1. The macroeconomic outlook is deteriorating

The global economy has been weakening rapidly

Global growth has decelerated rapidly, increasing the threat of a prolonged jobs recession. Following the deepest global recession since the end of the Second World War, the recovery has been short lived and shallow, barely recovering to rates prior to the crisis and unable to close the gap that has opened up. In the meantime, the macroeconomic woes in some advanced economies have worsened, increasing global uncertainty. While only a few countries have been facing serious and long-term economic and fiscal challenges, the global economy has cooled down fast as uncertainty has spread beyond the advanced economies, moving the world economy even further away from the pre-crisis trend path. At the current juncture, even a double dip remains a distinct possibility.[1]

Partly, the protracted nature of the recovery is due to the nature and depth of the crisis as well as its synchronized impact, which required policy action and economic adjustments on several fronts. A combination of unresolved financial market problems and financial reforms that have not yet been fully operationalized, a shift of private debt into public debt and subsequent sovereign debt sustainability issues, an ongoing process of private sector deleveraging and a global and sectoral restructuring of activities triggered by the crisis has put the brakes on global growth.

As a result of the weaker than expected recovery, labour markets are unlikely to recover from the strain they have suffered since the beginning of the crisis. Globally, nearly 27 million new jobseekers have been added to the already high global unemployment figure of almost 171 million prior to the crisis, and this gap is expected to open gradually further as new entrants into the labour market struggle to find gainful employment. Under current trends, unemployment will be a reality for more than 200 million people in 2012; and if the situation aggravates further, more than 209 million workers may be affected by 2013. The return of new uncertainty, in particular the risk of another recession in advanced economies during the first half of 2012, pushes further back any strong uptick in employment creation.

Short-term outlook

The outlook for a self-sustained global recovery worsened considerably during the summer months of 2011. After a V-shaped recovery in output, the mounting sovereign debt problems in some advanced economies have raised worries about a double dip in economic activity throughout the world. High levels of volatility have returned to financial markets which, combined with the continuing deleveraging in the private sector in advanced economies and the effects of fiscal austerity measures on global demand, have lowered expectations of a quick return to pre-crisis trends.

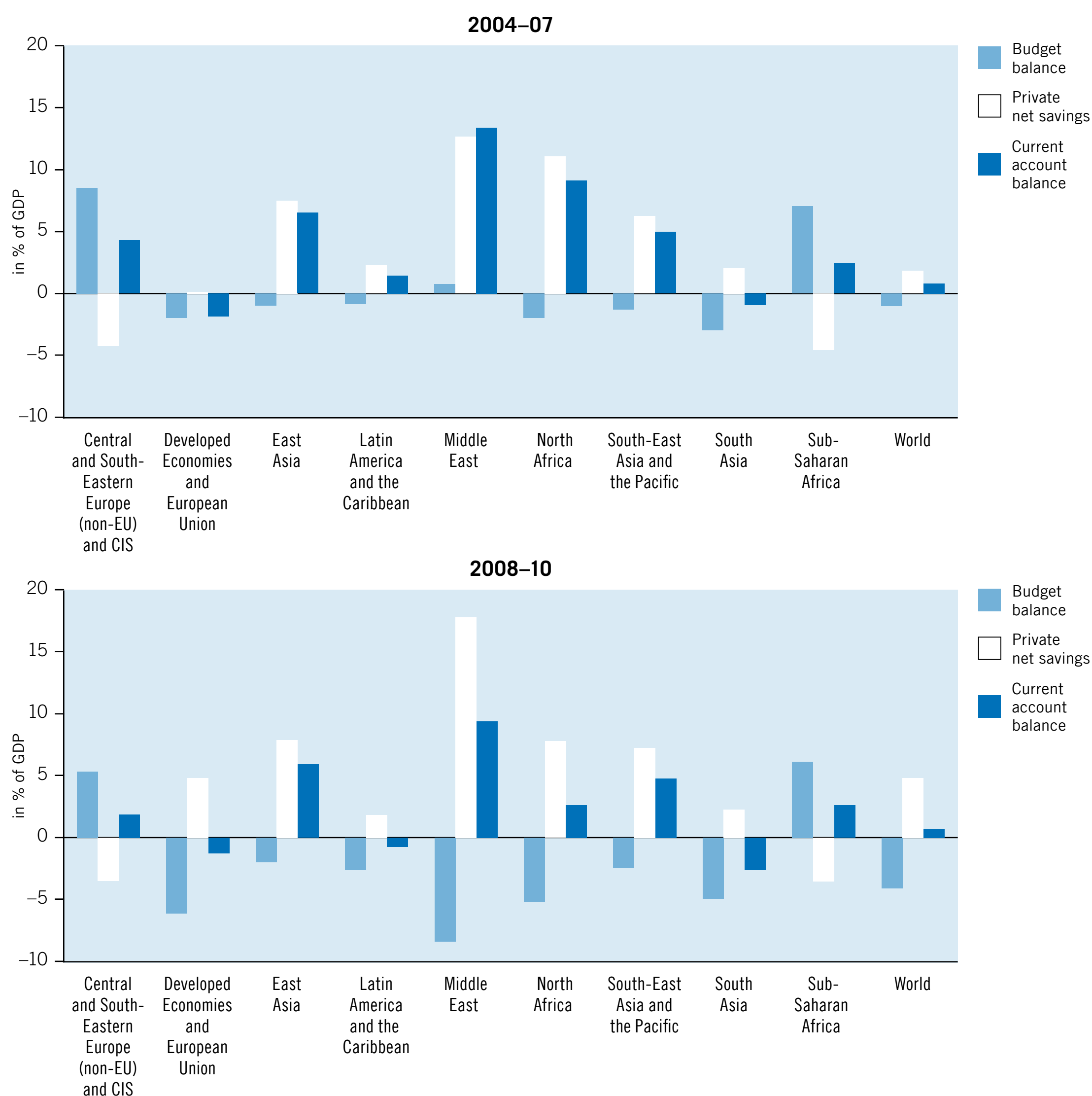
[1] There is no generally agreed definition of a global recession or a global double dip in economic activity. In the past, the International Monetary Fund (IMF) has considered global growth of less than 3 per cent to be the equivalent of a global recession (IMF, 2008).

Crisis conditions are spreading out again from advanced economies

Global economic growth has decelerated sharply, falling to 4 per cent in 2011 from 5.1 per cent in the previous year, and is projected to decelerate further over the medium term (IMF, 2011a). In part this is related to the still lacklustre growth in advanced economies. As a consequence, job creation in this region has been slow, limiting disposable income growth, putting substantial strain on public finances and depressing private consumption, business investment and trade in these countries. At the same time, emerging economies that managed to return to pre-crisis trend growth rates continue to rely heavily on demand conditions in more advanced economies, which has left them exposed to deterioration in economic conditions in this region. This vulnerability stems partly from the continued reliance of these economies on export-oriented growth. However, their recoveries also seem to have been driven by additional liquidity from central bank interventions around the globe which have led to asset price booms, although these are likely to be unsustainable over the medium term.

Demand conditions have worsened on a broad front as private households and firms have continued to choose to save rather than consume (see figure 1). Since 2010, public spending

Figure 1. Decomposition of demand conditions: Pre-crisis vs. crisis period



Note: The charts show average public, private and external balances over the pre-crisis (2004-2007) and the crisis (2008-2010) periods.
Source: ILO calculations based on IMF *World Economic Outlook* database, September 2011.

has lost substantial momentum. After having prevented a worse decline in output and employment through a decisive, albeit short-lived, fiscal stimulus, governments around the globe have felt the need to enact austerity measures that further depress GDP growth and job creation. At the same time, private sector demand has not reached a sustainable trajectory that would help pick up the slack caused by reduced public sector stimulus. Private spending has taken a hit from efforts to deleverage and is unlikely to return to pre-crisis levels (which were in any case unsustainable, at least in those countries where it had been supported by strong credit expansion). In this environment of heightened insecurity and depressed consumer confidence, business investment has also not recovered to pre-crisis levels, further dragging down aggregate demand. In particular, non-financial sector firms have accumulated substantial amounts of cash without injecting new funds into the economy.

Against this gloomy outlook, the risk now is that growth will remain below the job creation threshold necessary for continuous and self-sustained employment generation, locking countries into an adverse equilibrium in which low output growth and subdued job creation reinforce each other. Given the need for the world economy to absorb an average of 40 million new labour market entrants each year, even a modest weakening in global economic activity of 0.2 percentage points would lead to an increase in the number of unemployed of 1.7 million by 2013.

Overly tight fiscal policies weigh on aggregate demand

Before the recent return of crisis conditions, most governments around the world turned towards a less accommodative policy stance, under the rationale of bringing public debt developments under control. However, the uncoordinated manner in which fiscal tightening has been carried out has led to an overly tight stance on budgetary positions, at least from a global standpoint. Indeed, even though budget deficits are still large, particularly in advanced economies, most of the budget shortfalls have been predominantly driven by reduced tax revenues rather than by additional expenditures from fiscal stimulus packages (IMF, 2010a). Provided that activity resumes sufficiently, some of these large deficits can be expected to shrink automatically. In addition, sovereign debt positions have worsened substantially following a transfer of private debt (banking sector) to public debt, as governments tried to prevent large-scale banking failures at the beginning of the crisis. In order to address mounting concerns about the sustainability of government budget positions and rising sovereign debt risk premiums, many countries have started implementing substantial spending cuts which are likely to depress activity further, leading to a downward spiral of worsening growth and deteriorating public balances (see table 1 for an overview of recent austerity measures).

Table 1. Overview of fiscal austerity measures

	Details of consolidation measures	Projected consolidation period
Australia	Increase in tax on tobacco products and federal resource tax; planned introduction of 30 per cent Resource Super Profits Tax in mining business (July 2012)	2012
Brazil	Spending cuts helped achieve a primary fiscal surplus of 3.1 per cent of GDP in 2011, but further austerity measures have been delayed	2011–14
Canada	Planned cuts in federal spending programme (with the exemption of pensions, education and health), especially targeting public sector wages; cuts in operating costs of federal departments	2010–15
Denmark	Nominal freeze of several social benefits (unemployment, student financial aid, welfare) and foreign aid; reduction in duration of unemployment benefits; cuts in salaries of ministers by 5 per cent (around 2 billion Kroner); introduction of ceiling on family benefits; higher excise duties on unhealthy foods and tobacco	2010–13

	Details of consolidation measures	Projected consolidation period
Estonia	Increase of VAT (2 percentage points) and excise taxes; reduction in social benefits (health, pensions); operating spending cuts; (temporary) increase in second pillar pension contributions; land sales; discretionary spending cuts	2011–14
France	Cuts in public pensions, healthcare and public administration; raising of retirement age (from 60 years to 62 years by 2017); increase in taxes on capital; increase in top income tax rate by 1 percentage point	2010–13
Germany	Yearly consolidation of €25 billion from additional taxes (banks, air traffic, nuclear power; total around €8 billion); cuts in spending on social security and labour market policies (around €8 billion); cuts in military and administrative expenses (around €5 billion)	2010–14
Greece	Elimination of tax exemptions; increase in property taxes; higher excise tax on cigarettes and alcohol; higher tax on mobile telephones and petrol; special levy on profitable firms and on high-value real estate; 10 per cent reduction in general government expenditure on salary allowances; public sector recruitment freeze in 2010 and partial replacement of retiring civil servants; reduction in operating costs and subsidies for pension funds; significant reduction in the number of public sector special committees; amalgamation and drastic reduction in the number of the public bodies/entities linked to local authorities	2010–14
Hungary	Introduction of 16 per cent flat rate of income tax over two years; cuts to the public sector (reduction of wages, elimination of certain benefits); six-year tax for financial institutions; reduction of bureaucracy for investors; ban on foreign exchange mortgages	2011–13
India	Reduction in social sector spending	2010–11
Indonesia	Efforts to reduce corruption and improve government efficiency and tax enforcement	
Ireland	Tax increases and spending cuts (public sector wages, social welfare benefits)	2009–10
Italy	Public sector hiring freeze and public sector wage cuts (for civil servants with gross salary above €75,000); cuts in healthcare spending; strengthening of efforts against tax evasion; reduction in transfers from central to regional and local governments	2010–12
Japan	Revision of spending plans to freeze deterioration of primary balance; limitation of sovereign debt issuance in 2012 to 2011 levels	2012 onwards
Latvia	Increase of VAT (3 percentage points); introduction of capital income tax; increase of personal income flat tax rate (3 percentage points); broadened base for property tax; public sector wage cuts; pensions cuts; structural reforms in public administration; education and healthcare (revenue vs. spending consolidation in the ratio 20:80)	2009–10
Lithuania	Cuts in salaries of politicians; reduction in military appropriations; scrap indexation of minimum wages; revision of maternity leave allowances; rationalization of public expenses; increase of personal income tax flat rate to 20 per cent; increase of excise taxes (fuel, tobacco, gambling); introduction of a corporate tax on agricultural entities	2009 onwards
Netherlands	Consolidation effort of €18 billion until 2015 (around 3 per cent of GDP), with cuts concentrated in social security reforms (tighter eligibility criteria for childcare allowance, disability and unemployment benefits), development cooperation and military spending	2011–15
Portugal	Reduction in public sector pay and hiring (15 per cent reduction of central government services and managerial positions compared with 2010); increase of VAT and taxes on high-income earners; freezing of pensions, except for the lowest pensions; special contribution on pensions above €1,500; reform of the unemployment benefit system.	2010–13
Romania	25 per cent reduction in public sector wages; 15 per cent reduction in pensions and unemployment benefits	
Russia	Increase in non-energy tax revenues to lower deficit up to 2014	2010–14
Slovenia	Announcement to reduce budget deficit by investment cuts (rather than public sector cuts)	
Spain	Cut in public sector jobs (13,000 jobs) and pay (salary cuts of 5 per cent for civil servants and of up to 15 per cent for ministers and mayors); introduction of new income tax; scrapping of newborn benefits; reduction in public investments by €6 billion; cuts in public pensions; sale of public sector assets: one-third of public enterprises shall be closed or sold off	2010–13
Turkey	Introduction of the “fiscal rule bill”, including cuts in social security, local and provincial administration and unemployment benefits and levies for firms with floating capital	2010 onwards
United Kingdom	Emergency measures: abolition of the Child Trust Fund and cutting of employment programmes (Young Person’s Guarantee fund), civil service recruitment freeze. One-quarter of higher revenues shall be achieved by tax increases: increase in VAT (2.5 percentage points)	2010
United States	The Budget Control Act, signed into law in August 2011, is expected to result in an aggregate reduction in government spending of US$1.88 trillion over the period 2012 to 2021, with cuts to defence, education, national parks, low-income housing assistance and medical research, among others	2012–21

Source: Updated from IILS, 2010.

Fiscal positions have been weakened by financial sector support

Fiscal deficits can largely be explained by the fall in tax revenue associated with the economic contraction or slower growth. In addition, an important contribution to the increased expenditures is related to the substantial financial sector support measures implemented at the beginning of the crisis, in particular in some European countries. Due to the financial sector origins of the crisis, these support programmes have targeted the banking sector in advanced economies, in some cases channelling up to 90 per cent of additional public spending into bailing out banks and buying up distressed financial assets (IILS, 2009). In a survey of 77 countries (ILO and World Bank, forthcoming), the total budget for additional fiscal spending of US$2.4 trillion during the crisis years was accounted for largely by the high-income countries, whose share came to US$1.9 trillion, while the share of middle- and low-income countries came to US$520 billion. Of the US$1.9 trillion sectoral budget for high-income countries, US$1.2 trillion (almost two-thirds) went to the financial sector. This financial bailout dwarfed all other sectoral support in high-income countries, far greater than spending on healthcare (8 per cent), education and infrastructure (5 per cent each).

The often unconditional bailouts of the financial sector in advanced economies has compounded sovereign debt problems, in particular in the euro zone (see box 1) with sizeable spillovers to the global economy. Indeed, by buying up distressed assets and allowing banks to benefit on a broad scale from direct access to central bank credit for their financing activities, policy-makers have relieved banks from liquidity constraints, fearing that this would result in massive bank failures. At the same time, incentives for private banks to buy up large amounts of sovereign debt were strengthened as public guarantees relieved capital requirements for such assets and returns on sovereign bonds skyrocketed. As a consequence, banks – relying on such guarantees – started to buy sovereign debt from euro area countries at the height of the financial crisis in the expectation of using these assets to access central bank liquidity facilities. The ensuing change in banks' asset compositions has not only further weakened the banking sector in certain advanced economies, it has also transferred disproportionate risk onto sovereigns, which has led to the current re-emergence of crisis conditions.

In contrast, most emerging economies benefited from initially much better fiscal positions and lower financial sector stress, which allowed them to prioritize support for exports and the real economy. This, in turn, led to much stronger recovery in these countries, thereby helping to limit the impact of these measures on public debt and long-term sustainability.[2] Of a total budget of US$520 billion, the largest allocation for support was to manufacturing, with a 22 per cent share, followed by agriculture with a 9 per cent share, finance and construction, each with a 5 per cent share, and a 4 per cent share for infrastructure.

Even though the financial sector origins of the crisis explain the bias of advanced economies towards financial sector support, the choice of bailing out banks without any compensatory requirements remains a matter of much public debate. Now facing the risk of another recession, many governments in advanced economies are left with little ammunition to support the real economy. At the same time, putting further stress on the banking sector at the current juncture by having the sector pay for part of the clean-up costs, for instance via a financial transaction tax, risks further derailing the economy. Clearly, this dilemma cannot be solved at the level of any individual country but requires the coordinated intervention across a larger group of countries, to mutualize at least part of the recession risk, and stronger support for the global economy by more solvent countries.

[2] The largest number of countries, 40, adopted policies to support exports; 31 countries provided support for agriculture; 28 countries supported manufacturing; 19 countries supported construction; and 17 countries supported finance. Infrastructure was not listed separately, but was approximated from communications, which was supported by nine countries, and utilities, which was supported by seven countries (ILO and World Bank, forthcoming).

Box 1. Sovereign debt problems in the euro zone

Financial crises often lead to sovereign debt crises, threatening the chances for a sustainable recovery (Reinhart and Rogoff, 2009). This time is no exception. In particular, public finances in advanced European Union countries have been affected by large bailout programmes of their banking system as well as rapidly declining tax revenues. Already prior to the crisis many EU-27 countries had accumulated substantial amounts of public debt that rapidly increased further with the onset of the crisis, far beyond the thresholds that had been fixed by the Stability and Growth Pact. With the economic outlook deteriorating, unemployment rates increasing and public finances suffering, sovereign debt ratings plummeted, causing bond interest rates to sky-rocket in some member countries and bond markets to dry up. By summer 2011, these sovereign debt problems reached a stage where even a break-up of the euro area became conceivable, with unknown adverse consequences for member countries and the global economy alike.

In order to prevent a sovereign default of one of their member countries, EcoFin – the Council of European Economics and Finance Ministers – together with the International Monetary Fund undertook some short-term support measures to maintain sovereign solvency of some of their member countries and to prevent high long-term interest rates choking off the recovery underway in the euro area. To this avail, the European Financial Stability Facility (EFSF) was set up alongside the European Financial Stabilisation Mechanism (EFSM), two temporary funding facilities from which distressed countries are allowed to draw. Together EFSF and EFSM provide a financial safety net for EU countries' sovereign debt of more than €1,000 billion. It is planned that, by mid-2013, these temporary facilities be replaced by the European Stability Mechanism (ESM), or supplement it, the contours of which, however, still need to be approved in a treaty adopted by EU member countries.

In addition to these fiscal safeguard measures, EU member countries also adopted a Competitiveness Pact (the "Euro-Plus Pact"). This pact intends to accelerate convergence among member countries in order to avoid a further divergence of economic fundamentals that have already affected the cohesion of the currency area. In particular, unit labour costs were thought to be at the heart of the difficulties that some of the member countries faced in responding to the crisis and the ensuing worsening of public finances. The pact suggests measures to strengthen public finances through tax policy coordination, especially regarding corporate taxation. In addition, deflationary labour market and social policy measures were being emphasized on wage indexation, retirement ages and labour taxation.

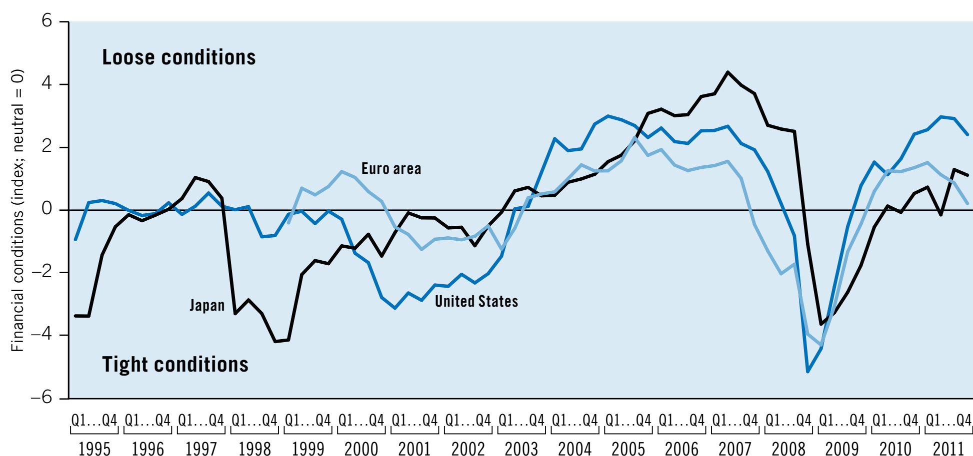
So far, the extent to which both the financial safety facilities and the competitiveness pact can address the fundamental weaknesses of the economic governance in the euro area remains to be seen. Recent conclusions adopted at an EU summit in Brussels suggest that national fiscal policies will come under greater scrutiny by supranational institutions such as the European Court of Justice to ensure that deficit ceilings and a debt brake are properly adhered to. On the other hand, neither euro-wide sovereign debt instruments ("euro bonds") nor a larger role of the European Central Bank as a lender of last resort to governments have been adopted during the summit, significantly limiting the effectiveness of the new EU fiscal framework.

In addition, supply-side measures such as those focused on in the Euro-Plus Pact would deliver results only over the medium term through internal devaluation and at the cost of prolonged periods of slow economic growth. These measures force adjustment through wage deflation, causing substantial social harm and threatening a sustainable recovery. At the same time, when carried out in isolation, they increase capital costs relative to other member countries for the entire adjustment period, depressing investment and job creation. Worse, if such measures are introduced in an uncoordinated way, other euro area member countries are likely to introduce similar measures to avoid deterioration of their competitive situation, further depressing the outlook for the entire currency union without solving the sovereign debt problems at the origin of the crisis. Instead, policy-makers should have taken advantage of the relative closedness of the euro area to coordinate their wage and fiscal policies such as to allow distressed member countries to benefit from demand spillover effects from countries more advanced in their recovery process (Stockhammer et al., 2009).

Unresolved financial sector problems limit investment dynamics

Despite this strong support for financial sector bailouts, more than three years after the height of the financial crisis many reforms to strengthen the stability of the financial system are only gradually being introduced. Countries had initially been quick to bail out failing banks and restrict certain types of financial transactions deemed to be particularly critical for the stability of the financial sector, and later more structural measures were announced or – in certain cases – legislated, such as the separation of commercial from investment banking activities and the strengthening of banks' equity bases. Most of these measures, however, are

Figure 2. Financing conditions (USA, euro area and Japan)



Note: The chart shows financial conditions for private sector firms based on the tightness of credit standards, the liquidity of commercial bond markets and borrowing interest rates. Positive values imply loose financial conditions, negative values tight conditions.

Source: OECD *Economic Outlook* 90.

still awaiting full implementation or are only gradually being phased in, such as the Basel III accords on banking supervision.

Indeed, lending to small and medium-sized enterprises (SMEs) in particular has not taken off in advanced economies. In the euro area in particular, lending conditions have remained tighter than before the crisis despite a return towards more normal conditions in most economies following the immediate aftermath of the crisis. In addition, lending conditions have started to tighten again in recent months among advanced economies against the backdrop of heightened market uncertainty (see figure 2). Given the importance of SMEs in generating investment and employment, going forward it will be crucial to relieve their financing conditions and allow them more broad-based access to banking and market-based credit. In part, such an improvement in financing conditions can be achieved by speeding up the implementation of the announced and agreed banking sector reforms to help to transform the current banking sector model and make it more amenable for real economy financing.

In this regard, it should be stressed that proper and comprehensive financial sector regulation can actually contribute to faster employment growth (see box 2). It will relieve enterprises and banks from economic and regulatory uncertainty and put the business model of the banking sector on a more stable footing. The reduced volatility in domestic and international markets that such tighter regulation might induce is a prime requisite factor for stimulating both investment and employment growth and might help to reduce precautionary saving. In addition, stricter prudential regulation and the limitation of implicit public guarantees against bank failures will help phase out current exceptional monetary measures, restoring market forces in the banking sector. This will improve financial conditions in the real economy, as banks will have greater incentives to channel their funds toward productive ends rather than volatile financial products. Adding up these effects, estimates by the ILO show that broad-based financial sector regulation could add more than half a percentage point to job creation rates (ILO, 2011a).

Policy space to boost the recovery remains limited

Policy space has been further restricted by recent turbulence in sovereign debt markets. Given the lack of adequate international coordination, and the mood of policy-makers around the globe, returns to a more expansionary stance of fiscal policy are unlikely – despite the adverse

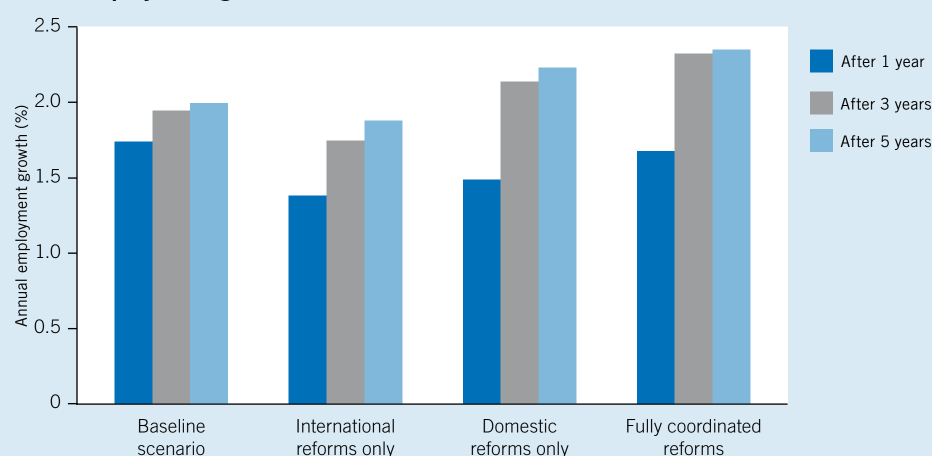
Box 2. Could financial market reforms increase employment growth?

Few existing studies have tried to identify the impact of financial market regulation on the real economy. Efforts have mostly concentrated on the effects of higher capital costs and the availability of credit due to stricter rules on GDP growth, and on regulation of international financial flows, such as international transaction taxes and capital controls, which are also expected to reduce financial depth and credit market activity. The extent to which such reduction in financial activity will lead to a slowdown of the real economy is still hotly debated, as are the actual effects of tighter regulation on the banks' dominant business model and its consequences for financing costs (see IIF, 2010; Kashyap et al., 2010; Admati et al., 2011). Disregarding methodological and conceptual differences across these studies, however, most agree that some – at least temporary – shortfall of GDP might be expected, if at least to account for the fact that the banking sector will have to reorient its activities to other, potentially less profitable domains.

None of the discussions presented in recent years, however, has looked into effects of financial market regulation on employment creation. They assume a stable and constant link between GDP and employment that is sufficient to derive relevant estimates for the number of jobs being affected. This is misleading for at least two reasons. First, a reduction in financial market stress may have an additional stimulus effect on employment creation, over and above positive effects for GDP, as uncertainty directly affects hiring incentives of firms. Second, financial reforms might also lead to changes in corporate governance, to the extent that credit or bond financing will be less available and might be replaced by increased fundraising on equity markets (for example, via private equity investment). Both effects constitute additional forces for job creation.

Recent estimates that take these transmission mechanisms into account present a more balanced picture regarding the extent to which labour markets will be affected by financial reforms (Ernst, 2011a). In particular, it can be shown that the labour market effects of financial regulation will depend on the extent to which financial reforms in the domestic sector are being coordinated with changes in the international financial architecture. Chiefly, this can be related to the fact that increased regulation in both areas would yield a double dividend in the form of more stable financing conditions and a more equitable income distribution, which helps strengthen domestic demand. In the absence of changes in either domestic or international financial regulation, reform measures would not have sufficient positive effects to outweigh some of the costs they bring about, at least in the short run (see figure below).

Employment growth under different financial reform scenarios



Note: The chart shows average annual employment growth rates for advanced G20 countries under different reform scenarios after 1, 3 and 5 years. The baseline scenario of no financial reforms is compared with scenarios where reforms are only implemented at the international level (e.g. financial transaction tax), the domestic level (e.g. stricter bank capital requirements) or both.

Source: Ernst, 2011a.

consequences for global growth. Partly, this is related to the fact that regardless of the way in which current fiscal austerity measures are being implemented, the crisis has revealed the fragile state of public finances in many advanced economies:

- Automatic stabilizers have helped much more during the crisis than discretionary measures. The swift increase in public spending and automatic reductions in tax pressure have contributed to a large extent to stabilizing demand conditions. It is estimated that overall, automatic stabilizers contributed up to 80 per cent to the overall stimulus that governments provided to their economies (OECD, 2009).
- Passive labour market policies and income-support measures have contributed strongly to limit the impact of the crisis on aggregate demand. In addition, active labour market

policies have acted as important flanking policies on the labour market, supporting job-seekers in finding new opportunities in alternative sectors or firms.

- Tax breaks on hiring for private businesses to create employment do seem to provide some relief despite the severe macroeconomic adversity. However, the deadweight costs of these tax breaks have proven to limit their potential benefits. In a weak macroeconomic environment, many businesses simply will not hire. Earlier experiences already demonstrated that these measures have been found to be very costly with only little additional effect on employment creation (Hungerford and Gravelle, 2010).

Implementing these insights more broadly would substantially enhance the balanced-budget multiplier, i.e. the capacity of governments to expand private demand even in the absence of deficit spending. It is estimated that under the current conditions of ineffective monetary policy, such reorientation of fiscal objectives ("smart spending") could yield multiplier effects of over 2, i.e. private demand would expand by more than two dollars for each dollar on the public balance sheet (e.g. Woodford, 2010).

Monetary policy also will need to be adjusted soon. Central banks have little ammunition left for guaranteeing liquidity provision to the real economy, despite the tightening financial conditions observed in many advanced economies. Quantitative easing and the attempts by both the Federal Reserve and the European Central Bank to lower long-term interest rates by buying up sovereign debt has so far not satisfied expectations by policy-makers and market participants. Risk premia, in particular on sovereign bonds of some countries, continue to be unsustainably high and show no signs of receding without major policy actions – such as a partial default by some sovereigns within the euro area.

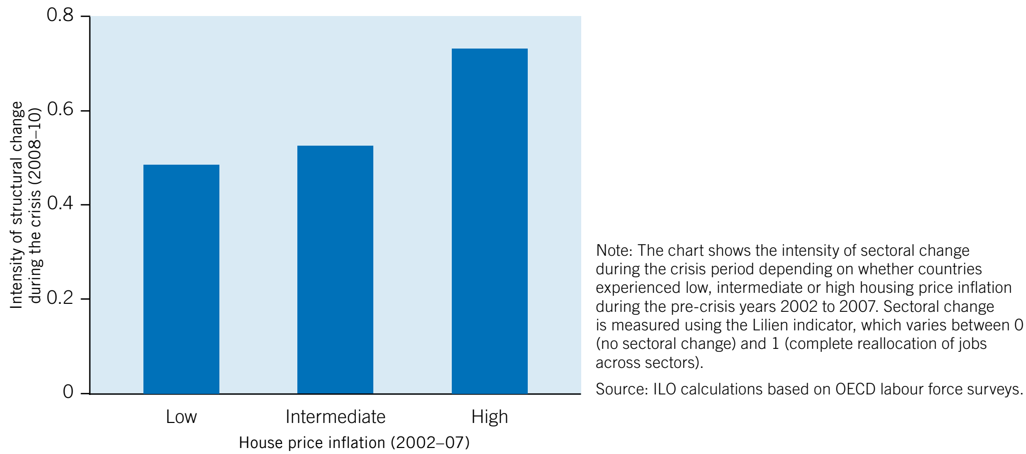
Forces acting over the medium term

Underlying the weaker than expected recovery of global activity and the short-run downside risks are structural changes that have been fuelling the crisis. In particular, the slowdown of productivity growth in advanced economies and the concomitant shift of global activity to the emerging world have opened up imbalances that have not yet been taken up in a satisfactory manner. This has resulted in a gradual and – due to the crisis – permanent decline in potential output growth, which will further weigh on policy-makers' options.

Structural imbalances have weighed upon the recovery

Structural imbalances that have built up over the past decade are likely to worsen the employment outlook. Housing and asset price bubbles as well as the ensuing crisis have created substantial sectoral misalignments that need to be fixed; this will require lengthy and costly shifts in employment, not only across the economy, but also across countries (see figure 3). Strong liquidity growth has created a boom in the housing and financial sectors, which is still ongoing in some economies, leading to misallocation of resources and generating structural unemployment in the labour market that are likely to take time to be fully resolved. These structural frictions are also responsible for a low employment response to growth, in particular in those economies where the boom has already been followed by a bust, such as the United States, Spain and Ireland. Going forward, the readjustment of these imbalances is likely to limit the effectiveness of policy interventions as traditional macroeconomic policies may be of limited help when it comes to rebalancing sectoral growth patterns. Additional policy levers, therefore, are needed to allow a more rapid reallocation of jobs and workers across the economy to promote faster employment growth.

Figure 3. Sectoral employment change and housing price conditions



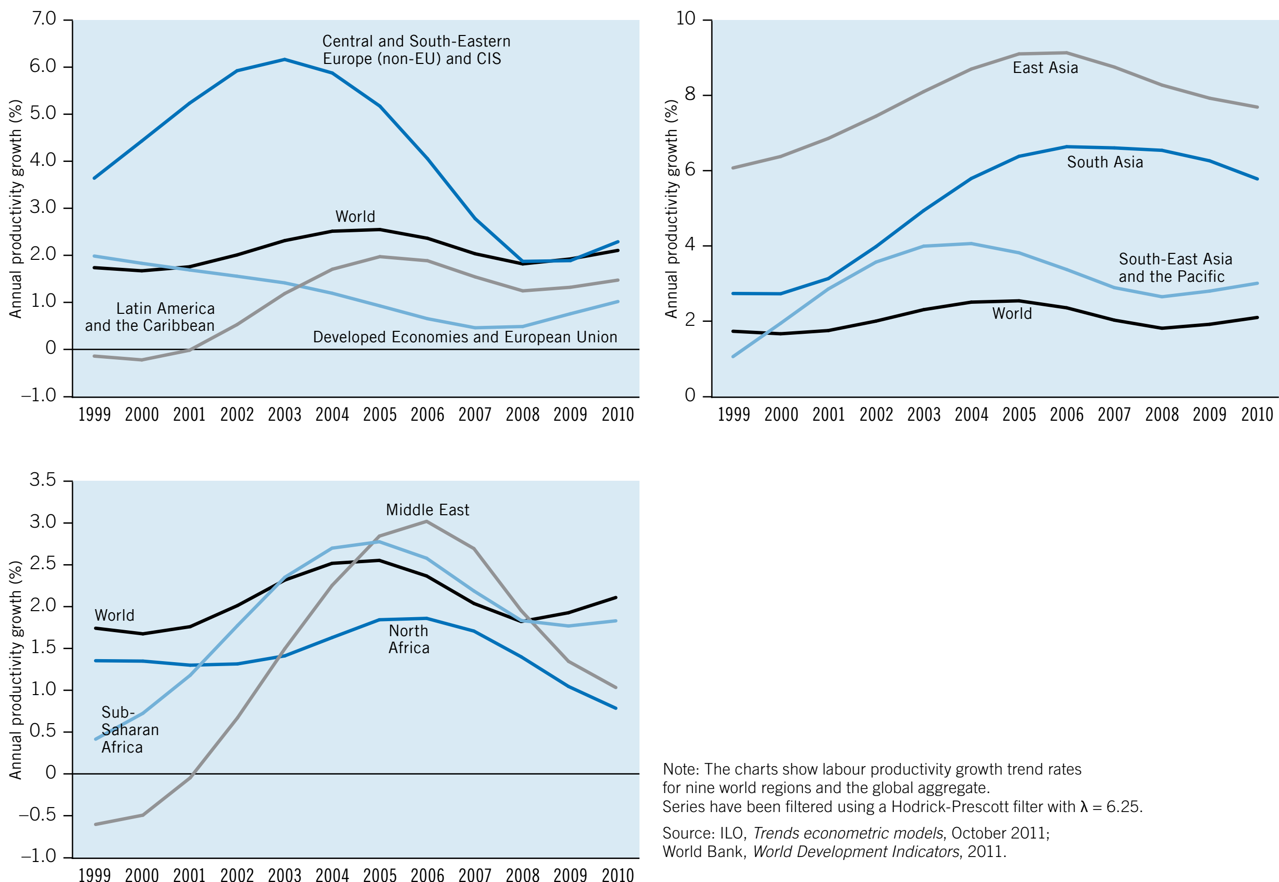
Note: The chart shows the intensity of sectoral change during the crisis period depending on whether countries experienced low, intermediate or high housing price inflation during the pre-crisis years 2002 to 2007. Sectoral change is measured using the Lilien indicator, which varies between 0 (no sectoral change) and 1 (complete reallocation of jobs across sectors).

Source: ILO calculations based on OECD labour force surveys.

Some parts of the world have seen a slowdown in productivity growth

Prior to the crisis, labour productivity growth had started to slow down in some parts of the world (see figure 4). The sluggish recovery and the spread of structural imbalances to other parts of the world has led to a broader deceleration of labour productivity growth rates. Such a slowdown in productivity growth in both advanced and emerging economies is likely to keep employment creation down as well. Ongoing structural change and shifts of resources across sectors are – at least temporarily – expected to keep productivity growth down. In addition, longer term trends have weighed on productivity growth as well: fast-growing emerging economies

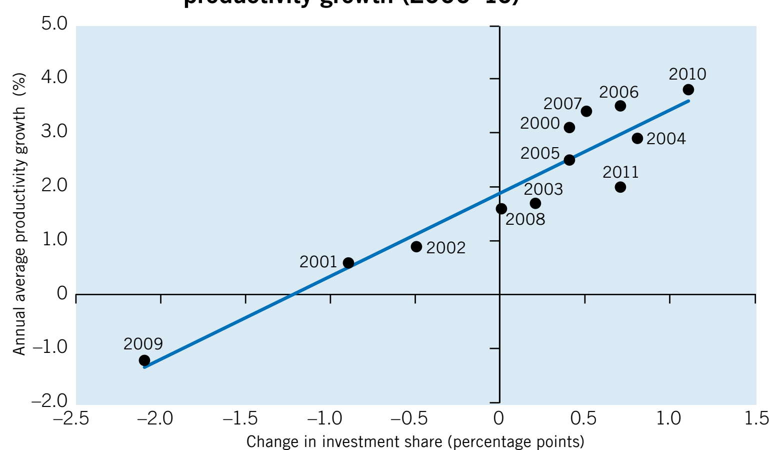
Figure 4. Long-term trends in productivity growth



Note: The charts show labour productivity growth trend rates for nine world regions and the global aggregate. Series have been filtered using a Hodrick-Prescott filter with $\lambda = 6.25$.

Source: ILO, *Trends econometric models*, October 2011; World Bank, *World Development Indicators*, 2011.

Figure 5. Changes in investment shares and global productivity growth (2000–10)



Note: Values for 2011 are forecasts.

Source: ILO *Trends econometric models*, October 2011; World Bank, *World Development Indicators*, 2011.

have been maturing (Eichengreen et al., 2011) and services-sector dominated advanced economies have faced difficulties in keeping technological progress at a constant high speed.

The slowdown in productivity trends and the expectation of lower rates of capital returns will weigh on capital outlays and is likely to delay any return to the investment growth seen prior to the crisis. On the one hand, lower productivity growth rates decrease expected rates of return, thereby weighing on asset prices and hence investment (see Cochrane, 1991, 2008). On the other hand, lower productivity growth might also limit the available cash flow to enterprises, thereby reducing the capacity of firms to invest. Together, these trends will reduce the economy's potential to increase its capital stock and to recover from the loss in wealth incurred during the crisis. This in turn will further weigh on future expected productivity increases, running the risk of creating a downward spiral towards permanently lower rates of trend growth (see the tight link between productivity growth and investment in figure 5).

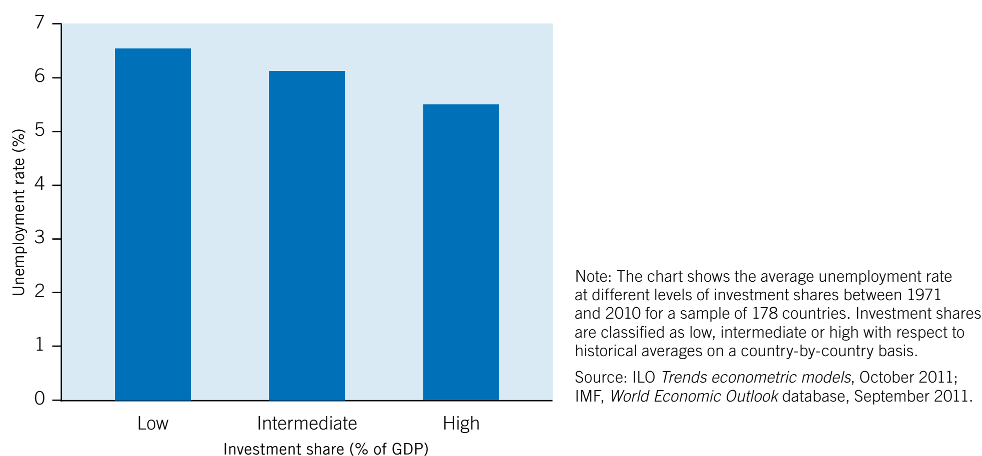
Recovery in investment has been sluggish, especially in advanced economies

Indeed, investment has already taken a large hit, both from the crisis and from unfavourable structural developments. Even though, investment managed to recover somewhat, but unequally across the globe. In advanced economies as well as eastern Europe, the unresolved financial sector problems, high levels of uncertainty regarding global prospects and the lower propensity of households to consume have slowed the recovery in corporate investment. With the onset of the crisis, business investment declined to historically low levels, often leading to net destruction of the capital stock, with particularly adverse effects on job creation. Given the slow recovery in investment, job creation has not resumed in these economies. Conversely, emerging economies, on the back of their strong overall performance, have already returned to pre-crisis investment rates and are expected to exceed them over the medium term.

This slowdown in investment bodes ill for stronger job creation in advanced economies, given the strong links between the two in the past. Indeed, in the past only strong investment growth – more than the expansion of production – was a precondition for reduced unemployment rates (see figure 6).[3] In addition, the employment intensity of investment has been depressed in the current macroeconomic environment, indicating that even faster investment

[3] For a detailed analysis of the impact of the observed slowdown in investment on employment dynamics, see IILS (2011), Chapter 2.

Figure 6. Investment and global unemployment



Note: The chart shows the average unemployment rate at different levels of investment shares between 1971 and 2010 for a sample of 178 countries. Investment shares are classified as low, intermediate or high with respect to historical averages on a country-by-country basis.

Source: ILO *Trends econometric models*, October 2011; IMF, *World Economic Outlook* database, September 2011.

growth than in the past is required to bring unemployment down. Indeed, as the crisis has led to substantial capital scrapping and re-evaluation of existing capital stocks, the threshold for investment growth necessary for job creation is likely to be higher than before the crisis, and investment rates need to surpass pre-crisis levels to absorb unemployment (Zoega, 2010). Moreover, investment in some emerging economies has not been as job-rich as in the past, so the current acceleration is not expected to add many new jobs and so will not bring down global unemployment.

World trade slowed, but has shown some recovery

World trade is central for a continuous, broad-based recovery in employment. At the height of the crisis in 2009, faltering international trade caused substantial adverse spillover effects, spreading crisis conditions to countries across the globe irrespective of their financial sector situation. At the same time, once uncertainty dissipated, the strong recovery of trade also supported the global revival of economic activity and employment growth experienced between the second half of 2009 and the beginning of 2011. Going forward, open world markets, and especially the capacity for emerging economies to market their products in more advanced economies, remain essential for preventing a more substantial deterioration of what is already a bleak situation. In addition, growing trade among emerging countries has contributed to a gradual decoupling of economies and the emergence of new centres of growth, which have the potential to stabilize global growth and prevent a more severe double-dip recession.

Indeed, world trade has helped to allow new growth drivers to enter the recovery process. Prior to the crisis, global growth had chiefly been driven by advanced economies (see table 2), as strong private consumption in major developed countries, such as the United States, France and Japan, had helped to absorb commodities and goods produced in the emerging world. With the onset of the crisis and in the following recovery, the sources of global growth have changed and partly moved to the emerging world. This indicates a major shift, not only regarding the sources of global growth, but also in the direction of world trade, and is likely to have long-term effects on the economic structure, in particular of advanced economies. As a matter of fact, countries that were running large current account deficits prior to the crisis – such as the United States and Spain – managed to regain some competitiveness and allow a stronger role for manufacturing trade in their recovery. Overall, this shift of growth and trade allowed at least a temporary reduction in the global imbalances that were at the origin of the global crisis.

World trade has already started to slow after the quick and strong recovery in 2010. On the back of lower consumption growth, in particular in advanced economies, world trade growth almost halved. However, the emergence of new centres of global growth among

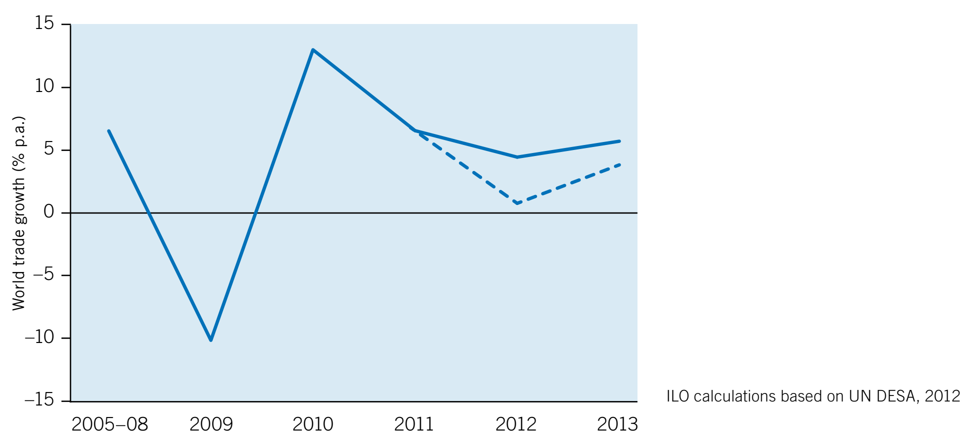
Table 2. Patterns of global growth

Was driven by	Growth in: Brazil	China	France	Japan	USA	Brazil	China	France	Japan	USA
	Prior to the crisis					After the crisis				
Brazil	–		No	No	No	–		No[(a)]	No	Yes[(b)]
China		–	No[(c)]	No	No		–	Yes[(c)]	No	No
France	Yes	Yes	–			No	No	–		
Japan	Yes[(b)]	Yes[(b)]		–		No	No		–	
USA	Yes	Yes			–	No	No			–

Note: The period "prior to the crisis" refers to the years 1998-2008, the one "after the crisis" to 2009–2010. The table presents summary evidence on the cross-country interactions between quarterly GDP growth rates using Granger causality tests. Reported test results are significant at 5% level. All growth rates were filtered using the Hodrick-Prescott decomposition prior to testing. For details on the methodology, see Ballon and Ernst (forthcoming). (a) Although it is not possible to reject the null hypothesis the test shows a decrease of 66% of the probability value associated with the test. This might indicate a switch of Granger causality between Brazil and France. (b) The null hypothesis is rejected at the 10% level. (c) Tests are for: 1993 to 2009Q1, and 2009Q2 to 2010Q4, respectively.

Source: ILO estimates based on EIU quarterly GDP data.

Figure 7. World trade growth: Baseline and downward scenario projections



ILO calculations based on UN DESA, 2012.

developing economies managed to keep world trade growing close to its historical average. Given the recurrent problems in advanced economies, a further slowdown is to be expected followed by a moderate rebound in 2013 (see figure 7).

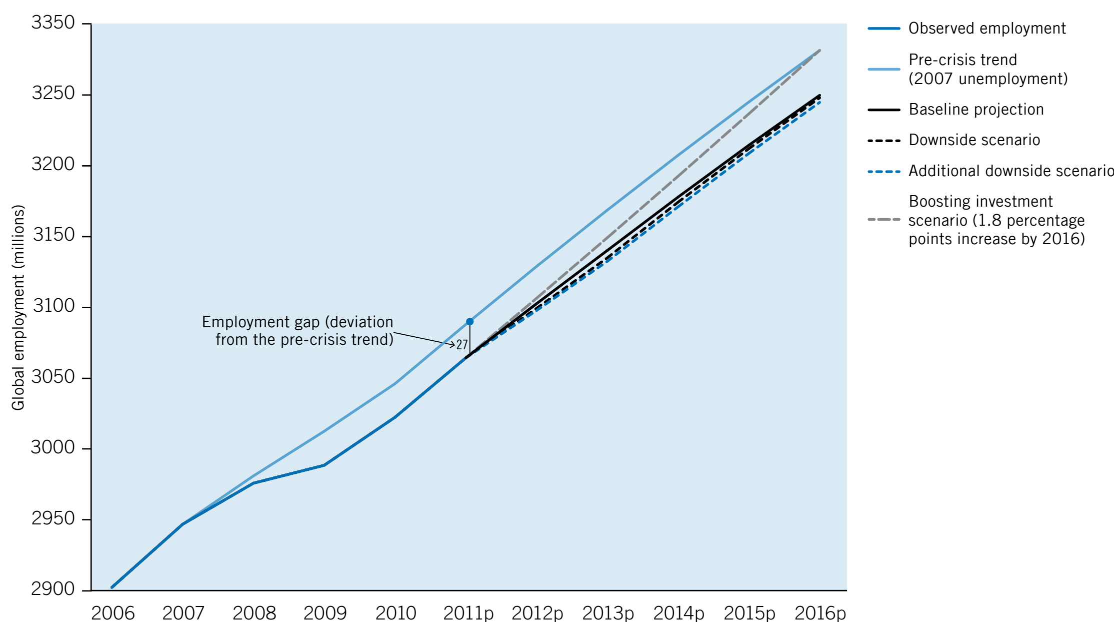
Scenarios and policy responses

The ILO's central projection foresees gradual slowdown in activity and flat unemployment

In our baseline scenario, employment growth rates are expected to remain subdued for several years. Against the background of high uncertainty and adverse long-term trends, investment is likely to remain subdued for a prolonged period, preventing a fast recovery in employment Rather, the slowdown in growth and the structural difficulties will lead to a further opening of the jobs gap, although without necessarily increasing the global unemployment rate. Part of the additional potential workforce will stay outside the labour market, thereby increasing the pool of discouraged workers. In countries without well-developed social security systems, people will increasingly be forced into low-quality, informal sector jobs to earn a living.

Going forward, this scenario implies a substantial drag not only on employment but also on income and, particularly, on wages. Disposable income will be under pressure both from higher

Figure 8. Global employment trends: Different scenarios



Source: ILO staff calculations based on ILO, *Trends econometric models*, October 2011; IMF, *World Economic Outlook*, September 2011.

taxation and lower public spending as governments aim to restore sound fiscal policies. At the same time, slow employment growth offers little opportunity for increased wages. Finally, at the current juncture, with strong liquidity creation but without much channelling through to the real economy, further hikes in asset and commodity prices can be expected, fuelling global inflation and lowering real wages across the world. The unemployment rate is expected to decline only gradually, with the number of jobseekers increasing globally, in line with the continuous growth of the labour force (see baseline projection, short-dashed line, in figure 8).

The situation could deteriorate substantially if sovereign debt problems spill over to private credit

The situation would substantially deteriorate if current turbulence in sovereign debt markets is not adequately addressed. In this situation, partial or full sovereign defaults, or even only a continuous transfer of funds, is likely to spill over into the banking sector, leading to substantial stress there and the possibility of bankruptcies of major European banks. The heightened uncertainty will also affect global capital flows and business sentiment again, with strong adverse effects on world trade (see figure 7). Such a disruption in economic activity together with very tight policy space could lead to a downward spiral in economic activity and the possibility of deflationary pressures, which would put off any recovery until well into 2013. Unemployment would take a further hit, adding an additional 1 million jobseekers globally over the next two years (see downside scenario, grey dashed-line, in figure 8).

A quick clean-up of the banking sector would speed up investment and job creation

Prospects for employment creation could improve substantially if current problems in the financial sector could be properly addressed. In particular, a quick implementation of financial sector reforms and the setting up of an operational framework that encompasses both domestic and international financial market reforms would substantially help in reducing

financial market volatility and stimulating employment growth. At the same time, a credible announcement of medium-term fiscal policy reforms, in particular in those countries where sovereign debt has reached critical levels, would ease market uncertainty and lower risk premia and interest rates. This, in turn, could contribute to a more rapid normalization of central bank activities, which would help restore confidence in the stability of the banking sector and lead a return to more normal lending conditions.

Under such a scenario, investment growth could resume more strongly, helping to accelerate job creation. To the extent that global investment shares increase by an additional 2 percentage points up to 2016, this would close the employment gap that was opened by the crisis and allow unemployment to decline to levels seen prior to the crisis (see boosting investment scenario, long dashed line, in figure 8). Unemployment rates would trend downward – instead of the current stagnation – and could reach pre-crisis levels before the end of 2013. At the same time, with most unemployed people looking for jobs in advanced economies, this reduction would lead to a substantial expansion of gainful employment and an ensuing increase in market incomes and aggregate demand, providing further stimulus to the global recovery. At the current juncture, however, such a scenario has only a slim chance of materializing.