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What does wage-led growth mean in developing countries with large informal employment?

by Jayati Ghosh

The past decade has been one in which export-led economic strategies have come to be seen as the most successful, driven by the apparent success of two countries in particular - China and Germany. In fact, the export-driven model of growth has much wider prevalence as it was adopted by almost all developing countries.

This was associated with suppressing wage costs and domestic consumption in order to remain internationally competitive and to achieve growing shares of world markets as far as possible. Managing exchange rates to remain competitive, despite either current account surpluses or capital inflows, became one of the major elements of this strategy. This was associated with the peculiar situation of rising savings rates and falling investment rates in many developing countries, and to the holding of international reserves that were then sought to be placed in safe assets abroad.

This is related to a classic dilemma of mercantilist strategy, which is evident in exaggerated form for the aggressively export-oriented economies of today: they are forced to finance the deficits of those countries that would buy their products, through capital flows that sustain the demand for their own exports, even when these countries have significantly higher per capita income than their own. The flows of capital from China and other countries of developing Asia is an egregious example of this.

The strategy also generated fewer jobs than a more labour-intensive pattern based on expanding domestic demand would have done, which meant that employment increased relatively little, despite often dramatic rises in aggregate output. This is why, globally, the previous boom was associated with the South subsidising the North: through cheaper exports of goods and services, through net capital flows from developing countries to the US in particular, through flows of cheap labour in the form of short-term migration.

The recent collapse in export markets halted that process for a while. Although there has been a recovery, it is very evident that such a strategy is unsustainable beyond a point. This is particularly true when a number of relatively large economies seek to use it at the same time. So, not only was this a strategy that bred and increased global inequality, it also sowed the seeds of its own destruction by generating downward pressures on price because of increasing competition as well as protectionist responses in the North.

So there are both external and internal reasons why it is hard to sustain such a strategy beyond a point. Externally, deficit countries will either choose or be forced to reduce their deficits through various means, and protectionist responses. Internally, the potential for suppression of wage incomes and domestic consumption will meet with political resistance. In either case, the pressures to find more sustainable sources of economic growth, particularly through domestic demand and wage-led alternatives, are likely to increase.

The process of global economic rebalancing was initiated by the financial crisis and is now likely to get accentuated through the current fragile recovery and potential instability of the near future. One important result is developing countries (and the surplus countries like China in particular) can no longer depend on exports to US as their primary engine of growth. The US trade deficit is set to shrink, and at a fundamental level it really does not matter whether this occurs through exchange rate changes, changes in domestic savings and investment behavior or increased trade protectionism.

So countries must diversify their sources of growth, looking for other export markets as well as for internal engines of growth. This is what makes arguments for a shift in strategy towards domestic wage-led growth so compelling.

In developed countries with relatively strong institutions that can affect the labour market, including collective wage bargaining, effective minimum wage legislation and the like, it is probably easier to think of wage-led growth and strategies to allow wages to keep pace or at least grow to some extent) along with labour productiv-

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ity growth. But what about most developing countries, where such institutions are relatively poorly developed and where many if not most workers are in informal activities, often self-employed? How are wage increases and better working conditions to be ensured in such cases? And what does a macroeconomic policy of wage-led growth entail in such a context?

In fact, it is still both possible and desirable to get wage-led growth in such contexts. There are five important elements of such a strategy in developing countries with large informal sectors:

- Make the economic growth process more inclusive and employment intensive: direct resources to the sectors in which the poor work (such as agriculture and informal activities), areas in which they live (relatively backward regions), factors of production which they possess (unskilled labour) and outputs which they consume (such as food).
- Ensure the greater viability of informal production, through better access to institutional credit to farmers and other small producers, greater integration into supply chains and marketing that improves their returns, and technology improvements that increase labour productivity in such activities.
- Provide increases in public employment that set the floor for wages (for example, in schemes such as that enabled by the National Rural Employment Guarantee Act in India) and improve the bargaining power of workers.
- Provide much better social protection, with more funding, wider coverage and consolidation, more health spending and more robust and extensive social insurance programmes, including pensions and unemployment insurance.
- Increase and focus on the public delivery of wage goods (housing, other infrastructure, health, education, even nutrition) financed by taxing surpluses.

The last point is often not recognised as a crucial element of a possible wage-led strategy, but it can be extremely significant. Furthermore, such a strategy can be used effectively even in otherwise capitalist export-oriented economies, as long as surpluses from industrialisation and exports can be mobilised to provide wage goods publicly. Indeed, this has been an important and unrecognised feature of successful Asian industrialisation from Japan to the East Asian NICs to (most recently) China. The public provision of affordable and reasonably good quality housing, transport facilities, basic food, school education and basic healthcare all operated to improve the conditions of life of workers and (indirectly) therefore to reduce the money wages that individual employers need to pay workers. This not only reduced overall labour costs for private employers, but also provided greater flexibility for producers competing in external markets, since a significant part of fixed costs was effectively reduced.

What are the macroeconomic advantages of such a strategy? Quite apart from the obvious benefits in terms of reducing poverty, improving income distribution and the conditions of informal workers, there are positive implications for the growth process. It allows for more stable economic expansion based on increasing the home market, and need not conflict with more exports either. It encourages more emphasis on productivity growth, thereby generating a "high road" to industrialisation.

Clearly, if countries in which the majority of the world's population are concentrated are actually to achieve their development project in a sustainable way, new and more creative economic strategies have to be pursued. Wage-led growth, including through measures such as those outlined here, is likely to be an essential element of such strategies.

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