EMPLOYMENT AND REAL MACROECONOMIC STABILITY: THE REGRESSIVE ROLE OF FINANCIAL FLOWS IN LATIN AMERICA

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Abstract. *The author examines economic reforms carried out in Latin America since the 1990s. Price stabilization was achieved, but there has been insufficient growth and economic instability has been detrimental to productive investment and employment. Frequent crises have had a severe recessionary effect and have discouraged capital formation and the creation of decent jobs. Financial capital flows were the chief causes of this general economic situation. A positive recovery in 2010 resumed the climb towards progress begun in the 2004–08 period, but still high levels of precarious employment and serious deficiencies in macroeconomic policy prevail.*

Precarious employment has long been a feature of Latin American societies. Although progress has been made in reducing poverty since the 1990s, there is yet to be a sustained and robust move towards a situation in which more stable jobs predominate and workers have social protection, are organized and can engage in collective bargaining, in keeping with the decent work concept of the International Labour Organization (ILO).

The countries of Latin America undertook sweeping economic reforms in the context of what is known as the Washington Consensus − including far-reaching trade and financial liberalization, privatization, and the introduction of fiscal discipline − in the belief that this would ensure stability and economic growth. Employment and equity, it was supposed, would improve markedly. The reality is that the past 20 years have seen price stability (inflation has generally been kept under control), but also low GDP growth and instability in the real economy, i.e. in output and employment. The significant progress made during the recent period of economic and social recovery (2004–08) notwithstanding, precarious employment was an acute reality even before the contagion of the global financial crisis; the contagion of

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course aggravated the problems.[1] The positive recovery begun in 2010 resumed the progress achieved during the 2004–08 period, but was accompanied by high levels of precarious employment and severe failures of macroeconomic policy and sustainability.

As work on this article was finishing, by mid-2011, the Latin American region was still in the ascending part of the cycle, notably as regards countries exporting natural resources, i.e. those able to enjoy very high prices (ECLAC, 2011). This has enabled a rise in employment, the formal sector, wages and GDP, but production capacity has only slightly improved. In the mean time, exchange rates have started to appreciate once more and real imports to increase (in volume) significantly faster than real exports (in volume). This can be kept up only if export prices are maintained at a substantially higher level than their average historical level.

A commonly held view (repeatedly expressed in evaluations of the reforms carried out) is that the region dealt efficiently with the macroeconomic challenge it faced but failed at some of its microeconomic tasks; those who implemented the Washington Consensus point to lack of action on "labour flexibility". Others, for example, stress the lack of productive development policies and the weakened collective bargaining strength of workers in the face of their employers, both problems aggravated by the Washington Consensus reforms. This article focuses on the macroeconomic issue, and contends that, contrary to the commonly held belief in the effectiveness of macroeconomic policy, it falls short in a way that played a decisive role in the disappointing performance of the economy and employment in recent decades. This is based on the observation that production and employment have been subjected to cyclical fluctuations in economic activity, domestic demand, access to credit and exchange rates. These are key macroeconomic variables, i.e. the general environment in which the producers of goods and services operate, and these variables' volatility has discouraged capital formation, employment and productivity in the economy as a whole, a handicap in which financial capital flows have played a crucial role, as have recent marked fluctuations in the terms of trade.

The macroeconomic environment results, for the most part, from the effects of and the relation between fiscal, monetary and exchange-rate policies, the domestic capital market and the external capital account. This in turn affects the pace and stability of economic growth, influencing the distribution of the fruits of production through its impact on the labour market and the strength of social policies. It is striking how the design and evaluation of

[1] This explains why the Global Jobs Pact was adopted at the 98th Session of the International Labour Conference, in June 2009 (ILO, 2009), and why the G-20, meeting at the Pittsburgh Summit the same year, committed to "Putting Quality Jobs at the Heart of Recovery".

macroeconomic policies have become increasingly dissociated from their effects on employment and growth, instead focusing excessively on controlling inflation and its short-term effects. This has meant an imbalance between objectives just when efficiency required the opposite: an appropriate balance between objectives and the necessary adaptation and coordination of the means for achieving them.

It is argued here that the time has come to move from the strong "financierist" and short-term bias of the macroeconomic approach imposed by the Washington Consensus to one in which the stated priority is the effect of policies on productive development, employment and equity. It is emphasized that the generation of more and better jobs is key to achieving a gradual reduction in the stark inequalities observed in markets and society. Explanations are given for why and how macroeconomic policy has to pay explicit attention to the different effects various policies have on large and small companies, on investment and consumption, on skilled and unskilled workers. Policy gradualism and the quality of coordination between the monetary, exchange-rate, financial and fiscal aspects, for example, make a substantial difference to economic growth and its distributional effects, notably on the level and quality of employment. The contrast between the notorious harshness of free-market reform and the disappointing results it obtains confirms the validity of the analyses set out below.[2]

The first part of this article sums up the main successes and failures of Latin America since the early 1990s, emphasizing changes in production and in the labour market situation. The second section documents the deeply unstable nature of the real economy and its relation to the extreme fluctuations in domestic demand and exchange rates faced by the various agents of production. Damaging instability is shown to stem chiefly from the globalization of volatility, with recurrent external shocks on financial capital flows. The third section examines the recessionary and regressive effects of that instability, considering the dynamic consequences of frequent recessions on productive investment[3] and the sources of jobs. The fourth section outlines the exchange-rate and financial ingredients needed for the macroeconomy to contribute to decent work. The fifth section concludes.

The central message is the need for major corrective action on the macroeconomic environment and on financial reform so as to stimulate capital formation, reduce structural

[2] For an analysis of the macroeconomic, trade and financial reforms implemented in Latin America within the framework of the Washington Consensus and their effects, see Ffrench-Davis (2006).

[3] We use the expression "productive investment", that is that which creates new productive capacity to differentiate from financial investment that deals with existing assets.

heterogeneity, both among workers and among entrepreneurs, and contribute to the dynamic creation of more and better jobs.

I. Macroeconomic reforms since the 1990s

1. Successes and failures from the point of view of stability and growth

In the decades leading up to the reforms of the so-called Washington Consensus, many Latin American countries suffered steep inflation, often as a result of huge fiscal imbalances financed by money printing by the central banks. As a result, aggregate demand far outpaced production capacity. In addition, external shocks caused by fluctuating terms of trade meant there were frequent highs and lows in the availability of foreign currencies.

Given the sources of that macroeconomic instability, the reforms of the 1990s prioritized the anti-inflation struggle and the imposition of fiscal discipline. One tactic was to insulate monetary management from certain pressures and to direct it as a priority to fighting inflation. This meant that in many cases the central banks ran monetary policy independently of other areas of macroeconomic policy and focused on controlling inflation, without considering its links to other basic development objectives.

By the mid-1990s, inflation had been curbed, an achievement that was associated to a substantial improvement in fiscal balances. Indeed, in the five-year period preceding contagion by the 1998 Asian crisis, the fiscal deficit averaged only 1.5 per cent of GDP, a marked improvement over the 3.9 per cent average recorded in the 1980s. For its part, money printing to finance the public deficit had practically stopped.

Events during the upturn begun in 2003 are particularly noteworthy. A significant improvement in tax revenues enabled much increased social spending and a reduction in the public debt, along with a sound fiscal balance. Thanks to those improvements and their positive countercyclical impact, when the global crisis hit, various Latin American countries had public resources they could put to timely use and/or had regained access to credit. In 2008 and 2009 they were therefore able to implement countercyclical policies to mitigate the recessionary and regressive impact of the financial crisis (ECLAC, 2010a, chapter 2).

Clearly, most Latin American countries met the Washington Consensus requirements for macroeconomic balance. However, the results in terms of the level and stability of economic growth and social equity were very poor, despite the significant recovery in economic activity observed between 2004 and 2008, and without even taking the 2009 dip into consideration. Indeed, as shown in table 1, annual GDP growth averaged barely 3.2 per cent between 1990 and 2008. To study its movements, we divided that period in two: 1990–97 (up to the outbreak of the Asian crisis) and 1998–2008 (until the contagion of the global crisis). Growth rates are very similar for both periods.[4] Table 1 also shows changes in product per member of the labour force.[5] During that 20-year period the labour force increased by 2.6 per cent annually, whereas GDP per worker grew by a mere 0.6 per cent each year.

Table 1

This meagre growth rate explains why, for example, per capita GDP in the G-7 countries is still almost four times that in Latin American countries.[6] In turn, a marked income disparity persists, as the ratio between highest and lowest income quintiles (Q5/Q1) of Latin American countries is over twice that of the G-7. Consequently, the region continues to lag well behind in the global context (World Bank, 2005) and this is clearly related to production structures. Indeed, the marked structural heterogeneity between different-sized companies and between workers with various skill levels implies lasting inequalities in the corresponding functioning of markets.[7] Robust growth requires greater productivity by workers at the bottom of the income scale, which will then enhance the employability of the poor and the middle classes. In the current situation in Latin America, there is plenty of scope for complementarity between policies that stimulate growth and reduced labour market inequality (Bourguignon and Walton, 2007; Ffrench-Davis, 2010a, chapter 7).

For example, training for workers and owners of small businesses is fundamental to improving employability, distributing productivity and contributing to equitable growth. Current training programmes tend to be limited, and to have a regressive distributional effect, since it is easier to build up the professional skills of trained workers than of members of the labour force with little schooling.[8] It is therefore imperative to intensify public training efforts and to place them at the centre of state programmes, and to redefine priorities in this area. This is fertile ground for public-private cooperation involving trade unions, employers, regional and non-governmental organizations in national strategies to make up for

[4] It is typically argued that the poor results reflect the time the reforms took to have an impact. This is clearly true, but the results for the second decade are similar to those for the first; what is more, 20 years have elapsed – a long and costly gestation period for the positive effects finally taking shape.

[5] Usually, product worker is used. Here we use product per member of the labour force, on the grounds that an equitable economy should provide employment to all jobseekers, and that those who do not find work should receive unemployment benefit. Joblessness in excess of frictional unemployment is a loss of potential productivity.

[6] Figures adjusted for the different purchasing capacity (purchasing power parity – PPP) of one US dollar in each market. Expressed in current US dollars, the difference in average income between Latin American and G-7 countries is much higher than the difference in PPP.

[7] For an analysis of and empirical data on the marked structural heterogeneity now prevailing in the economies of Latin America and their distributional implications, see Infante (2011).

[8] For example, training programmes for young people reach and operate better among "integrated" young people than among those who are socially marginalized (Rodríguez, 2011). Information on Chile indicates that in the 2000s, 80 per cent of public funds for training were used by large companies (cited in Ffrench-Davis, 2010a, pp. 197–198).

shortcomings in education and to make progress in the ongoing process of adjusting skills to changing forms of production.

2. *Precarious jobs and stagnating incomes*

The labour market situation depends not only on employer demand but also on jobseeker supply. It is worth noting that between 1990 and 2008 there was an annual increase of 1.6 per cent in the population and of 2.6 per cent in the labour force. The resulting sharp decline in the number of dependants per person in employment and the number of members per household improved the dependency rate. This is the outcome of accelerated demographic change in the age pyramid of the population, and was compounded by the gradual increase in women's participation in the labour market. The combination of the two resulted in a demographic dividend, or bonus, for family well-being. In contrast, pressure on the labour market intensified with the substantial annual increase of 2.6 per cent in the number of jobseekers (softened to 2 per cent in 2004-2008 – see table 1).

The fact that more women were employed is reflected in a slow but steady rise in their labour participation rate, from 57 per cent in 1990 to 60 per cent around 2010. The upward trend tends to slow, everywhere in the region, in periods of recession and increased unemployment, as shown in table 2.

Table 2

At present, average real wages are slightly higher than before the debt crisis exploded, in the early 1980s. In other words, there has been no appreciable change in this indicator for 30 years. This social failure compared with other developing regions was no doubt offset, from the point of view of households, by the above-mentioned improvement in the dependency rate. ECLAC data show that in 2007 average real wages were barely 12 per cent above their depressed 1990 level (Weller, 2009, pp. 16–19). This represents an annual increase in line with the slight rise in GDP per labour force member of 0.6 per cent from 1990 to 2008 (see table 1), despite some increase in wages and employment between 2004 and 2010 that made up for the falls of previous years (see 1998–2003 in table 2). The same table shows that minimum real wages rose substantially between 2008 and 2010.

Of course, wages only reflect what is happening in the formal labour market. This is relevant because precarious employment in the region forced many workers into informal jobs during periods of recession. Between 1990 and 2005, the percentage of workers in the informal economy is reported to have risen from 57 to 63 per cent of non-agricultural employment (Tokman, 2009, table 2); precarious conditions affect not only those working in the informal sector, but also a certain fraction of employees of formal-sector companies, according to the ECLAC surveys consulted by the author. The same sources, based on household surveys, indicate that in 12 of the 16 countries considered, employment in "low-productivity" sectors increased between 1990 and 2002 (ECLAC, 2009). As a result, the extent of precarious employment is more serious than indicated by average wages in formal markets.

Nonetheless, the major recovery in employment and wages between 2003 and 2008 led to less inequality and greater formalization of employment. In those years, average regional unemployment dropped sharply (from 11 per cent in 2002 to 7 per cent in 2008) and wages, notably minimum wages, recovered to some extent (ECLAC, 2011; and table 2). As to the formalization of employment, after the setbacks recorded up to 2003, the following years saw an increase in the proportion of workers covered by social protection, notably wage-earners in micro-enterprises and self-employed workers (Weller, 2011). Despite this partial progress, income distribution was still highly uneven in 2008 (ECLAC, 2010b), before the global crisis struck accompanied by further recessive effects.

At that point, poverty and job precariousness worsened and the upturn ended abruptly in 2009, with drops in output and investment. That year, unemployment reached 8.1 per cent. Poverty had fallen steadily from 44 per cent of the population in 2002 to 33 per cent in 2008; instead of continuing to fall, it rose (slightly) in 2009. Something similar had happened during the preceding recessionary shock in 1999–2002, which confirms the regressive impact of recessions.

Instead of continuing to give way to more formal jobs, the informal sector recovered lost ground. Between 2007 and 2009–10, the percentage of (mostly "involuntarily") self-employed workers increased. A household survey conducted by the ILO in five countries (Colombia, Ecuador, Mexico, Panama and Peru) shows that the number of formal-sector jobs fell and the share of informal self-employed in the non-agricultural employed rose by almost 3 per cent.[9] Moreover, in recessionary periods, not only do open unemployment and informal-sector jobs increase, but participation in the labour force predictably slows; this may further skew estimates of the lack of jobs and the problem of job quality. Chilean data for recessionary situations since the 1980s support that view, albeit on a smaller scale when the

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[9] Between 2007 and 2010, their participation rose from 22 to 24.7 per cent; see ILO (2010, table 2), based on the ILO labour information system for the region (Quipustat). These figures correspond to the weighted average for the five countries; the trend in Ecuador differed from that in the other four countries, owing to intense efforts to formalize a notoriously informal market, e.g. concerning labour and tax issues. The ILO survey shows that formal-sector employment in Ecuador rose from 35 to 45 per cent of wage-earners between 2007 and 2010.

recessions are brief, as in 2009. Indeed, the labour force participation rate fell by an average of 2.2 per cent in 2001-2003 (a long recession) and by only 0.6 per cent in 2009.[10]

II. The globalization of financial volatility – the main source of instability in the real economy

Weak growth is closely associated with instability in the variables which determine the real economy: the global demand faced by producers of goods and services (GDP), macro prices (exchange rates and interest rates), and the availability and cost of credit. These variables are key ingredients in the macroeconomic (im)balances faced by workers and entrepreneurs. This is because the real economy (that is where GDP is produced) adjusts to fluctuations in demand; sharp drops in demand may ease inflationary pressure but will also force production and employment downwards. Clearly, the evident success in controlling inflation and improving fiscal responsibility did not alone suffice to stabilize the real economy (Ffrench-Davis, 2006, chapters II and III; Ocampo, 2011).

Figure 1 shows changes in aggregate demand and demonstrates that this macroeconomic variable, a main determinant of the production of goods and services and therefore of employment, behaved like a roller coaster. What entrepreneur would feel comfortable producing on a roller coaster?

Figure 1

Clearly, fluctuations in demand are rapidly followed by fluctuations in effective GDP. In situations of rising demand, an increase in GDP is possible **only** if the economy was operating below production capacity, or potential GDP, i.e. if there was what is commonly known as an output or recessive gap (Ffrench-Davis, 2010b). Given the natural asymmetry of fluctuations around potential GDP (drops can be very steep while significantly exceeding maximum capacity is not viable), in recurrent stop-go conditions, **unstable aggregate demand inevitably gives rise to an average net utilization rate that is lower than production capacity**; consequently, actual productivity falls short of its potential, by comparison with a situation of stable proximity to the production frontier (ECLAC, 2010a, chapter 2).

The conclusion to be drawn from the data in figure 1 is that the region has often operated significantly below the production frontier, with substantial upswings and downturns pulling it closer to, or distancing it further from, potential GDP, but without holding steady to

[10] Estimates based on data from the National Institute of Statistics on trend growth in the labour force participation rate, chiefly because of women's growing participation rate.

it, as required by a balanced real economy. Frequently operating under potential output by definition leads to underemployment of capital and labour and to falling fiscal revenues. As is explained in the third section, it also discourages productive investment and, given the strong structural heterogeneity between the various agents generating GDP, tends to undermine job quality.

What causes the fluctuations in aggregate demand that lead to production instability and precarious employment?

The strongest determinant of these macroeconomic fluctuations, which generated recessive gaps between available production capacity and the use made of it during much of the 1990–2009 period, has been cyclical variations in incoming and outgoing capital flows. Those variations have tended to launch upswings (as in 1990, 1996 and 2000) and recessions (as in 1995, 1998 and 2009). Their effect is heightened by fluctuations in the terms of trade, which improved markedly as of 2003, only to fall in 2009 and subsequently to recover. Downward or upward shifts in those two variables have subsequently tended to be *endogeneized* by pro-cyclical domestic policies that reinforce them. An external shock indicator that measures the annual variation in financing stemming from: (i) external capital flows; (ii) profit remittances; (iii) migrant remittances; and (iv) variations in terms-of-trade effects, all expressed as percentages of GDP appears to be strong determinants of changes in aggregate demand (see Ffrench-Davis, 2008). Besides having diverse effects (for example, some are loans subject to amortization and interest payments and others are unrequitable remittances), these four variables affect spending capacity in the national economy: a positive variation leads to a direct increase in domestic spending; additionally, it can have indirect multiplier effects through macroeconomic policies.

As indicated, the rise and fall in demand between 1990 and 2010 tended to be spearheaded by such external shocks in most Latin American countries, displacing the imbalances that had a domestic origin and tended to predominate in the launch of cycles in earlier decades. The multiplier, procyclical effect may be observed in figure 2, where the upswings initiated by positive external shocks are followed by greater increases in domestic demand, and vice versa for recessionary downturns (Kaminsky, Reinhart and Vegh, 2004; Ocampo, 2007).

Since the expanding adjustment processes of 1990, 1996 and 2004 started from recessive situations, the initial recovery of domestic demand involved a move toward equilibrium in employment, production, imports, tax revenues, exchange rates and stock prices. In all three instances, however, the process fell wide of the mark, overshooting, with excessive exchange rate appreciations and external deficits, paving the way for recessionary downturns (Ffrench-Davis, 2006, chapter VII; and 2010b).

The more varied nature of the capital account in this era of financial globalization makes it imperative to distinguish between the behaviour of its various components. Greenfield foreign investment (creating new production capacity) and the long-term credit associated with imported capital goods remain relatively stable throughout the cycle and are indissolubly linked to productive investment (gross fixed capital formation, or GFCF); they therefore tend to imply higher employment. In contrast, financial and stock market flows show greater procyclical volatility, and have thereby contributed little to the financing of gross fixed capital formation (Uthoff and Titelman, 1998); these are two negative attributes. Something similar happened with inflows from the sale of national firms to foreigners (also a part of foreign direct investment), funds which in recessions tend to emigrate abroad. In fact, financial flows to and from the region, instead of stabilizing the macroeconomy, have tended to destabilize it.

Thus, during upswings the emerging economies reach “vulnerability zones”, experiencing distortions in macro variables with regard to levels that are “sustainable” in the medium term: real exchange rate, external liabilities and short-term components, currency mismatches (holding assets in one currency and liabilities in another), current account deficit, stock market indices, real estate prices, etc. This highlights the need for effective countercyclical regulation to ensure that capital flows strengthen productive investment and are consistent with a sustainable macroeconomic environment. The composition, level and deviations from the trend in the volume of financial flows are crucial variables. The relevance of countercyclical regulation for equity and employment stems from the differing capacity for action and reaction of typical agents in diverse markets, as is explained in part 3.

Capital flows have also been a source of instability for the real exchange rate (RER), one the variables most influencing economic agent decisions between production and consumption, and with regard to the composition of each, notably between products that are or are not tradable internationally. Figure 2 shows the strong correlation between the region’s average RER and net capital inflows between 1987 and 2010, and demonstrates that the RER behaved extremely procyclically in a manner closely bound to the cyclical nature of capital flows. Indeed, increased financial capital revenues have tended to result in strong currency appreciations that have repeatedly had a destabilizing effect on the current account (they tend to overshoot); in times of crisis, however, they experience strong devaluations. This makes the RER highly inefficient when it comes to export quality and the output of small- and medium-sized enterprises (SMEs) for the domestic market.

Figure 2

In short, fluctuations in aggregate demand, its composition and the exchange rate have been excessively influenced by the capital account and its financial flows. The transmission of its procyclicity to national economies has undermined productive development, job creation and employment stability.

III. Why recessionary instability is also regressive and depressionary[11]

The labour market situation is the most influential variable when it comes to income distribution, especially in economies with modest levels of social expenditure (the norm in this region of low tax burdens).

Instability in domestic demand and in the exchange rate has both static and dynamic effects on employment. One static effect is the utilization rate of available productive capacity; an explanation was given above of how fluctuations in the rate have caused substantial recurrent gaps between installed capacity or potential GDP (GDP*) and actual GDP. Such gaps and the volatility of variables such as the RER have profound dynamic effects on: (i) the investment ratio and its impact on the trend for future economic growth; (ii) the amount of value-added generated by exports and their interrelation with the rest of domestic production; (iii) the development of SMEs competing with imports; and (iv) the degree of formality or precariousness of the labour market.

1. Why is instability in the real economy regressive?

Instability in the real macroeconomy and inequality are linked because of the widespread structural heterogeneity characterizing developing economies. Reference is made here to the differing capacity for action and reaction of typical agents in diverse markets, such as: large- and small-scale entrepreneurs; highly skilled and unskilled workers; productive investors and financial investors or purchasers of existing assets; productive investors and consumers; great mobility of financial capital and highly skilled labour, contrasting with the limited mobility of physical capital and unskilled labour. The asymmetries resulting from this heterogeneity are intensified by unstable economic activity and “macro prices”. For example, during peak financial inflows, a substantial part thereof is consumed because consumption responds more rapidly than productive investment; if those flows are accompanied by currency appreciations, as they often are, the tendency to import consumer goods is heightened.

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[11] For further analysis, see Ffrench-Davis (2010b), section 5.

This means that after the peak, liabilities are left without a countervailing payment capacity; the usual change in expectations, reversal of flows and abrupt devaluations lead to a downswing, with drops in domestic demand exerting a downward pull on production, employment and fiscal revenues. This is compounded by the very limited impact of social protection institutions, which have little countercyclical and progressive capacity to transfer income at times of crisis, whether for purposes of reintegration into the labour market, training or compensation for lost earnings (ILO/ECLAC, 2011).

A distinction must be made between production for external markets and the rest of GDP, i.e. that which remains in the domestic market. For example, between the average Latin American GDP growth of 1990-1997 and 1998-2003, 90 per cent of the change (annual average fall of 1.9 points in the growth rate) was concentrated in production for the domestic market (Ffrench-Davis, 2006, chapter 4). This indicates that actual instability was mostly located in national markets, which depend on the local macroeconomy. It is in those markets that SMEs and the informal sector operate, their role in exports being negligible.

In short, real instability is asymmetrical and inevitably implies under-use of potential productivity, lower actual output and fewer jobs compared with situations of stability in the real economy. Indeed, higher rates of capital use imply that the average employment level is higher and that the labour force combines with a greater use of physical capital. The consequent rise in actual productivity means that the well-being of workers and investors (wages and profits) is improved thanks to better use of capacity; this occurred progressively to a significant extent during the 2004–08 recovery.

2. *Real instability, productive investment and employment*

The dynamism of GDP and employment depends, to a large degree on the investment ratio (the additions to the stock of capital made by nationals and foreigners on the national territory, as a proportion of GDP). The investment or formation of capital itself generates new jobs, and subsequently its addition to the stock of capital also tends to provide permanent jobs because of the greater production of goods and services which it underpins. The higher the investment (and therefore the stock of capital), the more likely an increase in the number and quality of jobs.

Spending on equipment and machinery, on building housing and business premises, and on infrastructure − which constitute investment in fixed capital, or GFCF − was notoriously low during most of the years the Washington Consensus prevailed (see table 3). Indeed, the investment ratio was closer to the low level recorded in the lost decade of the 1980s than to the 1970s' level (when GDP grew by an average of 5.6 per cent in Latin

America). The capital stock/labour force co-efficient is closely related to the level of per capita GDP, average wages and, probably, their distribution (Ffrench-Davis, 2006, chapter II).

Table 3

There is a nexus between low investment and instability of domestic demand. The greater the instability, the greater the recessive output gap, which depresses productive investment and tends to result in a more precarious labour market with greater informality (Weller, 2009).

Indeed, higher utilization rates for potential GDP and the consequent increase in average actual output tend to stimulate investment in new capacity. The dynamic effect will be more significant if the economic agents have solid expectations that public policy will maintain effective demand close to the production frontier. Moreover, this positive effect is reinforced if the authorities enact reforms to supplement long-term capital markets, improve training for the labour force and encourage innovation and productive development.[12]

The longer and more robust the economic recovery, the higher the ratio. This is not just common sense – two examples will serve to illustrate. Between 1990 and 1998, Chile, whose economy had been functioning on the productive frontier for almost ten years, raised its investment ratio by five GDP points in 1990–95 and by nine points in 1996–98, with respect to the 1974–89 average (Ffrench-Davis, 2010a, p. 233). In 2005–08, Latin America, for its part, achieved its highest investment ratio since the 1970s, exceeding the 2000–04 average rate by three GDP points; then took place a continued and vigorous regional recovery, with marked increases in the capacity utilization rate (Ffrench-Davis, 2010b, figure 1).

The explanation for this effect is that, as the economy moves towards full capacity, actual output rises, corporate profits and liquidity go up and expectations improve: in turn, potential investors react positively, but their new investments take time to mature because materializing a productive investment usually takes longer than buying an apple or a car.

Unfortunately, since the 1970s, the region has not managed to sustain prolonged processes of production close to GDP*. The usual outcome is that high underutilization rates prevail, a result of the real macroeconomic instability generated by volatile capital flows and procyclical macroeconomic policies. This prevents GFCF from reaching “cruising speed”.

In contrast to Latin America, several Asian countries have had notably higher investment ratios. For example, the Republic of Korea was investing roughly one third of its GDP (with GDP growth of 7–8 per cent for 30 years and generation of full employment),

[12] For example, cluster-based productive development policies can be highly appropriate.

compared with less than one fifth of GDP in Latin America. This poor result can be attributed not just to shortcomings in the required development policies, but also to the above-mentioned macroeconomic failures and the nature (*financieristic* rather than *productivistic*) of the capital market reforms introduced by the Washington Consensus.

3. *Financial flows, exchange rate instability and employment*

The region's RERs have been highly unstable, with strong cyclical fluctuations. This has harmed export development, its diversification and the degree to which the export effort has been integrated into national economies (Agosin, 2007; Rodrik, 2008; Williamson, 2000).

Certainly, such highly volatile rates do not reflect equally changing levels of "sustainable equilibrium". Exchange rate levels are "sustainable" provided they respond to changes in relative productivity among Latin American countries and their business associates. "Structural" variables such as relative productivity tend to change gradually over time rather than shift abruptly. In the case of the Latin American countries, this refers to export productivity (especially of the non-traditional variety) and the productivity of import substitutes (especially production by SMEs). Consequently, employment in those sectors is at risk when the exchange rate overappreciates, because of a temporary inflow of financial capital or a temporary increase in the prices of primary exports. What is "temporary" can sometimes last several years, potentially worsening the resource allocation brought on by misaligned or overappreciated exchange rates. The situation can go into reverse very suddenly, causing a maxi-devaluation and steep drops in domestic demand that destroy jobs and SMEs (Frenkel and Ros, 2006).

The highly cyclical changes in the RER of many countries have distorted investment decisions. While it is true that, during upturns in economic activity with exchange-rate appreciation, cheap foreign currency offers an opportunity to import equipment and machinery at lower cost, by the very nature of such flows (which as already pointed out are channelled towards speculative rather than productive investment) tend to generate excesses in luxury construction and to create jobs in the marketing of imports that will not be sustainable when steps are taken to correct an ever-larger external deficit. On the other hand, they artificially crowd-out production of importable tradables that compete with imports (many produced by SMEs, as indicated), and discourage diversification toward non-traditional areas with higher value-added and the addition of value to traditional exports. That outcome has a negative impact on sustainable employment and job quality. Diversification and the addition of value-added are required if exports are to "drive or pull national development", while dynamic SMEs are key to equitable growth.

The decision not to regulate the exchange rate, which is implicit in allowing it to float free of intervention by the economic authorities, is diametrically opposed to an export-driven development strategy aimed at generating growing competitivity in the domestic economy as a whole (systemic competitivity). Intervening in situations of extreme misalignment, as various Latin American countries recently did, is a progress (examples are Brazil and Peru[13]), but the point is to intervene systematically and in timely fashion in order to avoid serious misalignments and thereby deep exchange-rate uncertainty for the producers of tradables.

Major upswings and downturns in economic activity caused by unstable aggregate demand and exchange rate instability naturally affect the level of employment, job formality, the nature of employment contracts and wage trends. Given the structural heterogeneity of our markets, instability in the real macroeconomy has a distinctly regressive effect on income distribution and job quality.

IV. Ingredients for a macroeconomics conducive to decent work

Faced with evidence that the regressive impact on employment is closely related to financial capital flows and their volatility, how can these shortcomings in macroeconomic policies affecting job sources and development dynamics be corrected?

External savings are needed to supplement national savings, in order to finance an increase in the investment ratio and access to innovation. An “all-or-nothing” approach to the capital account is therefore ill-founded. A fundamental objective of macroeconomic policies, and of national financial market reform, should be to establish how to develop national development by taking advantage of the potential benefits of foreign savings, while simultaneously lessening the intensity of capital account cycles and their unfavourable effects on national economic and social variables.

A coherent series of countercyclical policies − fiscal, monetary, exchange rate, domestic financial market and, inevitably, capital account regulation − is therefore essential. It must be accompanied by efforts to “supplement” capital markets with the establishment of robust, inclusive long-term funding segments. All these macroeconomic policies must be efficiently coordinated – there is no room for independence in this respect. Spreading the adjustment effort among the various policies tends to have better macroeconomic results, in terms of macro prices well-aligned on sustainable levels and an actual GDP closer to its potential level.

[13] See Carvalho and Pires de Souza (2010) on Brazil, and Dancourt and Jiménez (2010) on Peru.

The various macroeconomic policies have been analysed elsewhere (Ffrench-Davis, 2006, chapter II, and 2010b). Here the focus narrows to a brief discussion of capital flows, their connections with the domestic capital market and their influence on policy space for exchange-rate policy.

Two aspects of the region's economies are relevant here. First, the strikingly incomplete nature of capital markets, with weak or non-existent segments. The distributional and resource-allocation impact of this capital market failure is exacerbated by the strong structural heterogeneity existing between the various economic agents, to the detriment of SMEs, self-employed workers, innovation and agents with limited assets.

The domestic capital market reforms of the Washington Consensus undermined development banking and the long-term segment essential for productive development (ECLAC, 2010a, chapter 2). They run counter to the recommendations emanating from the Monterrey Consensus (United Nations, 2007), which advocates increased resources for economic and social development that are effectively inclusive and countercyclical to the functioning of the international and domestic capital markets.

Reorganization of the national financial system should aim to channel resources towards savings and productive investment, generating sustainable jobs. This requires a powerful development banking, that comprises a robust long-term segment able to direct savings towards productive investment funding, including the creation of instruments allowing the most vulnerable to have access to financing, and covering segments that are either weak or non-existent today (SMEs, "microenterprises", entrepreneurs with little experience or capital, innovation, training), and prudential and countercyclical regulation of the domestic market. In fact, development banking can play a major countercyclical role, as Brazil's National Bank for Economic and Social Development (BNDES) did when the global crisis spread there in 2008–09 (ECLAC, 2010a, p. 78).

It is extremely difficult to reform domestic markets toward financing for development when the capital account is indiscriminately open. Extreme financial openness, such as that implemented in the 1990s, has linked the Latin American region with the most speculative segments of international financial markets. As a result, the most dynamic segment of the domestic capital market has been the one with major financial activity, with short-term flows to and from abroad, characterized not only by its procyclical volatility but also by its weak ties to productive investment.

Countercyclical regulation of financial inflows and outflows allows the national financial system to be reorganized in such a way as to channel resources to savings and productive investment and, given an inclusive bent, reduces the structural heterogeneity between the various social and economic sectors. It is a key factor in raising the investment ratio and creating better jobs.

Countercyclical regulation of the capital account permits action on the direct source of cycles of boom and bust. During upturns, it reduces upwards pressure on the exchange rate, while at the same time allowing for the timely adoption of monetary policies that contract aggregate demand. It is very relevant that implementing such regulations during upturns creates space for expansionary monetary and fiscal policies during recessions and mitigates the need for massive devaluations.

In general, experience of well-designed countercyclical restrictions on inflows of short-term capital or liquid flows has shown them to be effective for development and employment, enabling the adoption of countercyclical macroeconomic policies (Ocampo, 2011; Magud and Reinhart, 2006; Williamson, 2000). Such regulations are aimed at generating a more sustainable macroeconomic environment during upswings and minimizing costly recessive adjustments during falls from imbalances as a result of overheating.

Several Latin American countries have made interesting regulatory reforms (see, for example, ECLAC, 2010a, box II.2). Chile's successful experience in the first half of the 1990s illustrates the effectiveness of coherent and systematic countercyclical regulation of the capital account. Central to a set of countercyclical macroeconomic policies, the amount of capital income and its composition were regulated, making short-term inflows (whether on loans or stock market) more expensive. To this end, a non-remunerated reserve requirement had to be deposited with the Central Bank, with a substantial share of the gross inflow (20–30 per cent) and a long term (90–360 days). By regulating the composition and the amount of inflows, the reserve requirement made room for countercyclical exchange-rate and monetary policies (Magud and Reinhart, 2006). Thanks to those policies, Chile maintained an aggregate demand consistent with its productive capacity and a sustainable exchange rate, with GDP growing at an annual average of over 7 per cent. In the second half of the 1990s, Chile gradually integrated the trend towards financial liberalization and allowed the regulatory power of the reserve to be persistently weakened. It was therefore contaminated by the Asian crisis in 1999 (Ffrench-Davis, 2010a, chapter VIII). In the wake of the crisis that broke out in 2002, also Argentina applied an active exchange-rate policy with capital account regulation, enabling, for almost five years, strong economic recovery with a sustainable competitive real exchange rate and inflation control.

Capital account regulation of this kind endeavours to achieve sustainable balances in the real macroeconomy, i.e. the opposite of trying to perpetuate imbalances.

Reform of the pension systems in various Latin American countries into private fully-funded schemes has generated ever-larger sources of long-term savings.[14] The neo-liberal approach has exerted pressure for the liberalization of their investment in international financial markets. Naturally, if there is very broad scope for action, they can become sources of macroeconomic instability.[15] The sheer size of those funds (which are built up by workers' contributions from their wages) and the fact that they constitute very long-term savings mean they have a crucial role in a *reform of the reforms* as: (i) factors of real macroeconomic stability (Zahler, 2006); and (ii) key players in the gradual restructuring of the domestic capital market towards financing for development. The workers' pension funds should preferably be used to strengthen the sources of funding for investment and, ultimately, job creation.

As for the exchange rate, the aim of a countercyclical intervention intended to strike a balance − for example, by means of central bank sale-purchase transactions, regulation of the level and composition of flows, and export revenue stabilization funds − is to have the real powerful players in the market (the producers of exports, importers and producers of import substitutes who are the relevant players in productive development and equity) be those who have the greatest influence in determining the exchange rate. This is the "market" that should prevail, not the market of short-term operators and rent-seekers. Achieving this would help reduce structural heterogeneity, generating more egalitarian conditions for workers and for diverse entrepreneurs.

In short, the urgently required *reform of the reforms* of the Washington Consensus should give priority to linking the financial system − both the national financial market and the capital account − to the domestic investment process and the national economy rather than to external, short-term and speculative financial markets. Steps must be taken to foster stable domestic demand and macro prices such as the exchange rate, and to try to spread economic power by giving preferential treatment to SMEs.

[14] The impact on fiscal accounts has usually been negative, as the State continues to fund existing pensions but without the flows of workers social security contributions now redirected to private institutions.

[15] Their procyclical role can be observed in the case of Chile during the Asian crisis, when pension fund administrators sent abroad funds equivalent to 4.8 per cent of GDP at a time of acute short supply of loans on domestic markets (Ffrench-Davis, 2010a, p. 241).

V. Concluding remarks

Productive investors in Latin America have been subjected to great instability in the real macroeconomy, with high recessionary gaps, in a notoriously incomplete financial market, particularly in the case of the financing needs of small enterprises. This helped depress capital formation and undermined employment, thus contributing to the prevailing inequality.

Instability in the real macroeconomy tends to be asymmetrical in terms of distribution, since the sectors with higher revenues and better market access take fuller advantage of the opportunities that arise during upturns and are more easily able to adapt during recessionary periods. As a result, not only does the informal sector expand during recessions, but the gaps between SMEs and large corporations, between highly skilled and unskilled workers also widen. Income distribution tends to deteriorate during recessions and to improve during recoveries, but the trend is stronger in the former than in the latter. In addition, efforts flag when it comes to economic reforms which require continuity and a long-term outlook.

In dynamic terms, the labour market is negatively affected by the recessionary impact of instability on investment. Capital expansion is constrained, whereas the size of the potential labour force inexorably increases over time. Thus, the usual discrimination intensifies against less-skilled workers who face situations of growing unemployment, as well as against owners of small enterprises.

The high costs generated by the economic cycles in Latin America are linked to the strong ties established between domestic financial markets and procyclical segments of international financial markets. The way in which liberalization occurred resulted in greatly heightened financial activity without any increase in national savings, with a very low capital formation and wide fluctuations in economic activity and employment: in other words, *financierism* prevailed over *productivism*. The main cause was a financial market dominated by agents specializing in short-term financial investment rather than productive investment; they played a key macroeconomic role. In turn, as those flows fluctuated wildly, very few financed productive investment. This was aggravated by the fact that volatility gave rise to financial and exchange-rate crises whose recessionary effects slowed capital formation and employment.

This article has documented how the type of macroeconomic approach adopted has a decisive effect on the degree of stability; and how stability affects the course of growth and influences the degree of equity or inequity built into national markets. Sustainable development requires public policies tending towards social inclusion that enable countries to enter the international market in a state of greater internal integration, not one of social disintegration. The approach to reform domestic capital markets and the linkages with international financial markets are crucial challenges in achieving a sustainable macroeconomy conducive to economic and social development, with decent work as a strategic variable.

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Table 1. Latin America (19 countries): Growth in GDP, population and economically active population, 1971–2010

(annual rates of change, constant 2000 prices)

	1971–1980	1981–1989	1990–1997	1998–2003	2004–2008	1998–2008	1990–2008	2009–2010
Total GDP	5.6	1.3	3.3	1.4	5.3	3.2	3.2	2.1
Per capita GDP	3.0	−0.8	1.5	−0.2	4.0	1.8	1.7	1.0
GDP per worker	1.7	−1.5	0.3	−0.9	2.9	0.9	0.6	0.2
Population	2.5	2.1	1.8	1.6	1.5	1.5	1.6	1.1
Econ. active pop.[a]	3.8	2.9	3.0	2.4	2.0	2.3	2.6	1.9

Source: author's calculations based on ECLAC data bank and ECLAC (2011). Preliminary figures for 2010. [a] Based on figures from ILO Lima and ILO/ECLAC (2011).

Table 2. Labour force participation, unemployment and wages: 1990–2010

Latin America	1990–1997	1998–2003	2004–2007	2008–2010
Participation rate (%)[a]	57.1%	58.3%	59.1%	59.4%
Unemployment rate (%)[b]	8.2%	10.8%	9.0%	7.6%
Econ. active pop. (in millions)[c]	185.2	223.2	249.4	267.5
Increase in real average wages (%)[d]	1.0	−0.9	1.3	1.3
Increase in real minimum wages (%)[e]	2.1	0.1	3.3	5.5

Sources: [a] ILO Lima and ILO/ECLAC (2011) figures on the ratio of the economically active population or labour force to the population of those 15 or older. Corresponds to preliminary re-evaluations. Weighted average, includes data adjusted owing to methodological changes for Argentina (2003) and Brazil (2002); does not include Bolivia or Cuba. [b] Urban unemployment rates according to ILO, calculated on the basis of national household surveys. Corresponds to the weighted average for Latin America (19 countries), including Cuba but not Haiti or Guatemala. Includes adjustments owing to methodological changes for Argentina (2003) and Brazil (2002). [c] Corresponds to the sum of the Latin American labour force (19 countries) according to ILO. [d] Based on ECLAC data bank and ECLAC (2011), weighted average of 15 countries: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, El Salvador, Guatemala, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay and Venezuela. [e] Corresponds to the weighted average for Latin America (19 countries) based on ECLAC data (2011); the nominal values were deflated by each country's official consumer price index. Preliminary figures for 2010.

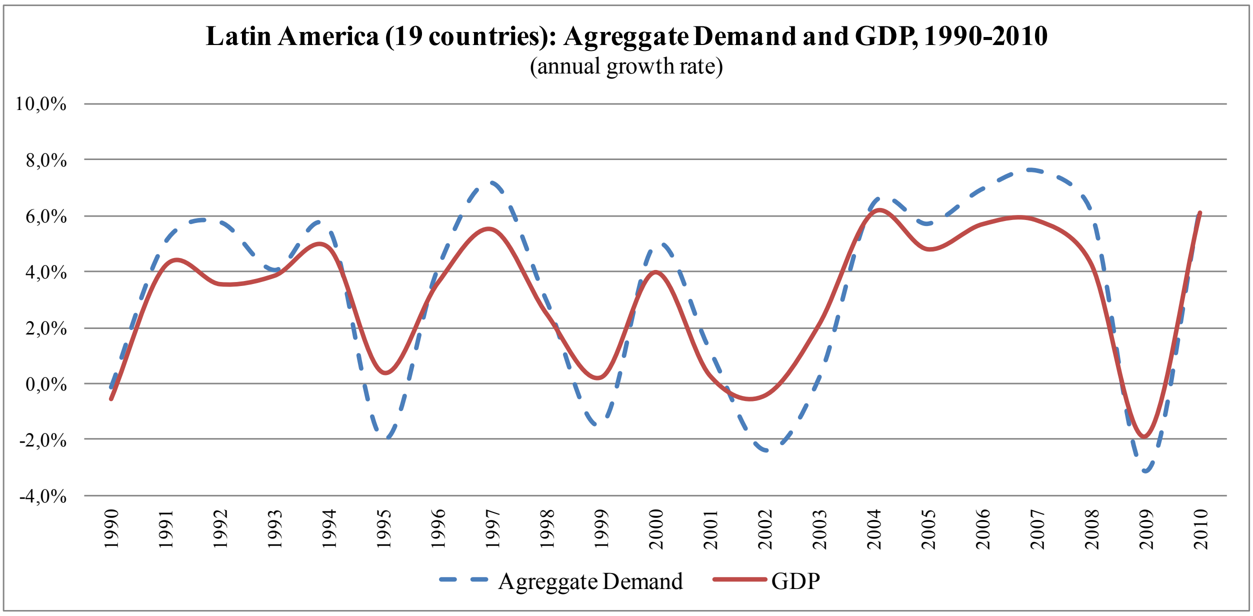
Table 3. Latin America (19 countries): Gross fixed capital formation, 1971–2010

(annual averages)

	1971–1980	1983–1990	1992–1998	2000–2004	2006–2010
GFCF (% of GDP)	23.7	17.6	18.7	17.6	21.0
GDP growth (%)	5.6	2.1	3.5	2.4	4.0

Source: author's calculations based on ECLAC data bank and ECLAC (2011). Preliminary figures for 2010.

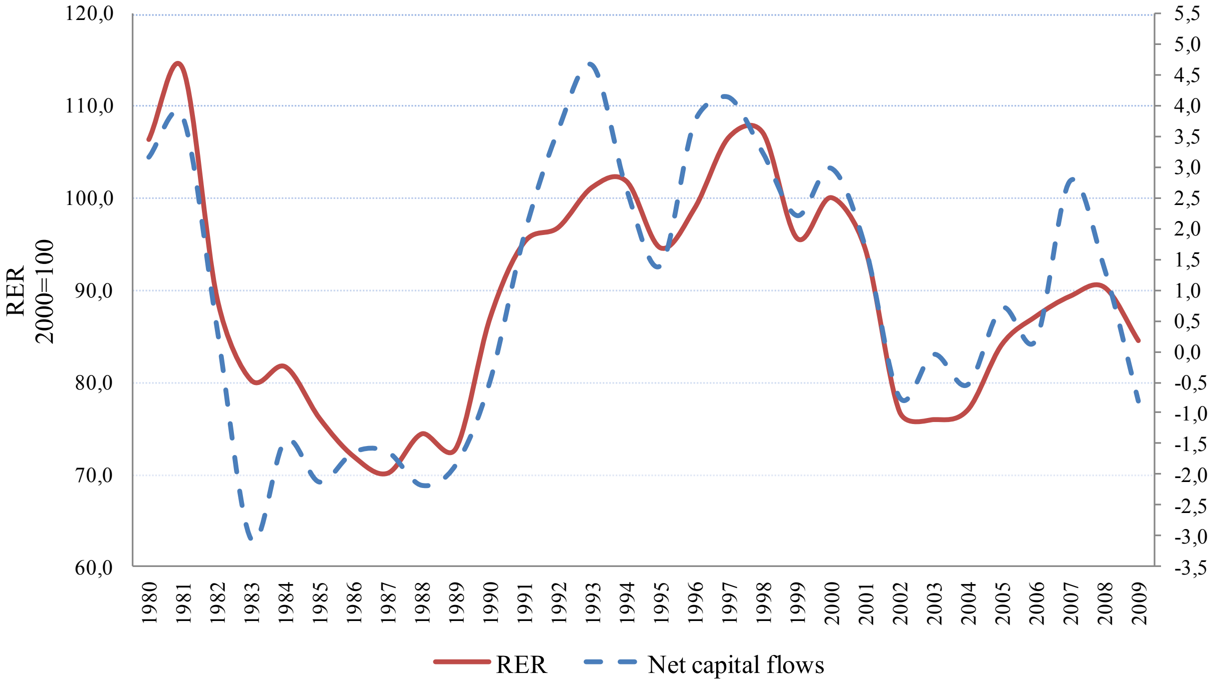
Figure 1



Source: Ffrench-Davis (2006) and updates, based on ECLAC data (2011).

Figure 2

Latin America (19 countries): Net capital flows and RER, 1980-2009
(RER in 2000=100, flows in % of GDP)



Source: Ffrench-Davis (2006), updated from ECLAC data bank. The nominal exchange rate used to prepare this figure is defined as dollars per local currency for the regional weighted average.