is a case in point (box 6.2). Another is the experience of a number of developing countries that have a history of very high inflation. To be sure, in these countries nominal wage increases alone were

Chart 6.4

ANNUAL GROWTH RATES OF UNIT LABOUR COSTS AND INFLATION

(Per cent)



Source: UNCTAD secretariat calculations, based on IMF, *International Financial Statistics*; ECLAC, *CEPALSTAT*; UNSD, *National Accounts Statistics: Main Aggregates and Detailed Tables*; *EC-AMECO* database; and *UNCTADstat*.

Note: Unit labour costs refer to the total economy. Selected developing countries comprises Argentina, the Bolivarian Republic of Venezuela, Brazil, China, Honduras, Mexico, Panama, the Republic of Korea, South Africa and Tunisia.

not responsible for triggering inflation. However, bouts of accelerating inflation, often triggered by external shocks, spilled over into nominal wage increases. These fuelled a cost-price spiral as governments attempted to protect wage incomes from inflation by applying backward-looking indexation mechanisms. Such wage policies are costly, because for central banks to bring inflation down to the target level against permanent upward price pressures from the cost side, they are obliged, time and again, to raise interest rates. This deters real investment and employment for the sake of nominal stabilization.

Thus, linking wages to both productivity growth and the central bank's inflation target would also facilitate the task of the central bank in preventing inflation, while giving it greater scope to stimulate investment and growth. Investment in real productive capacity will also benefit from an adjustment of nominal wages according to the proposed scheme. This is because when domestic demand grows at a similar rate as the supply potential, it induces firms to invest and stimulates industrial growth and job creation.

Linking nominal wage growth to the productivity growth trend and to the inflation target would ensure that the share of wage income in total income remains constant, but it will not increase that share. And if wage restraint has been exercised over several years before the introduction of the scheme, the share may remain constant at a relatively low level. Therefore, it may be desirable for governments to correct the outcome of the primary distribution of income between capital and labour in an effort to redress inequities and national inequalities. However, it will be difficult to achieve this by raising nominal wages by more than productivity growth plus the target rate of inflation without prior agreement between trade unions and employers' associations. Employers unwilling to accept a reduction of their profits resulting from higher unit labour costs have no difficulty in passing on the higher unit labour costs to prices when there is growing demand from wage earners. Any attempt to increase the wage share will then turn out to be counterproductive: higher prices will restore profits, but at the same time higher inflation will tend to reduce the real value of workers'

Box 6.2

WAGE ADJUSTMENT IN RESPONSE TO AN IMPORT PRICE SHOCK

Negative supply shocks resulting from sharp increases in import prices have their own logic. The most quoted examples in the past have been the oil shocks that affected the world economy in the mid-1970s and at the beginning of the 1980s. At the time, countries with fairly rigid nominal wages and wage structures were more successful than others in preventing an acceleration of inflation as a result of the original inflationary shock resulting from higher oil prices and inelastic demand for oil. This is because rigidity of wages means rigidity of nominal wages, but flexibility of real wages. A one-off price shock on the goods market translates into higher inflation (i.e. a continued *increase* in the price level) only if the spark of inflation jumps from the goods to the labour market. This happens when nominal wages are indexed to the actual price level, as in many countries that had so-called backward looking indexation schemes like the *scala mobile* in Italy. That scheme was designed to prevent a fall in real wages and protect workers from the redistribution that can occur with inflationary processes. However, when the prices of imports rose sharply, as with oil, they did not lead to a shift in income distribution in favour of domestic profits, but rather to redistribution in favour of a third party – in this case the foreign suppliers of oil. The domestic producers who bore the brunt of higher import costs in the first round passed on the increase in wages to prices, thereby turning a one-off price shock into a permanently higher inflation rate. This prompted the central bank to take restrictive action and led to a fall in employment.

Rigidity of nominal wages, in the sense that wage adjustments do not reflect actual inflation, is preferable for adjustment to import price shocks, as it provides flexibility of real wages, which is necessary to avoid permanently higher inflation resulting from the initial inflationary bout. This may help to prevent an additional demand shock of restrictive monetary policies, which compromises growth and job creation.

accumulated savings. Moreover, it will prompt the central bank to adopt a more restrictive monetary policy, with attendant effects on investment, growth and employment. The only way to avoid this would be by imposing price controls.

In any case, policies that try to increase the share of wages require a high degree of social consensus if major social and economic disruptions are to be avoided. However, governments may seek to improve income distribution by using other instruments to correct the market outcome in favour of those with weak negotiating power. Possible government policies include progressive taxation (as discussed in chapter V) and the use of the proceeds for greater social transfers in favour of certain target groups. Public spending designed to improve the provision of essential goods and services and make them more affordable may also be increased.

The analysis of the different causes of greater inequality discussed in this *Report* suggests that a number of institutional arrangements are necessary for implementing the recommended rule for the setting of nominal wages. Most important is government support for the creation and empowerment of unions with a nationwide mandate, which can be instrumental in implementing a successful incomes policy. Equal wages for similar occupations across an economy are essential for reducing income inequality and increasing mass demand in line with productivity growth. This can be achieved much more easily through collective bargaining between strong unions and employers' associations. And their behaviour can be influenced by government recommendations or guidelines for wage adjustments.

In this way a process of domestic-demand-led growth can be nurtured, while ensuring that wage growth neither substantially exceeds nor substantially falls short of a rate that supports stability of both prices and employment. Greater attention may need to be given to such institution-building and related governance reforms, particularly in developing countries that are in the process of enlarging their manufacturing sectors.

Additionally, for successful adjustment to demand shocks it is crucial that workers who are under pressure to quickly "price themselves back into the market" – which, as shown above, is not possible anyway – be given protection. It is also desirable to protect workers against prolonged phases of unemployment, not only for social reasons but also from a macroeconomic perspective, which may be even more important. To prevent the "pass through" to wages of high unemployment following shocks on goods or financial markets, a tight safety net is needed. This would allow temporarily unemployed workers to search for jobs being created elsewhere in the economy without having to substantially lower their standard of living and their demand for goods and services.

3. Specific aspects of incomes and employment policies in developing countries

Developing countries have huge potential for productivity growth. Hence they also have considerable scope to reduce income inequality by distributing the productivity gains more equally. This requires an incomes policy that takes into account a number of additional elements, depending on the characteristics of each economy (*TDR 2010*, chap. V). These include, in particular, the large number of self-employed workers in agriculture and those engaged in informal activities. Another aspect concerns the distribution of rents accruing from the exploitation of natural resources and from the large productivity gains resulting from combining imported advanced technologies with locally abundant cheap labour, especially through FDI and in export-oriented industries. A third aspect relates to nationwide collective bargaining and regulation mechanisms, which tend to be weaker in most developing countries. These aspects are discussed below.

(a) Reducing inequality in the context of a large informal sector and small-scale self-employment

Depending on the level of industrial development, informal employment and self-employment account for a large share of total employment in many developing countries. Moreover, the number of self-employed has been growing in many countries because of inadequate employment creation in the modern formal sectors. In these countries, it is therefore important to complement an incomes policy for the formal sector with measures to increase the incomes and purchasing power of informal workers and the self-employed. Mechanisms that link agricultural producer prices – and implicitly the earnings of farmers – to overall productivity growth in the economy would gradually improve the living conditions of rural populations. Developed countries have used such mechanisms for decades, enabling those employed in agricultural activities to share in the productivity growth occurring in the rest of the economy. Equally important, since these segments of the population tend to purchase locally produced consumer goods, such mechanisms would also contribute to increasing the demand for those goods. Productivity and incomes in the agricultural sector could also be enhanced through public investment in agricultural research and rural infrastructure development, publicly assisted agricultural support organizations and concessional public lending to small-scale farmers (see also *TDR 2010*, chap. V).

While there can be no doubt about the desirability of improving living standards in rural areas, including through better remuneration for farmers, it should be borne in mind that economic development is associated with a process of a deepening division of labour. In this process, many of the self-employed poor and those employed in the informal sector need to be attracted into formal, dependable employment with the promise of reasonable, rising and reliable wage incomes. Strengthening the social safety net in parallel with a sustained expansion of the formal sector could help prevent workers from returning to activities in the informal sector if they lost their jobs in the formal sector.

(b) Commodity prices, rents and inequality

Another challenge, confronting many commodity-dependent developing countries, concerns the management of revenues from the exploitation of natural resources and of the gains from rising international commodity prices. In order to ensure that commodity rents (i.e. the difference between the sales price and the cost of exploitation of natural resources) serve to reduce inequality in developing countries, the relevant authorities in those countries

should conclude appropriate contractual arrangements with companies – frequently large foreign TNCs – engaged in exploiting their natural resources. In most cases, these contracts will require the collection of higher royalties and taxes from these companies, a substantial share of which could then be channelled into the domestic economy (see also *TDR 2010*, chap. V, sect. D).[6]

Some of the gains in the terms of trade resulting from substantial increases in commodity export prices may be shared in a similar way as the productivity gains discussed earlier. However, the scope for raising the general level of real wages in response to terms-of-trade gains is circumscribed by the supply available to satisfy growing domestic demand. Therefore, such a policy needs to be accompanied by measures for lowering the costs of financing domestic investment and improving access to credit for a large number of domestic entrepreneurs in order to increase fixed investment for the production of domestically consumed goods and services. This is of particular relevance when terms-of-trade gains from commodity prices are expected to be temporary.

(c) *Productivity rents from a combination of advanced technology with abundant cheap labour*

As discussed in section B above, producers of manufactures in developing countries often use imported advanced technologies, especially when the production is for export. The transfer of such technologies and the introduction of more capital-intensive production techniques typically occur through FDI which is attracted by low labour costs in the host country. Such investment may contribute substantially to raising the average level of productivity in the low-wage country. The gains from this combination of advanced technologies with relatively low labour costs are generally captured by employers – be they domestic or TNCs – in the form of higher profits, or by foreign consumers in the form of lower purchasing prices. As unit labour costs are the most important determinant of competitiveness between countries and regions, the rents or the gains in market shares that the employer is able to realize by cutting prices can be extremely high.

The policy challenge for the low-wage countries is to ensure that an appropriate share of the productivity gains arising from this combination of capital and labour accrues to domestic wage earners. This cannot be achieved by leaving wage determination to a deregulated labour market. Here again, an incomes policy can play an important role. In the catch-up strategies of some successful industrializers in Asia (e.g. Japan and the Republic of Korea), domestic producers who obtained most of such productivity rents used a large share of those rents for reinvestment in export-oriented activities, thereby creating new employment opportunities. However, this process was sustainable only until a new generation of high-productivity, low-wage competitors emerged. Consequently, it became clear that faster overall wage growth was necessary to sustain the expansion of effective demand through an increase in domestic mass income and consumption (*TDR 1996*, Part Two, chap. I).

Therefore, the general rule for nominal wage adjustment should be based on the average productivity increase in all sectors, including industries with very high productivity increases resulting from the combination of advanced technologies with low domestic wages. This would help achieve a sustained increase in domestic demand and reduce income inequality between sectors and regions. Where this rule is difficult to implement, a similar result could be had by governments in the countries concerned by adequately taxing quasi-monopoly rents appropriated by TNCs and using the proceeds to increase domestic demand for domestically produced goods. Boosting domestic demand could be achieved either directly through purchases by the public sector or indirectly through temporary wage subsidies, public employment programmes and/or financial support for local private investors.

4. *Legal minimum wages*

In developing countries the degree of labour protection and organization of the labour force and employers is low, and structured negotiations for determining wages and employment conditions are rare. It is therefore especially difficult to establish an institutional framework for an incomes policy based on nominal wage adjustments in line with productivity growth plus the inflation target. Since it may take considerable time to create responsible institutions that can represent workers and employers effectively,

a measure that could be implemented more rapidly for reducing inequality could be the establishment of minimum wages (*TDR 2010*, chap. V). In other countries, setting minimum wages may be a useful complement to collective bargaining.

Legally established minimum wages exist in most developed countries and in many developing countries, although a number of developing countries with large informal sectors may not always fully enforce such legislation. In particular, countries that lack a tight social safety net have frequently and for a long time chosen to use legal minimum wages to protect low-skilled workers from exploitation by powerful employers. Yet, despite considerable empirical evidence showing that legal minimum wages have only a minor or no effect on unemployment, such legislation has been criticized by those who view wage setting by the government as an intervention in an efficient market. These critics argue that since minimum wage legislation which seeks to protect low-skilled workers may set a wage level that exceeds the equilibrium price of labour, there is a higher risk of those workers remaining or becoming unemployed than in the absence of such legislation. They have been challenged by over 650 economists, including 5 Nobel laureates, who have stated that "a modest increase in the minimum wage would improve the well-being of low-wage workers and would not have the adverse effects that critics have claimed" (Economic Policy Institute, 2006).

In the neoclassical model underlying the reasoning of the critics, minimum wages are determined by the marginal productivity of workers with specific qualifications, but in most occupations neither the marginal contributions of individual members of a production team nor their relative contributions can be measured (box 6.1). Therefore all societies have a wide range within which they can determine the level of a legal minimum wage without violating any law of the market or the principle of supply and demand. If, for example, there was a rule that the minimum wage should always be half of the average wage of the economy under consideration, it is hard to imagine how such an arrangement would increase the risk of some groups becoming unemployed. Some labour-intensive goods and services would probably become more expensive, but the purchasing power of a large group of employees would rise, thus helping to create additional income and employment throughout the economy (see also G-20, 2012: 12).

Most minimum wage schemes have some indexation to inflation. Developing countries, in particular, tend to choose indexation mechanisms based on past inflation instead of an inflation target, and in many cases adjustment to productivity growth is not part of the mechanism. This kind of indexation is problematic for the same reasons as those discussed above in the context of general wage adjustments, especially since it creates inflation inertia. Again, when legal minimum wages are adjusted regularly in line with the average productivity growth of an economy and the targeted rate of inflation, rather than arbitrarily in response to the varying influences of interest groups on political decisions, they can have a positive effect on the investment-productivity-growth dynamic. Poverty will then be reduced not only by raising the income of those that earn the minimum wage, but also by the additional employment that is created in response to higher demand and higher profits in firms where productivity growth exceeds the average. Moreover, legal minimum wages and their regular adjustments can provide an important reference for wage negotiations in the private sector.

5. The international framework

In the discussion of national policies in the preceding sections it is implicitly assumed that the processes of adjusting to different changes in the overall economic setting are not affected by adverse external macroeconomic and financial developments or by divergent policies pursued in other countries.

However, in a world of increasingly interdependent open economies, a country's macroeconomic performance is increasingly influenced by external developments and policies in other countries. These can have a strong impact through international trade and financial relations. An individual country – comprising all its companies – may run persistently high current-account and trade surpluses based on greater price competitiveness, for various reasons. It can be the result of an increase in the unit labour cost that is not reflected in the valuation of its currency if the exchange rate is fixed unilaterally or multilaterally. Germany in the EMU is a classical example (box 6.3). On the other hand, an overvaluation of a country's currency resulting in its loss of competitiveness has been a feature of many developed and

Box 6.3

LABOUR MARKET FLEXIBILITY, GERMANY'S RELATIVE SUCCESS AND THE EURO CRISIS

Coinciding with the establishment of the European single currency area in 1999, Germany began to pursue new ways to fight high and persistent unemployment. As schemes such as reducing the work time and other measures had failed to reduce unemployment, in a tripartite agreement in 1999, policymakers, employers and union leaders agreed to abandon the traditional formula that based wage growth on equal participation of workers in productivity growth plus the inflation target. In its place, they opted for a strategy whereby redistribution in favour of capital was regarded as a means of reducing unemployment, based on the hope that this way productivity growth would translate into employment creation.

The new German labour market approach, in combination with the abolition of national currencies in the member States of the euro area, brought about a huge divergence in the growth of unit labour costs – the major determinant of prices and competitiveness – among these countries. Unit labour costs barely rose any more in Germany, whereas in most countries in Southern Europe, nominal wage growth slightly exceeded national productivity growth and the commonly agreed European inflation target of 2 per cent. France was the only country to exactly meet the agreed path for nominal wage growth since the introduction of the euro: French labour costs rose in line with national productivity performance and the euro zone's inflation target of 2 per cent.

Although the divergence among EMU members represented a low but fairly stable margin, and price and wage increases were small, they persisted over many years, so that a huge gap accumulated over time. At the end of the first decade of the EMU, the cost and price gap between Germany and Southern Europe had grown to around 25 per cent, and that between Germany and France to 15 per cent. In other words, Germany's real exchange rate vis-à-vis most of its euro area partners depreciated quite significantly, despite the absence of national currencies.

The growing gap in unit labour costs and prices had a strong impact on trade flows. While at the time of the establishment of the euro they were fairly balanced, as they had been for many years before, the first decade of the euro zone was a period of dramatically rising imbalances. As Germany's exports grew much faster than its imports, its current-account surplus widened. Meanwhile Southern Europe and France experienced widening trade and current-account deficits. Even after the shock of the financial crisis and its devastating impacts on global trade that affected German exports, in 2010 and 2011 Germany's surplus was quickly restored, to about €150 billion per year, of which exchanges with other EMU countries accounted for around €80 billion.

The current deep recession and the austerity programmes in the deficit countries have tended to reduce the visible deficits. However, without a fundamental turnaround in competitiveness, these countries lack the required growth stimulus. This experience shows that absolute and accumulating advantages of one country against other countries with similar trade structures are unsustainable; the huge gap in competitiveness has to be closed sooner or later. Failure to do so creates uncertainty on the part of lenders that have to finance the current-account deficits, as a result of which interest rates tend to increase. In order to be able to make net repayments of any debt that has been accumulated as a result of current-account deficits, the indebted country has to achieve a swing in its current-account balance at some point. A debtor thus has to be given the possibility to generate a current-account surplus. However, if the surplus countries use all means to defend their surplus positions, default by debtors is unavoidable.

The experience of the euro zone also shows that the conditions for competition among countries are different from those among firms. Individual firms are able to achieve a competitive advantage by increasing their productivity through innovation, which enables them to produce at lower unit labour costs than their competitors. But this mechanism does not work at the level of countries. Competitiveness among countries trading mainly in manufactures is strongly influenced by their relative average wage

Box 6.3 (concluded)

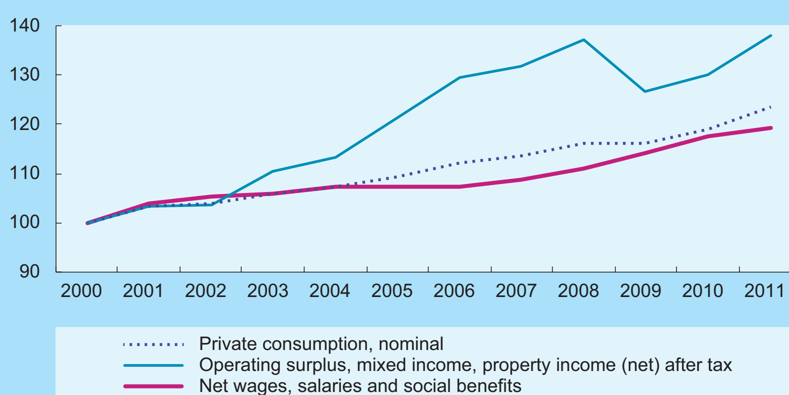
levels. In a world of national currencies and national sovereignty over monetary policy, a country supplying comparable manufactures at much lower prices than others would gain market shares and accumulate trade and current-account surpluses. However, political pressure to adjust wages and prices in international currency would mount, and sooner or later the country would be forced to adjust its wages, measured in international currency, through a revaluation of its currency.

In a currency union, however, member countries explicitly or implicitly agree not to opt for deflationary or inflationary policies (i.e. maintaining nominal wage growth below, or above, national productivity plus the commonly agreed inflation target). With an inflation target of close to 2 per cent (as set by the European Central Bank) the implicit agreement among EMU members is that unit labour costs would not rise by more than this rate. This implies that each country should use its productivity increase – be it 1 per cent as in Germany or 2 per cent as in Greece – for augmenting real wages or reducing working hours, or a combination of both. If, in any of the member countries, unit labour costs or inflation deviate from the commonly set inflation target, no matter whether this deviation is upwards or downwards, an unsustainable external position will arise.

The German approach to promoting its competitive position by keeping wage growth below the rate of its productivity growth plus the EMU inflation target not only led to intra-euro area imbalances; it was also unsuccessful at the national level. While exports from Germany began to rise sharply soon after the launch of the currency union, domestic demand remained as flat as real wages. This undermined the dynamics of its own domestic markets and increased the vulnerability of its trading partners (see chart).

CONSUMPTION AND INCOME IN GERMANY, 2000–2011

(Index numbers, 2000 = 100)



Source: Federal Statistical Office of Germany, January 2012.
Note: Income in fourth quarter of 2011 estimated.

The hope for a substitution of capital by labour and for rising employment at given output growth did not materialize. Moreover, the result of the German experiment was disastrous for several other EMU members which lost market shares. Without a substantial increase in German wages, these other countries will now need several years of falling wages to restore their international competitiveness. However, time is not on their side: lower wages are causing domestic demand to fall and the current recession to deepen, especially in countries with relatively small export shares (in the order of 25 per cent of GDP), such as Italy and Spain. The resulting depression is, as Greece has amply shown, politically untenable.

emerging economies, leading to a trade deficit. There can be many reasons for such an overvaluation, but the major one is carry trade – currency speculation based on interest rate differentials between currencies of countries – which recently has increased considerably as a result of very low interest rates in the United States and Europe. Overvaluation may lead to a severe financial crisis when the current-account deficit and foreign debt grow quickly; but it can also severely weaken a country's ability to diversify its production structure.

The macroeconomic shocks that arise from such mispricing in currency markets affect the economy as a whole, and therefore cannot be tackled at the level of the firm. The appropriate way to deal with such shocks is by revaluation or devaluation of the currencies concerned, rather than by wage cuts in the deficit countries. Recent examples in the euro area as well as many earlier examples in developing countries clearly show that attempts to redress huge trade imbalances through across-the-board domestic wage cuts do not work. The share of exports in overall demand is often too small for the expected effect of increased competitiveness on growth to be fast enough to prevent a deep recession triggered by the fall of domestic demand following wage reduction. Moreover, when wage cuts take place simultaneously in several countries that are trading partners, there is a fallacy of composition by which the competitiveness effect that could be had from wage compression is largely eroded. By contrast, devaluations favour exports of manufactures, but do not have a direct negative effect on domestic demand. Most importantly, they push back demand for imports and thereby stimulate demand for domestically produced goods.

The appropriate way to deal with macroeconomic shocks is by revaluation or devaluation of the currencies concerned, rather than by wage cuts in the deficit countries.

Therefore, to be efficient, the adjustment process in developed and developing countries alike should be integrated into a rational global or regional monetary system; otherwise, external macroeconomic shocks will continue to threaten the smooth adjustment described above. In order to buffer macroeconomic shocks, changes in nominal exchange rates should reflect changes in fundamentals (i.e. the differential in the rate of inflation or in the rise of unit labour costs) across countries. This way, changes in the unit labour cost at the country level can be equalized if measured in the currencies of the country's trading partners. This is the most effective instrument for preventing macroeconomic shocks stemming from misalignments of real exchange rates and countering the potential risk of overvaluation exerting downward pressure on wages, which would increase inequality. At the same time, a system in which the pattern of exchange rates follows nominal unit labour cost differentials is a necessary condition for avoiding beggar-thy-neighbour behaviour in international trade. In countries with open capital markets, exchange rates following inflation or unit labour cost differentials increase the scope for pursuing national monetary policies that foster growth by encouraging investment in fixed capital.

Another important aspect of the international framework is the way in which countries deal with the relocation of fixed capital. This may favour developing countries in the form of inward FDI when foreign investors are motivated by the opportunity to increase their profits by exploiting the wage differentials between rich and poor countries. The rule for real wage adjustment along the lines of national productivity growth, as proposed in this *Report*, is difficult to implement in developing countries as they frequently lack the labour market institutions, including trade unions and employers' associations, necessary for an effective incomes policy.

Therefore, principles that give due importance to adequate wage adjustments should play an important role when establishing the conditions for inward FDI. One of the conditions could be that the foreign affiliates of TNCs apply the principle of adjusting wages to the increase of overall productivity plus the national inflation target in the host country. In doing so, these firms would set a standard for domestic firms. To be more effective, these policies should be coordinated among all developing countries that are hosting or trying to attract FDI. This may be necessary in order to avoid excessive wage competition which in the end only benefits foreign firms in the form of higher profits or foreign consumers in the form of lower prices.

Observing such a rule for wage adjustments would by no means deprive foreign investors of their – often huge − extra profit arising from the combination of advanced technologies that boost absolute productivity with low absolute wages in the host country. The wage increase that they would guarantee would not be linked to their own productivity increase but to the average increase in the host economy as a whole. In a way, the application of such a rule would simulate conditions that exist in well-functioning labour markets. Foreign firms in low-wage countries not willing to adjust wages in this way would demonstrate that they are not respecting market principles.

The third area where more international cooperation is necessary relates to competition among countries. There is a widespread perception that accelerated globalization is compelling countries to compete in similar ways as companies. In this view, countries' wealth is considered to be dependent on each country's ability to effectively adjust to the challenges that are created by open markets for goods and capital. Countries with superior capital and technology endowments would come under competitive pressure from trading partners with a relatively large supply of labour and weak labour market institutions, and vice versa. In particular, the emergence of a huge pool of idle labour in developing countries like China and India would fundamentally change the capital-labour ratio for the entire world, and would bring about equilibrium of low and high wages somewhere in the middle.

As discussed earlier, declining wage shares are not a "natural" by-product of globalization, and the model describing competition among companies does not apply to countries, particularly not to countries with independent currencies. In a dynamic market economy, companies compete through differentiation of productivity and profits. They have to accept the price of labour, which is determined on the markets for different qualities of labour in the same way as the price of capital. Consequently, the success or failure of a company is determined by the specific value it adds to the goods and services traded on international markets. Companies that are able to generate higher productivity through innovation and new products produced at lower unit labour costs than their competitors can offer their goods at lower prices or make higher profits at given prices.

However, this mechanism does not apply at the country level. Regardless of whether wages are centrally negotiated for the economy as a whole or whether they are the outcome of a flexible labour market with a high degree of labour mobility, they will tend to be more or less equal for similar occupations. Thus countries, unlike companies, have to be considered as wage setters, not wage takers. Consequently, when productivity advantages are reflected in higher nominal and real wages, stronger growth of the average productivity of the entire economy does not increase the competitiveness of all companies against the rest of the world.

However, even if productivity gains, instead of being translated into higher real wages, were used to reduce prices, this would not necessarily improve the country's competitiveness or the competitiveness of all its enterprises. The prices in a country that consistently uses wage-dumping policies to improve its competitiveness would not necessarily be lower than in the rest of the world when expressed in the currencies of its trading partners. In a world of national currencies and national monetary policies, a country supplying its goods at much lower prices would gain market shares and accumulate huge trade and current-account surpluses. However, political pressure to adjust wages and prices measured in international currency would mount, and sooner or later the country would be obliged to undertake such an adjustment through a revaluation of its currency.

The principle to be applied is straightforward: given the increasingly open borders for trade and capital flows, the international trade and financial systems must be designed in such a way that in the global division of labour companies in different countries are not in danger of permanently losing out against those in the rest of the world. If nominal wage increases in one country consistently exceed the overall gain in productivity by a wider margin than in its trading partners, that country risks getting into an unsustainable position. This is because most of its companies either have to ask for higher prices and accept a permanent loss of market shares, or accept lower profits to avoid the loss of market shares. However, with open markets, the gap in price competitiveness compared with the rest of the world has to be closed one way or another.

In the present era of globalization, many countries have sought to defend their competitive positions

by undervaluing their exchange rates. Although this strategy cannot be successful in the long run, there is always a risk that governments will use exchange-rate manipulation or wage compression, subsidies and lower corporate taxes to artificially improve the international competitiveness of their domestic producers. This kind of "new mercantilism" needs to be banned. All countries can simultaneously boost productivity, wages and trade to improve their overall economic welfare, but not all of them can simultaneously achieve current-account surpluses or higher market shares. Successive rounds of competitive devaluations or a race to the bottom in wages or taxes are counterproductive, and are likely to cause considerable harm. Therefore, there is a need for an international code of conduct that goes beyond the existing framework of international rules of trade policy, including the WTO's Balance-of-Payments Provisions (WTO, 2012). The code should oblige countries whose national policies have the potential to damage their trading partners and to destabilize the international economic system to adjust their nominal exchange rates in line with differential changes in inflation or unit labour costs.

E. Conclusions

The experience of the past few decades has shown that greater inequality does not make economies more resilient to shocks that cause rising unemployment. On the contrary, it has made economies more vulnerable. Pay increases below productivity growth and increased job uncertainty systematically destabilize domestic demand. Compensating the gap in domestic demand growth by increasing household debt or by gains from stock markets or housing bubbles, as in the United States in the run-up to the global financial crisis, is unsustainable.

A market economy cannot function by relying exclusively on a presumed efficient allocation of resources through flexible markets and flexible prices in all markets, including the labour market. Much more important are arrangements that allow investors in innovative activities to drive the economy towards higher levels of activity and structural change. Such arrangements include, in particular, measures for the proper functioning of the labour market, of which the most important are: first, linking the growth rate of average wages and, where applicable, the minimum wage to the overall performance of the economy as measured by overall productivity growth; second, adjusting this growth to a target rate of inflation; and third, ensuring, as far as possible, and according to the specific circumstances of each country, that the wage level for similar qualifications is similar throughout the economy, and is not left to the discretion of individual firms.

> A comprehensive incomes policy linking wage and productivity growth and including legal minimum wages and a tight social safety net for poorer families would favour investment dynamics and monetary stability.

Such arrangements are in stark contrast to the dogma of labour market flexibility, which has re-emerged from the new spike in unemployment in the context of the financial crisis. But the obvious failure to return the global economy to a sustainable growth path after 2008, and in particular the failure to revive domestic demand in the developed world, should be taken as a warning sign. If a large majority of people lose faith in the willingness of companies and governments to provide them with a fair share of the collectively produced income, income growth itself will drastically suffer.

Relearning some old lessons about fairness and participation is the only way to eventually overcome the crisis and pursue a path of sustainable economic development.

A comprehensive incomes policy, based on the principles and institutions outlined in this chapter and including legal minimum wages and a tight social safety net for poorer families, will not hamper successful economic strategies based on investment dynamics and monetary stability. On the contrary, it will help to stabilize income expectations of households and their consumption, thereby linking the most important determinant of effective demand in most economies to the expansion of the supply potential. Moreover, it will allow monetary policy to be more closely geared to the stimulation of investment and growth. Finally, it will provide the flexibility to handle negative supply-side shocks without major disruptions, as it will help to prevent additional downward adjustments of demand that are likely to result from restrictive monetary policies. ■

Notes

1 Demand could even fall before wages decline if consumer sentiment dims. For instance, if the prospect of falling wages is broadly discussed among union members or accompanied by strikes and demonstrations, private households may reduce consumption in anticipation of an expected wage cut.

2 In light of this, the idea that "profit-led growth" can lead to the same outcome as "wage-led growth" (falling or rising real wages), depending on the openness of the country concerned (Onaran and Galanis, 2012), is misleading.

3 *Financial Times*, Draghi urges eurozone to focus on growth, 4 May 2012.

4 Negative supply shocks have their own logic. However, even in such situations, it is preferable to link wage adjustments to the average growth of productivity rather than to the negotiating power of labour and capital in general or at the firm level (see section D.2).

5 This was also recognized by Keynes, when he wrote that in a market economy "[it] is by altering the rate of profits in general that they can be induced to produce this rather than that" (Keynes, 1936: 141).

6 When the prices of oil, mineral and metal products escalated after 2002, concerns grew that, while the resulting returns on investment of the companies involved soared, the share of the rents accruing to the respective host countries remained unchanged, or even fell (UNECA and AfDB, 2007; UNECA, 2009; *TDR 2010*, chap. V).

References

Barkbu B, Rahman J, Valdés R et al. (2012). Fostering growth in Europe now. IMF Staff Discussion Note SDN 12/07, June. Washington, DC, IMF.

Economic Policy Institute (2006). Economists' statement. Hundreds of Economists Say: raise the minimum wage. Available at: http://www.epi.org/page/-/pdf/epi_minimum_wage_2006.pdf.

Elmeskov J, Martin J and Scarpetta S (1998). Key lessons for labor market reforms: Evidence from OECD countries' experience. *Swedish Economic Policy Review,* 5(2): 205–252.

G-20 (2012). Boosting jobs and living standards in G20 countries. A joint report by the ILO, OECD, IMF and World Bank. June.

Hayek FA (1960). *The Constitution of Liberty*. Chicago, University of Chicago Press.

IMF and G-20 (2012). Euro area imbalances. Annex to *Umbrella Report for G-20 Mutual Assessment Process, 2012*. Available at: http://www.imf.org/external/np/g20/pdf/map2012/annex2.pdf.

Keynes JM (1930/1971). A treatise on money. In: *The Collected Writings of John Maynard Keynes*, Vol. V. London, Macmillan and St. Martin's Press for the Royal Economic Society.

Keynes JM (1936/1973). The general theory of employment, interest and money. In: *The Collected Writings of John Maynard Keynes*, Vol. VII. London, Macmillan and St. Martin's Press for the Royal Economic Society.

Nickell S (1997). Unemployment and labor market rigidities: Europe versus North America. *Journal of Economic Perspectives*, 11(3): 55–74.

OECD (1994). *The OECD Jobs Study*. Paris.

Onaran Ö and Galanis G (2012). Is aggregate demand wage-led or profit-led? Conditions of Work and Employment Series 31, International Labour Office, Geneva.

Siebert H (1997). Labor market rigidities: At the root of unemployment in Europe. *Journal of Economic Perspectives*, 11(3): 37–54.

UNCTAD (*TDR 1996*). *Trade and Development Report, 1997.* United Nations publication, Sales No. E.96.II.D.6, New York and Geneva.

UNCTAD (*TDR 2005*). *Trade and Development Report, 2005. New Features of Global Interdependence*. United Nations publication, Sales No. E.05.II.D.13, New York and Geneva.

UNCTAD (*TDR 2008*). *Trade and Development Report, 2008. Commodity Prices, Capital Flows and the Financing of Investment*. United Nations publication, Sales No. E.08.II.D.21, New York and Geneva.

UNCTAD (*TDR 2010*). *Trade and Development Report, 2010. Employment, Globalization and Development*. United Nations publication, Sales No. E.10.II.D.3, New York and Geneva.

UNECA (2009). *Africa Review Report on Mining*. E/ECA/CFSSD/6/7. Addis Ababa, United Nations Economic Commission for Africa.

UNECA (2010). *Economic Report on Africa 2010, Promoting high-level sustainable growth to reduce unemployment in Africa*. United Nations publication, Sales No. E.10.II.K.1, Addis Ababa, Ethiopia.

UNECA-AfDB (2007). The 2007 Big Table. Managing Africa's Natural Resources for Growth and Poverty Reduction. Summary Report. United Nations Economic Commission for Africa and African Development Bank, 1 February. Available at: http://www.uneca.org/thebigtable/.

WTO (2012). Understanding on the Balance-of-Payments Provisions of the General Agreement on Tariffs and Trade 1994. Geneva. Available at: http://www.wto.org/english/docs_e/legal_e/09-bops.pdf.